FEDERAL RESERVE BANK OF SAN FRANCISCO

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CDFIs Unmasked

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All too often, it's the people and businesses that need credit the most that can't get it. As a result, already distressed communities decline further, increasing the need for money in the community but, at the same time, making it harder to come by. Community development financial institutions (CDFIs) help reverse this downward spiral, acting as financial intermediaries that find ways to make loans and investments which traditional financial institutions would consider "risky" or unbankable. In spite of this "riskiness," CDFIs do quite well overall: members of the CDFI Coalition, which represents more than 350 established CDFIs in 50 states, have loaned and invested some $3.5 billion in our nation's most distressed communities with a collective loan-loss rate comparable to the best banks.

CDFIs differ in structure, size and development-lending goals:

Community Development Banks (CDBs) are insured depository institutions. Many CDBs go beyond merely lending money and include such components as real estate development and skills development programs like job training, business technical assistance and non-bank financing.

Capital sources for CDBs include conventional banks, insurance companies, foundations, government agencies and wealthy individuals. Challenges facing CDBs range from recruiting and retaining personnel, who need a certain amount of expertise in the field to be useful, to creating a sense of mission. Providing leadership in the community can be as important as providing money. In many ways, CDBs are seen as the local handyman--often intimately familiar with local problems, they can link area residents, financial resources, and government programs in a coherent renewal effort.

South Shore Bank, for example, realized that reviving Chicago's South Shore neighborhood meant renovating its many deteriorated multi-unit buildings. So the bank's holding company established a real estate company, City Lands Corp. (now Shorebank Development Corp.) to develop residential and commercial property to benefit low- and moderate-income residents. Today, Shorebank trains residents to become property managers and provides assistance in solving practical problems ranging from screening tenants to reducing energy costs.

Community Development Credit Unions (CDCUs) are member-owned and controlled financial cooperatives that bring credit and financial services to people and communities with limited access to mainstream financial institutions. CDCUs are organized around a common bond such as church membership, employment, or geographic proximity.

In contrast to "mainstream" credit unions, CDCUs target low-income people and communities. They can expand their capital base by accepting deposits from non-member institutions and can receive low-interest loans, deposits and technical assistance from the National Credit Union Administration and the National Federation of Community Development Credit Unions. Finally, they have greater flexibility in determining membership.

CDCUs require broad community buy-in to get rolling, which can take eighteen months to three years. Other challenges facing CDCUs include competing with other credit unions, who sometimes find distressed communities profitable, and providing technical assistance to borrowers, such as credit counseling and business planning. A labor-intensive endeavor, CDCUs serve large numbers of people with very small borrowing and savings plans.

About 100 community development credit unions have lent more than $2 billion over the past 65 years, with a loss rate of less than 2 percent.

Community Development Loan Funds (CDLFs) are financial intermediaries that borrow capital from socially conscious investors and lend it, primarily in lower-income communities, to support nonprofit affordable housing efforts, worker-owned and community-based businesses, and other projects. Funders include individuals, foundations, banks and religious institutions.

In the world of CDLFs, technical assistance is crucial. Borrowers often need help to plan and implement successful projects and develop capacity to undertake more ambitious projects; banks need their loans repaid.

CDLFs traditionally have dealt with higher-risk borrowers, but the market is changing quickly. In the past, CDLFs have faced challenges obtaining investments from banks and other financial institutions, who, if they lend at all, lend at much higher rates since they anticipate low returns.

Community Development Venture Capital Funds (CDVCs) provide equity, similar to purchasing stock in a company, for community real estate and small-and medium-sized business projects that provide good jobs in low-income communities. Capital sources for CDVC funds are foundations, corporations, individuals and government.

Financial institutions usually require borrowers to have a certain amount of equity, so if their business goes under, the lender can recover at least part of the loan. CDVCs can provide this equity. In this way--unlike lenders--CDVCs become partners with businesses. CDVC funds help advance the social good through more than just financing by, for example, joining the boards of companies in which they invest and advocating good hiring, labor and environmental practices.

To start a CDVC, one needs approximately $5 million to $10 million and a fair amount of expertise. CDVCs have trouble attracting skilled people, since anyone with enough expertise can earn a lot more money in the private sector.

Microenterprise Development Loan Funds (MDLFs) foster social and business development through loans and technical assistance to low-income people, who run very small businesses or are self-employed, and who are unable to get conventional credit. Like CDLFs, they offer training and technical assistance to the borrower.

MDLFs work either by getting direct loans from the organization administering the fund or through peer groups. In the latter scenario, small loans are made to groups of eight to 10 people who loan the money to one or more members with the best business plan. The rest of the group acts as guarantors of the loan, ensuring that funds will be available to other members once the first person has repaid the loan. These programs have had mixed results when not tailored to an individual community.

MDLFs are fairly expensive to operate, since they require a lot of time recruiting and training people, and providing technical assistance. On the whole, though, they have helped many who otherwise would not have had access to capital. About 50 microenterprise development loan funds have lent more than $25 million, averaging $2,500 per loan.

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For more information, you may contact the CDFI Coalition, 924 Cherry St., 2nd Floor, Philadelphia, PA 19107, (215) 923-4754, www.cdfi.org; The Woodstock Institute, 407 S. Dearborn St. #550, Chicago, IL 60605, (312) 427-8070; CDCVA, 700 Lonsdale Building, Duluth, MN 55802, (218) 722-0861; Chicago Community Loan Fund, 343 S. Dearborn St., Suite 1001, Chicago, IL 60604, (312) 922-1350; Shorebank Corp., 1950 E. 71st St., Chicago, IL 60649, (773) 753-5697; National Federation of CDCUs, 120 Wall St., 10th Floor, New York, NY, 10005, (212) 809-1850, x 220.