ADAPTATION OR EXTINCTION? COMMUNITY DEVELOPMENT LOAN FUNDS AT A CROSSROADS

JULIA S. RUBIN
Rutgers, the State University of New Jersey

ABSTRACT: This article examines community development loan funds (CDLFs), a type of community development financial institution that provides financing and technical assistance for businesses; for-profit and nonprofit real estate and housing developers; nonprofit organizations looking for facility or operating capital; and low-income individuals looking for financing to purchase or rehabilitate their homes. Like many nonprofits and social enterprises, CDLFs have experienced a worsening political and economic environment since 2000, leaving many of them struggling to stay alive as the subsidized capital necessary to fund their operations largely has evaporated. The article reviews CDLF origins, structures, and current activities; discusses the field's historic sources of subsidized capital and why they have shrunk; reviews potential new sources of capital and the organizational ways that CDLFs are responding to their changed environment; and makes recommendations for CDLFs, funders, and policy makers. It is based on organizational-level data from annual surveys of CDLFs conducted by the CDFI Data Project and the Opportunity Finance Network; on two dozen interviews with CDLF, foundation and bank officers and staff and policy makers involved with the field; on documents from individual CDLF institutions; and on contemporary press accounts.

Healthy communities require access to affordable capital—mortgages to purchase and maintain homes; financing to build and rehabilitate commercial properties, community facilities, and affordable housing, or to start and grow businesses; and checking and saving accounts to keep and build assets. Unfortunately, low-income individuals and communities have limited access to affordable credit, investment capital, and financial services, a fact that greatly hampers efforts to improve conditions in these areas.

Community development financial institutions (CDFIs) are one response to this problem. CDFIs were created to improve economic conditions for low-income individuals and communities by providing a range of financial products and services that often are not available from more mainstream lenders and financiers. There are four different types of CDFIs—community development banks, credit unions, venture capital funds, and loan funds—each of which offers a range of financial products and services to individuals and organizations (Benjamin, Rubin & Zielenbach, 2004).

Direct Correspondence to: Julia Sass Rubin, Edward J. Bloustein School of Planning and Public Policy, Rutgers, The State University of New Jersey, 33 Livingston Avenue, New Brunswick, NJ 08901. E-mail: jlsrubin@rci.rutgers.edu.

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This article examines community development loan funds (CDLFs), a type of community development financial institution that provides financing and technical assistance for businesses; for-profit and nonprofit real estate and housing developers; nonprofit organizations looking for facility or operating capital; and, increasingly, low-income individuals looking for financing to purchase or rehabilitate their homes.[1] Financing by CDLFs is intended to further various social goals, such as increasing economic growth and job creation in low-income areas; creating housing for low-income individuals; stabilizing population decline in distressed communities; improving the availability and quality of community facilities in underserved 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). Most of the organizations and people financed by CDLFs are not able to obtain capital from more traditional sources, or cannot obtain it on terms that they can afford.[2]

A majority of CDLFs have a nonprofit legal structure. Historically, they have relied on a combination of below-market-rate loans and grants to capitalize their activities.[3] CDLFs relend this capital at market or near-market rates, using the spread—or difference between these rates—to help finance their operations.

The late 1990s was a hospitable economic and political environment for community development financial institutions (Benjamin, Rubin, & Zielenbach, 2004). Like all CDFIs, CDLFs grew both in absolute numbers and in capitalization levels. However, the environment has changed dramatically since 2000, leaving many CDLFs struggling to stay alive as the subsidized capital necessary to fund their operations largely has evaporated.

This environmental change has sparked a conversation within the industry and among the foundations that have supported it, regarding what the future business and industry models should be for CDLFs and how best to transition them to that vision. Some consensus appears to have developed that, because CDLFs cannot count on either public or private sources of subsidized capital, they must become sustainable and find ways to operate utilizing primarily market-rate capital, with little or no subsidy. To foster that transition, significant intellectual activity is taking place to expand CDLFs' access to conventional capital markets via loan securitization.[4] Some of the largest CDLFs also have been streamlining existing operations; outsourcing some of their activities; focusing on those activities that are most profitable; and even merging with other organizations to reduce costs and expand their reach.

It is not clear whether a majority of community development loan funds have the human or financial capital necessary to weather such a transition. Yet CDLFs that do not survive could leave their communities without access to necessary financial products and services. Even the CDLFs that are able to adjust to a low-subsidy environment by focusing primarily on the more profitable aspects of their operations risk behaving increasingly like conventional financial institutions, ultimately moving away from their community development objectives and the low-income communities that they serve.

The situation facing CDLFs is not unique. Over the last three decades, nonprofit organizations in all fields of service have felt a growing pressure from federal and state governments, foundations, and their own board members to become more "business-like" in their operations (Dees & Backman, 1994; Ryan, 1999; Dart, 2004). In particular, nonprofit organizations are turning increasingly to market-based, revenue-generating opportunities to replace reductions in government and foundation funding (Dees, 1998; Ryan, 1999).

While some of these "social enterprises" are successful in earning capital through market mechanisms, many nonprofits are discovering that running a business can create its own challenges. At the very least, finding the resources necessary to start and run a business and adopting a "business mindset" can be very difficult for a nonprofit (Bowie, 1994; Emerson & Twersky, 1996; Foster & Bradach, 2005). More critically, it can move a nonprofit organization's activities away from its social mission and potentially even harm the individuals the organization was created to serve

(Salamon, 1993, 2002; Bowie, 1994; Dees, 1998; Weisbrod, 1998, 2004; Alexander, Nank, & Stivers, 1999; Eikenberry & Kluver, 2004; Young, 2005).

Unlike those nonprofits that have adopted business-like behavior relatively recently, CDLFs have operated in this manner from the field's origins. As financial institutions, they are staffed primarily by individuals with private-sector experience, who bring with them an understanding of business methods and models. They fund their operations in part from revenues that they earn by lending. Finally, they have a "double-bottom line" of both social and financial objectives. These objectives are interrelated—the CDLF financial model only works if the loans CDLFs make are repaid, enabling them to generate revenues for operations, and to relend the capital. Repayment of loans is also critical to the CDLF's social model, as it signals that the organization or individual that received the loan was successful.

However, the CDLF model also has required subsidies in the form of below-market interest rates from investors and operating grants from governments and foundations. These subsidies have enabled CDLFs to perform the most basic aspect of their social mission—meeting an otherwise unmet need for capital. The subsidies also have created the organizational surpluses necessary for CDLFs to go beyond basic lending, allowing them to experiment with and model the viability of transactions that conventional financial institutions consider too risky; provide technical assistance to their borrowers; make high-cost predevelopment and microloans; and advocate on behalf of the low-income communities that they serve.[5]

Thus, the CDLF industry's response to its increasingly challenging funding environment not only illustrates the potential limits of the market model for nonprofit organizations, but also highlights the important role that surpluses can play in enabling nonprofit organizations to meet their social objectives (Tuckman, 1993; Ryan, 2001). In an environment of fewer subsidies and greater competition, such surpluses are becoming increasingly rare, with potentially devastating consequences for the populations that nonprofit organizations are designed to serve.

This article will proceed as follows. Part I reviews CDLF origins, structures, and current activities. Part II discusses the field's historic sources of subsidized capital and why they have shrunk. Part III reviews potential new sources of capital and the organizational ways that CDLFs are responding to their changed environment. The article concludes with recommendations for CDLFs, funders, and policy makers.

The article is based on organizational-level data from annual surveys of CDLFs conducted by the CDFI Data Project (CDP) and the Opportunity Finance Network; on two dozen interviews with CDLF, foundation and bank officers, and staff and policy makers involved with the field; on documents from individual CDLF institutions; and on contemporary press accounts.[6] To protect their confidentiality, most of the individuals interviewed as part of this research are not identified.

TABLE 1

Community Development Loan Funds by Quintiles*

	Total Capitalization	Capitalization as % of Total	Median Fund Capitalization	Mean Fund Capitalization	Direct Financing Outstanding as % of Total
Funds 1 to 20	$2,241,588,241	77%	$45,424,482	$69,504,268	79%
Funds 21 to 40	$354,313,809	12%	$15,912,444	$17,715,690	11%
Funds 41 to 60	$184,735,068	6%	$8,823,379	$9,236,753	6%
Funds 61 to 80	$101,828,833	3%	$4,872,143	$5,091,442	3%
Funds 81 to 98	$30,795,731	1%	$1,449,062	$1,710,874	1%

*As of 2005 fiscal year; quintiles based on total capitalization; percentages may not add to 100 because of rounding.

PART I: THE COMMUNITY DEVELOPMENT LOAN FUND INDUSTRY

As of 2005, there were approximately 500 community development loan funds in existence in the United States, with approximately \$3.5 billion in assets.[7,8] CDLFs financed more than \$2.2 billion of activities that year. This figure is somewhat misleading, however, as CDLF financings were heavily concentrated in a few large organizations. As of 2005, the largest community development loan fund, Self-Help Ventures, accounted for almost 32% of all capital and 36% of all direct financing outstanding.[9] The five largest CDLFs accounted for 52% of total loan fund capital and 55% of all direct financing outstanding (CDFI Data Project, 2007).

Table 1 provides additional data regarding the field's concentration. The top 20 CDLFs held 77% of all capital and were responsible for 79% of all direct financing outstanding. Most CDLFs are relatively small, with a median capital of \$8.9 million (CDFI Data Project, 2007).

Most community development loan funds began as either business- or housing-focused lenders (CDFI Data Project, 2006). Business-focused community development loan funds originated in the late 1960s and early 1970s, with efforts by a few Community Development Corporations (CDCs) and a group of revolving loan funds to make loans to businesses in order to promote economic development (Grossman, Levere, & Marcoux,1998; Rubin, 1998).[10] Housing-focused community development loan funds began in the late 1970s with a loan fund set up by the Institute for Community Economics (ICE), an organization whose mission was to create cooperative land trusts, designed to build communities and make home ownership affordable for low-income individuals (Chuck Matthei, personal communication, April 2, 1998; Kirby White, personal communication, April 4, 1998). ICE ultimately was involved in the creation of approximately 25 community development loan funds around the country as well as the creation of the industry's trade association, the National Association of Community Development Loan Funds.[11]

Housing and business loans still make up the bulk of CDLF financing activities, accounting for 66% and 17% of all CDLF direct financings outstanding as of fiscal year 2005. However, many CDLFs have diversified their offerings, moving into the provision of operating and facility construction loans to other nonprofits, including charter schools, child care centers, health care facilities, social services agencies, and arts organizations. Such financings accounted for almost 14% of all CDLF direct financing outstanding as of fiscal year 2005 (CDFI Data Project, 2007). As with their business and housing finance activities, CDLFs began providing capital to nonprofits because more traditional capital sources viewed the nonprofits' revenue streams as too unpredictable to make them good credit risks.[12]

As Table 2 demonstrates, 21 of the largest CDLFs account for most of the direct financings outstanding, regardless of area of specialization. Facilities lending is particularly concentrated by volume, with the ten CDLFs that make the most facilities loans accounting for more than 76% of the total direct financings outstanding in this area.[13] Housing lending also appears to be highly concentrated, with the top 10 lenders accounting for more than 80% of all direct financings outstanding. The housing concentration, however, mostly reflects the impact of the largest housing lender, Self-Help Ventures Fund, which on its own accounts for 50% of the total outstanding direct housing financings. If Self-Help is removed from the total, the top 10 housing lenders' share drops to 33% of the overall dollars outstanding (CDFI Data Project, 2007).

There is a significant overlap between the top housing and community facility lenders, with 6 CDLFs among the top 10 lenders in each area. This reflects the path of diversification, from housing to community facility lending, taken by many of the funds. There is less overlap between the top housing and community facility lenders and the top business lenders, with only three funds being among the top 10 in each area.

CDLFs lend both independently and in conjunction with conventional lenders. When lending in partnership with more conventional institutions, CDLFs generally take a subordinate position,

TABLE 2

Ten CDLFs with Greatest Direct Financing Outstanding in Housing, Community Facilities, and Business*

Community Development Loan Funds	Direct Financing Outstanding for Housing	Direct Financing Outstanding for Community Facilities	Direct Financing Outstanding for Businesses
CDLF 1	$748,440,928	$19,724,905 (5)	$53,076,811 (1)
CDLF 2	$104,870,327	$19,178,025 (7)	
CDLF 3	$89,329,254		
CDLF 4	$53,728,511	$17,482,030 (8)	
CDLF 5	$45,188,000	$20,250,500 (4)	$43,619,500 (2)
CDLF 6	$43,588,400		
CDLF 7	$41,277,302		
CDLF 8	$33,185,614		
CDLF 9	$27,925,053	$19,378,029 (6)	
CDLF 10	$27,606,506	$12,923,888 (9)	
CDLF 11		$67,992,324 (1)	
CDLF 12		$32,998,433 (2)	$16,890,795 (5)
CDLF 13		$24,529,839 (3)	
CDLF 14		$10,923,517 (10)	
CDLF 15			$30,091,795 (3)
CDLF 16			$19,871,948 (4)
CDLF 17			$15,370,549 (6)
CDLF 18			$13,093,238 (7)
CDLF 19			$11,700,000 (8)
CDLF 20			$10,524,781 (9)
CDLF 21			$10,194,010 (10)
Top 10 CDLFs as percent of total	**80.39%**	**76.64%**	**58.31%**
Total number of CDLFs with direct financing outstanding by specialization	**69**	**53**	**71**
Median direct financing outstanding for all CDLFs by specialization	**$4,433,448**	**$1,787,297**	**$2,381,350**

*As of 2005 fiscal year.

absorbing most or all of the risk. Such partnerships can consist of collaborations on one project or can last for many years and include multiple joint investments. In addition to coinvesting with the CDLFs, the partnering banks also may invest directly in the CDLFs and bank staff members may sit on the CDLFs' boards of directors.

Through partnerships, in which CDLFs assume the higher-risk portions of joint deals, and through successful solo lending, CDLFs play an important role in demonstrating the financial viability of low-income communities to traditional financial institutions. In the area of small business lending, for example, CDLFs have encouraged banks to lend to small business customers located in low-income markets, a group that most banks previously had rejected (Rubin & Stankiewicz, 2001).

In order to encourage local banks to increase their commercial lending to rural, primarily low-income parts of Maine, Coastal Enterprises (CEI), a 30-year-old CDFI, began making subordinated commercial loans in rural areas of the state. These loans acted like equity on a borrower's balance sheet, making these borrowers more attractive to commercial banks. In the poorest rural parts of the state, such as Washington County, CEI also created targeted lending strategies and sent workforce development specialists and loan officers on monthly visits, to develop contacts and deal flow. CEI currently is partnering with four banks on subordinated debt deals and receives regular calls from other banks interested in partnering on specific investments (Carla Dickstein, personal communication, November 15, 2006).

In the area of multifamily housing, CDLFs have helped bring commercial banks into individual projects and have demonstrated how to underwrite such projects successfully and profitably. Banks initially were very reluctant to finance multifamily affordable housing developments. They typically were willing to provide only a first mortgage, and even then only if another entity was willing to finance the predevelopment, construction, and permanent capital aspects, and to do so in a subordinate position, so that the banks would have first access to the collateral should anything go wrong. Banks now consider lending to multifamily development projects reasonably safe because of the underlying physical collateral; the presence of subordinate, risk-alleviating financing such as CDLF loans, Low-Income Housing Tax Credit equity, and public loans; and the extensive organizational and project-based counseling and technical assistance that the CDLFs provide to the borrowers. The same holds true for commercial real estate developments (Sean Zielenbach, personal communication, February 25, 2006).

As a result, conventional financial institutions have become much more involved in real estate projects that previously were financed primarily or exclusively by CDLFs. Construction and permanent financings now come quite frequently from banks and less often from CDLFs. In certain markets, CDLFs and their bank supporters find themselves competing for the same multifamily loans (Sean Zielenbach, personal communication, February 25, 2006).[14]

As banks have moved into markets that had been served entirely by CDLFs, the latter have had to take on increasingly risky investments (Rubin & Stankiewicz, 2001). In real estate finance, for example, as conventional lenders have become more willing to take on more of a project's financing costs, CDLFs have often been pushed further into making early-stage, higher-risk loans. This heightened risk position, coupled with a lower interest rate spread associated with higher interest rates, has caused many multifamily CDLF lenders to revisit their loan pricing so as to make it closer to market cost. CDLFs are less willing and able to offer deeply discounted monies and more willing to provide market-rate financing, particularly if their dollars are effectively the only ones available for seed/gap capital (Sean Zielenbach, personal communication, February 25, 2006).

Because most CDLF loans are riskier than those made by banks, and at times are unsecured, CDLFs also provide extensive pre- and post-investment technical assistance to their portfolio companies. The technical assistance is used both to help potential borrowers qualify for capital and to assist them with various aspects of operations after they have received that capital. The type of assistance provided includes help with writing business plans, putting together marketing strategies, and developing financial systems.

The newest area of CDLF activity is the provision of home loans to individuals. As of fiscal year 2005, 21 CDLFs, representing approximately 20% of all CDLFs surveyed, reported providing housing loans directly to individuals. These organizations closed more than 1,858 mortgages (CDFI Data Project, 2007). While this represents a tiny fraction of the mortgages made by conventional financial institutions, this type of financing has benefits beyond the individual homeowners served. Home loans from CDLFs are an important alternative to the expensive subprime home loans that often are the only route to home ownership for many low-income families. By successfully making housing loans to low-income individuals, CDLFs also are demonstrating the financial reliability of such individuals to conventional lenders.

Self-Help, a North Carolina CDFI, created a program that significantly furthers both goals. In 1994, Self-Help began buying "non-conforming" mortgage loans from area banks in an effort to make mortgages available for individuals who cannot obtain financing from a bank or conventional lender because of credit or other problems, as well as those who traditionally have been underserved by banks, such as female-headed households, minority households, rural families, and low-income households. In 1998, the organization joined forces with Fannie Mae and the Ford Foundation to offer a national secondary market for affordable home loans. Under this partnership, the Ford Foundation provided Self-Help with a $50 million grant that Self-Help has used as a loss reserve to enable it to acquire many more nonconforming loans made by conventional lenders, in order to free up capital that the lenders could use to make additional loans to underserved customers. Self-Help credit enhances the mortgages and sells them to Fannie Mae (Ford Foundation, 1998).

Another little-documented area of CDLF activity is the role these institutions have played in shaping policy. CDLFs and other types of CDFIs have influenced government at both the national and state levels. The Clinton Administration's creation of the CDFI Fund, the New Markets Tax Credit, and the New Markets Venture Capital programs were all strongly encouraged and shaped by CDFIs and their leaders (Pinsky, 2001; Rubin & Stankiewicz, 2003; Roberts, 2005). CDFI advocacy also played a role in the Clinton Administration's 1995 strengthening of the Community Reinvestment Act (Pinsky, 2001).

At the state level, CDFIs also have advocated successfully for program funding as well as increased regulation and consumer protection. The latter has included efforts to enact and strengthen state-level community reinvestment act legislation; help pass laws to curtail predatory lending and fringe banking; and advocate on numerous local issues, ranging from workforce to environmental protection. Some of the largest CDFIs, such as Self-Help, The Reinvestment Fund and Coastal Enterprises, have created specialized subsidiaries, or have dedicated personnel, to conduct research and influence policy. Self-Help's Center for Responsible Lending, for example, has contributed significantly to knowledge and regulation on the issue of predatory lending, including the 1999 passage and subsequent evaluation of the first state-level antipredatory lending legislation. The Center works with academics and advocates around the country to conduct research, build coalitions, advocate for antipredatory lending policies, and support litigation (Center for Responsible Lending, 2006).

PART II: SOURCES OF CDLF CAPITAL

Community Development Loan funds are capitalized mostly through debt, which accounted for 67% of all CDLF capital as of fiscal year 2005.[15] The remaining 33% of CDLF capital is equity. Since most CDLFs are nonprofit in legal form, this equity consists primarily of grants and accumulated earnings.

Table 3 shows the sources of debt capital for the industry as of 2005. Banks, thrifts, and credit unions were by far the largest sources, providing almost 50% of all debt capital. Other sources included foundations; federal and state governments; nondepository financial institutions; corporations; religious institutions; national CDFI intermediaries; and individuals interested in socially conscious investing.

As Table 3 documents, there is substantial variation in sources of capital between the larger and smaller CDLFs. Banks, thrifts, and credit unions provided more than 57% of all debt capital for the 20 largest CDLFs, but less than 34% of all debt capital for the rest of the industry. In contrast, the Federal Government and religious institutions combined accounted for less than 10% of all debt capital for the 20 largest funds, but supplied almost 29% of all debt capital for the rest of the field.[16]

This variation reflects the greater ability of larger institutions to attract debt capital from banks, thrifts, and credit unions, which have become an increasingly important source of capital for CDLFs. Capital loaned to CDLFs increased 91% between 2000 and 2005, with both the 20

TABLE 3

CDLF Debt Capital by Source*

	Banks, Thrifts & Credit Unions	Foundations	Federal Government	Religious Institutions	State & Local Governments	Nondepository Financial Institutions	Individuals	Corporations	National CDFI Intermediaries	Other
All CDLFs	49.6%	16.3%	9.5%	6.4%	4.6%	4.0%	2.9%	2.5%	2.5%	1.7%
Twenty CDLFs with greatest capitalization	57.7%	16.9%	6.3%	3.0%	4.9%	4.4%	2.0%	1.7%	2.0%	1.2%
All other CDLFs	33.9%	15.1%	15.8%	13.1%	4.0%	3.1%	4.7%	4.2%	3.4%	2.7%

*As of 2005 fiscal year; the 90 CDLFs exclude Self Help, Local Initiatives Support Corporation, and six loan funds for which data are not available.

TABLE 4

Percentage Change in Debt Capital by Source: From 2000 to 2005*

	Banks, Thrifts & Credit Unions	Foundations	Federal Government	Religious Institutions	State & Local Governments	Nondepository Financial Institutions	Individuals	Corporations	National CDFI Intermediaries	Other
All CDLFs	165%	47%	22%	41%	204%	196%	31%	108%	110%	40%
Twenty loan funds with greatest capitalization in 2000	184%	46%	−8%	31%	257%	209%	11%	22%	57%	104%
All other loan funds	103%	51%	79%	59%	148%	107%	56%	680%	308%	−24%

*Based on 56 CDLFs for which data are available for both fiscal years.

TABLE 5

Capital Under Management as Percentage of Total CDLF Capital, by Source, for 20 Largest CDLFs*

	Banks, Thrifts & Credit Unions	Foundations	Federal Government	Religious Institutions	State & Local Governments	Non-Depository Financial Institutions	Individuals	Corporations	National CDFI Intermediaries	Other
2000	76%	83%	66%	64%	52%	87%	56%	87%	78%	50%
2005	82%	83%	50%	59%	61%	91%	47%	51%	58%	73%

*Based on 56 CDLFs for which data are available for both fiscal years.

TABLE 6

Percentage Increase in the Amount of Capital Under Management, 1995 to 2000 Versus 2000 to 2005*

	Debt	Equity
1995 to 2000	156%	166%
2000 to 2005	91%	36%

*For 28 CDLF for which data are available for all three fiscal years.

largest CDLFs and all other CDLFs growing at comparable rates of 92% and 89%, respectively. As Table 4 demonstrates, however, dollars loaned by depository financial institutions grew by 165% during this time period, accounting for 60% of the overall growth in debt capital for the industry. Conversely, the debt capital that came from foundations, the federal government, and religious institutions, the three next largest sources of capital, only grew by 47%, 22%, and 41%, respectively.

Table 5 shows that the 20 largest CDLFs increased their share of debt capital from banks, thrifts, and credit unions from 76% in 2000 to 82% by 2005, even as their share of all debt capital stayed constant at 74%. The 20 largest CDLFs also increased their share of debt dollars from state and local governments and nondepository financial institutions. However, these are relatively small sources of debt capital, accounting for less than 5% each.

Equity capital also grew during this time period, increasing by 57% for all funds. The 20 largest CDLFs increased their equity dollars by 54% versus 68% for all others. Although the CDP database does not provide sources for the equity dollars, CDLF equity generally comes from growth in retained earnings and from grants, particularly from federal and state governments and foundations.

Although CDLFs grew their capital under management between 2000 and 2005, the growth rate was much slower than during the prior 5 years. As Table 6 documents, the 28 loan funds for which data are available for all 3 years grew their debt and equity capital by more than 150% between 1995 and 2000. Between 2000 and 2005, however, these CDLFs grew their debt by 91% and their equity by only 36%.[17] The greater growth in debt versus equity capital reflects the increasingly important role of depository financial institutions, which fund CDLFs primarily through debt, and the shift by some foundations from grants to debt-based, program-related investments.

These overall growth rates also mask the trends in the underlying environment that are making it increasingly difficult for CDLFs to raise the subsidized capital they need for the high-risk loans and investments, the provision of technical assistance, and the financial experimentation that is their mainstay. Loans from depository financial institutions to CDLFs, for example, can carry market or near-market rates of interest, greatly limiting the subsidy that CDLFs rely on for many of their activities. The remainder of this section will detail the environmental trends affecting the industry, including the decline in federal government support for community development finance; the changing nature of funding from conventional financial institutions; and the decrease in funding by foundations.

As noted earlier, the most dramatic increases in financial service provision to lower-income markets occurred during the mid to late 1990s, during the Clinton Administration, which had made a strong commitment to such a goal. Clinton's support of the Community Reinvestment Act and sponsorship of the CDFI Fund was critical to the growth of the CDFI industry and to the expanded efforts by lenders of conventional financial institutions to serve historically underserved communities. The George W. Bush Administration has been much less welcoming to community development finance. Evidence of this is most notable in the administration's treatment of the

TABLE 7

President's Proposed CDFI Fund Budget, FY 2001 to 2008

Fiscal Year	Amount
2001 (last year of President Clinton's budget)	$118 million
2002 (first year of President Bush's budget)	$80 million
2003	$75 million
2004	$60.6 million
2005	$55.5 million
2006	$54.5 million
2007	$54.5 million
2008	$29 million (proposed)

Community Development Financial Institutions Fund and the Community Reinvestment Act (CRA), as detailed below. The New Markets Tax Credit program, while an important source of capital for larger CDLFs, particularly those providing real estate and housing finance, has been of more limited usage to date for smaller organizations and for non–real estate business financings.

The Community Development Financial Institutions Fund

The CDFI Fund is one of the few sources of grant and equity capital for community development finance. As Table 7 demonstrates, under the Bush Administration, the CDFI Fund has seen a dramatic reduction in funding, from $118 million in fiscal year 2001, the last budget under President Clinton, to $55 million in fiscal year 2007. Even to maintain this reduced level of support required a significant lobbying effort by the CDFI industry, as the Administration's proposed fiscal 2006 budget called for moving all funding to the Department of Commerce, except for that which was necessary to maintain oversight of existing commitments and for administration of the New Markets Tax Credit (NMTC) program.[18] The Administration's fiscal 2007 budget again called for similar consolidation provisions. The president's fiscal 2008 budget, proposed following the election of democratic majorities in both houses of Congress, reversed this strategy and requested a $29 million allocation for the CDFI Fund.

In addition to reducing overall funding levels, the current administration also has limited the Fund's flexibility in utilizing its allocation by pushing it to focus more of its resources on evaluation, and by prioritizing NMTC administration over other spending. For example, the president's 2008 fiscal budget requested $12 million for administering the NMTC, leaving only $17 million to fund technical and financial assistance.

New Markets Tax Credit Program

The NMTC program was designed to combine public and private sector resources in order to bring $15 billion in new investments to impoverished rural and urban communities. The program was enacted as part of the Community Renewal Tax Relief Act of 2000, along with the New Markets Venture Capital program. The last round of the NMTC originally was to take place in fiscal year 2007. However, in December 2006, the program was extended through 2008, with an additional $3.5 billion in funding. A bill to authorize new funding for an additional 5 years has been introduced in Congress.

The CDFI Fund, which administers the NMTC program, allocates a set pool of tax credits to financial intermediaries, called community development entities (CDEs), based upon a competitive application process. The CDEs then offer the credits to investors in exchange for equity capital investments. The credit is equal to a 39% cumulative tax reduction for the investors and must be used over 7 years—allowing for a 5% reduction in taxes in each of the first 3 years, and a 6% reduction in each of the remaining 4 years (CDFI Fund, 2005).

The program came into existence with strong encouragement and support from the CDFI industry. When the program was being designed, there was great hope that it would be a significant new source of equity capital to fund business lending and investments. Due to several statutory and regulatory provisions, however, the program so far has been used primarily to finance real estate transactions (Rubin & Stankiewicz, 2003).[19] Even more critically, the highly competitive nature of the program and the expense and expertise required to meet its legal and compliance requirements have favored the largest and most sophisticated CDLFs, both in obtaining and utilizing NMTC allocations.

These limitations aside, the NMTC has provided a critical new source of fee-based revenue and an opportunity to expand the size and nature of financing activities at a time when other sources of CDLF capital have become more difficult to obtain. Additionally, some smaller CDLFs have been able to take advantage of the NMTC program by partnering with larger entities, such as Coastal Enterprises, or the Community Reinvestment Fund (Rubin & Stankiewicz, 2005; Seidman, 2007).

The Community Reinvestment Act

Banks and financial institutions provide capital for community development loan funds primarily in order to comply with the Community Reinvestment Act (CRA), which was enacted by Congress in 1977 in order to encourage regulated financial institutions to fulfill their "continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered" (NCRC, 2005). The CRA is crucial for CDLFs because any weakening of its provisions translates into fewer resources to fund CDLF activities.

Regulations for the CRA have been revised several times. Most significantly, they were strengthened in 1995 via changes that "focused CRA evaluations on objective performance measures rather than the more subjective and process-oriented factors that regulators previously had used . . . required banks and thrifts to disclose information about their small-business, small-farm, and community development lending," and instituted tailored examinations for large banks, small banks, and wholesale or limited-purpose institutions that "more closely align[ed]" the CRA examinations of different types of banking institutions with their business strategies (Barr, 2005, p. 112). Subsequently, large banks, those with assets of $250 million or more, were evaluated on their lending, investments, and services, while smaller banks underwent a streamlined review based solely on their lending activities. These changes, in combination with "increasingly intense consolidation in the banking industry, which provided greater opportunities for community organizations and regulators to evaluate bank and thrift performance under CRA in the context of merger applications" (Barr, 2005, p. 113) led to a broadly perceived strengthening of the CRA.

Four federal agencies enforce the provisions of the CRA—the Federal Office of Thrift Supervision (OTS), which oversees savings and loan institutions; the Office of the Comptroller of the Currency (OCC), which oversees nationally chartered banks; and the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, both of which have responsibility over state-chartered banks (NCRC, 2005). In 2001, these four federal agencies began a review of the 1995 regulations that resulted in new amendments issued in 2004 and 2005.[20] For the first time in the history of the CRA, the four regulatory bodies did not issue a consistent set of rules—while the FDIC, OCC, and Federal Reserve issued identical amendments to the CRA regulations, OTS amendments differed.

The amendments issued by the FDIC, OCC, and Federal Reserve created a new category of banks, known as intermediate small banks. This category encompassed institutions with assets between $250 million and $1 billion. Such intermediate small banks were no longer to be evaluated on their investment and service activities. Instead they are evaluated under the small bank lending test and a flexible new community development test. The new rules also exempt the intermediate small banks from CRA loan data collection and reporting obligations for their small-business, small-farm, and community development loans. Finally, the new rules dictate that holding company affiliation will no longer be a factor in determining which CRA evaluation standards will apply to a bank. Thus, a bank's CRA evaluation will be determined solely by its asset size, regardless of how large are its holding company's assets. The new regulations did not change the evaluations for those banks with assets of more than $1 billion or those banks with assets of less than $250 million (Marsico, 2006).

The OTS went a step further than the other three agencies, increasing the asset threshold for small savings associations (which are subject only to the streamlined lending test and have no investment or service requirements), from less than $250 million to less than $1 billion. The OTS also exempted savings and loan institutions with over $1 billion in assets from the three-part community development test, replacing it with a community development test that required 50% for lending and 50% for any combination of lending, investment, or financial services (Marsico, 2006). In March 2007, after significant lobbying by CRA supporters, the new director of OTS reversed these changes, aligning the agency's CRA regulations with those of the three federal banking agencies.

Supporters of the Community Reinvestment Act see the 2004 and 2005 regulatory changes as part of an ongoing effort by the law's opponents to "dismantle the act, piece by piece" (Rubin & Rubinger, 2004). The National Community Reinvestment Coalition found that as a result of the intermediate small bank category changes, "1,508 banks with 13,643 branches and total assets of $679 billion were no longer subject to the more rigorous lending, investment, and service tests for large banks and no longer required to disclose data about their small business, small-farm and community development lending" (Marsico, 2006, p. 540).

The current political environment also makes it highly unlikely that CRA will be expanded in the near term to cover other types of financial services providers, such as investment banks, mortgage banks, or insurance companies. Such an expansion is advocated by CRA supporters; by representatives of populations that lack access to financial services; as well as by some commercial banks that argue for it on grounds of fairness, since bank deregulation has resulted in commercial banks accounting for an increasingly small portion of financial service provision.

Beyond the recent changes to the Community Reinvestment Act, the U.S. financial services sector has experienced other changes in its environment over the last few decades, caused by globalization, domestic deregulation, and technological advances (Avery et al., 1999). These changes have impacted the sector's relationships with community development financial institutions. The most dramatic recent change has been consolidation of the banking industry through mergers of increasingly large organizations.

Consolidation of Conventional Financial Institutions

The 10 largest U.S. commercial banks now control 49% of all domestic banking assets, a substantial increase from the 29% they controlled a decade ago (Economist, 2006). This consolidation has had both positive and negative impacts on the CDLF industry. On the positive side, banks planning either to acquire or to be acquired themselves, have been more likely to be concerned about their CRA rating, and thus to make community development-related investments, even if these investments may be unprofitable (Avery, Bostic, & Canner, 2000; Bostic et al., 2002).[21] The negative consequences of consolidation have included reductions in both home purchase and small business lending by the merged organizations. This is particularly true for larger banks that acquire other larger banks and for markets that experience increased concentration of banking services (Avery et al., 1999; Samolyk & Richardson, 2003). An additional consolidation-related concern when large institutions merge is the reduction that occurs in the absolute number of sources of capital for community development. This leaves fewer sources of capital for CDLFs to approach, diminishing the overall odds of a CDLF being able to obtain a capital commitment.

Bank consolidation also has resulted in an increased emphasis on profitability by the larger banks, which have felt pressure to justify the mergers to their shareholders. This has led them to cut costs by consolidating facilities and activities (Tully, 2006), leaving some communities with few or no local banks and bankers. Such communities lose the leadership that bankers, "with their financial clout and community development obligations," can provide, including the ability to have bankers serve on CDLF lending committees and boards of directors (Seidman, 2007, p. 1). The increased emphasis on profitability also has encouraged banks to focus on their most lucrative activities, such as advising on mergers and acquisitions, at the cost of riskier and less profitable ones, such as commercial lending (Hovanesian, 2005).

Finally, the increased emphasis on profitability has translated into less subsidized capital available for CDLFs, as banks increasingly view their CRA-related activities as profit centers. This is made easier by the recent increase in investment options created specifically for the purpose of providing financial institutions with market-rate or near-market-rate returns, while enabling them to receive either investment test or other credit under the CRA. These investment options include mutual funds, such as the Access Capital Community Investment Fund and the CRA Qualified Investment Fund, which invest in economically and geographically targeted fixed income instruments. They also include separately managed accounts that groups, such as CRA Fund Advisors, can set up to suit the particular investment objectives of banks, pension funds, and foundations. These investment options pose challenges for CDLFs, which generally cannot compete on financial returns and have not been able to demonstrate that they produce higher social returns than other community development investment alternatives.

CDLFs seeking bank investments also must contend with higher interest rates, which translate into a higher cost of capital for banks, and subsequently for their CDFI borrowers. For those CDLFs that are reluctant to pass the higher costs on to their borrowers, the higher rates mean a smaller profit margin with which to cover their own expenses.

The diversification and mergers within the financial services industry also mean that more and more commercial banks are part of larger financial services organizations. Such entities can minimize CRA scrutiny by moving assets to those operations not covered by the Act—as has been the case with commercial banks that own subprime lending subsidiaries that do not have to meet the same CRA standards as the parent entities.

Foundations

Foundations have been a small but important source of capital for CDLFs. Over the last decade, a handful of large foundations, including the Ford Foundation, the John D. and Catherine T. MacArthur Foundation, and the F.B. Heron Foundation, have made numerous investments in the field, while others, such as the Rockefeller Foundation, the Fannie Mae Foundation, the Open Society Institute, the Annie E. Casey Foundation, and the W.K. Kellogg Foundation, have supported specific organizations and/or initiatives.

Foundations are particularly important as a source of difficult-to-obtain grant dollars. Grants act as equity on a CDLF's balance sheet, enabling it to create loan-loss reserves to secure its investments, and to attract debt capital from banks. Operating grants also enable CDLFs to subsidize their most costly, and often most developmental, operations.

Foundations also provide CDLF with program-related investments (PRIs), which are loans with lower interest rates and longer durations (generally 10 years) that are used primarily to fund CDLFs' lending activities. PRIs accounted for more than 16% of all CDLF debt capital in 2005; and PRI dollars to CDLFs increased by 47% between 2000 and 2005 (CDFI Data Project, 2007). These figures reflect multiyear investments that, for the most part, began in the mid 1990s.

More recent foundation support for CDLFs' lending activities has dropped, due in part to the stock market decline, which shrank foundation assets and led to an overall reduction in foundation giving. More significant, however, have been decisions by the most active foundation investors to change the nature of their support for the sector or to withdraw support entirely. Foundations generally view their dollars as seed money, intended to catalyze other sources of capital and ultimately lead to organizational or project sustainability. For CDLFs, this has meant that the subsidized foundation dollars that helped capitalize many organizations in the industry's early years have become rare or unavailable.

Some foundations have pulled back entirely, no longer funding CDLFs or other types of CDFIs except when the work of individual organizations overlaps with their other programmatic interests, such as workforce development; child care initiatives; or efforts to stop predatory lending. Others are focusing their resources on those few organizations or programs perceived to be the most innovative and likely to bring about the next wave of significant development within the industry—those experimenting with securitization or other ways to utilize market-rate capital, or policy initiatives that could increase the impact of CDFI activities.

Even those foundations that have continued to fund individual CDFIs evaluate these investments relative to the range of other community development options available, such as the fixed instrument and equity funds discussed previously. As one foundation official stated, "There has been a lot of activity in the last five years and it's reshaped the landscape a lot and signaled to foundations and banks that they can have the same impact with a better return."

This quote points to an additional challenge for CDLFs, and for all CDFIs—the difficulty of verifying that the social impact of their investments is greater than that created by alternative community development investments. CDLFs have not been able to quantify the outcomes they produce beyond the widely used measures of jobs created and retained. Even the job-related figures are challenging to aggregate, as individual organizations use different methodologies to track this information, reflecting varying levels of organizational capacity, and the lack of money and authority to impose a unifying, industry-wide standard.

The problem is exemplified by answers that CDLFs provided to the CDFI Data Project (2004) questionnaire. The questionnaire asked them to report the number of community service organizations financed in a given year; the number of child care, educational and health care slots that these organizations had at the time of financing; and the projected number of such slots created as a result of the financing. Twenty-nine of the 63 organizations that reported financing community facilities did not know how many slots existed at the time of their financing, and 39 were not able to project how many new slots were created as a result of the financing.[22]

PART III: ALTERNATIVE SOURCES OF CAPITAL

In response to the increasingly challenging environment that they are facing in raising subsidized capital, CDLFs have turned their energies toward finding ways to reduce their ongoing reliance on such capital by becoming more sustainable. For many organizations, sustainability is associated with increasing their capital under management. While some small CDLFs can survive due to ongoing local subsidies or unique environments that create barriers to new competitors, overall it is very difficult to cover operating expenses with a small capital base.

Intermixed with the push for sustainability is an emphasis on reaching scale to be able to maximize impact (Moy & Okagaki, 2001; National Community Capital Association, 2004; Dunlap, Okagaki, & Seidman, 2005). The goal of getting to scale is not “growing BIG institutions,” but rather increasing the volume of financings by a factor of five to ten (Pinsky, 2006, p. 8). In their 2004–2010 strategic plan, the Opportunity Finance Network, a CDFI industry trade association, listed increasing volume of financings as its most important strategic goal, reflecting frustration that, despite impressive growth, the CDFI industry had failed to reverse growing economic inequality or the ravages of predatory financial institutions.

To grow their volume, CDLFs have been targeting new or previously limited sources of capital, such as state and local governments, individual investors, pension funds, and the capital markets. CDLFs also are rethinking the way they do business and repositioning themselves, in order to cut costs and find new ways to utilize market rate capital to fund their operations.

State and Local Governments

Most state governments experienced a significant financial crisis that began in 2001 and lasted through 2004. The crisis was a result primarily of the national economic slowdown, exacerbated by increased demands on state services. Although state revenues generally have grown rapidly since then, not all states have returned to fiscal solvency. Furthermore, the Center on Budget and Policy Priorities warns that “many states risk a rapid return to deficits unless they recognize that some of their current ‘surplus’ revenues are only temporary and thus should not be used to fund ongoing tax cuts or spending increases” (McNichol & Lay, 2006, p. 1).

Although the variable economic conditions in the states present an uneven playing field for community development finance, overall the states offer a more receptive policy environment than currently exists at the federal level. Community organizations also have a track record of successfully lobbying for state-level CDFI funds, community reinvestment acts, and tax credits designed to encourage community economic development.[23]

The power of state-level initiatives is best illustrated by California, where public-sector activity over the last decade has encouraged the creation of numerous innovative sources of capital to fund community development finance. In 1996, The Community Organized Investment Network (COIN) was established in the state at the request of the insurance industry as an alternative to state legislation that would have required insurance companies to invest in underserved communities. As of 2003, it had facilitated over $740 million in insurer investments in affordable housing and economic development projects.

The COIN program also certifies California CDFIs, which then become eligible for investments from the COIN-managed pool of capital. Most recently, COIN member insurance companies were responsible for the creation and capitalization of Impact Capital, a for-profit organization that has been an innovator in securitizing multifamily mortgages in low- and moderate-income communities.

In 1997, California adopted a 20% tax credit for qualified deposits of $50,000 or more in CDFIs in the state. In 2001, the program was extended for 5 more years. Furthermore, in May 2000, then State Treasurer Phillip Angelides launched The Double Bottom Line: Investing in California’s Emerging Markets initiative, “to direct investment capital—through state programs and the State’s pension and investment funds—to spur economic growth in those California communities left behind during the economic expansion of the past decade” (Angelides, 2001, p. 1). As part of this initiative, Angelides successfully encouraged the boards of two of California's largest public pension funds, on which he serves, to invest in real estate and businesses in the state's poorest communities. As of 2006, the two pension funds, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), had made more than $4.34 billion in real estate and $1.09 billion in business investments in such communities (Angelides, 2006).

Individual Investors

Individuals have been a source of capital for community development loan funds from the field's beginnings, when they helped capitalize the first community development loan funds through below-market-rate loans. At present, however, such socially responsible investors make up a fairly small percentage of all capital sources. In 2005, community development loan funds received less than 3% of their debt capital from individuals.

Community development loan funds face a number of challenges in attracting individual investors. First, investors perceive community investments as higher risk. Unlike community development banks and credit unions, CDLFs also cannot offer insured deposits and their products are more diverse and difficult to explain to investors, making them more challenging to sell than conventional bank or credit union offerings. An additional challenge is the fact that CDFIs offer lower broker commissions than other investment options, which can translate into reduced incentives for brokers to offer community investment products (Kanders, 2002). As the field of social investing continues to evolve, however, CDLFs increasingly are looking at individuals as a potentially important source of future capital.

CDLFs, which are mostly nonprofit in legal form and thus unable to accept equity investments except as grants, generally structure their investments from individuals as low-interest loans. The Reinvestment Fund (TRF), a CDFI headquartered in Philadelphia, offers individuals the option of investing as little as $1,000 for a period of 3 to 10 years. TRF admits that the financial return on such loans is "modest," but argues that the social return "is enormous" (TRF, 2006a, p. 4).

Individuals also can invest in CDFIs via intermediaries, which aggregate the capital and provide due diligence on different CDFIs. Intermediaries include socially responsible investment organizations such as the Calvert Foundation, Trillium Asset Management, and Domini Social Investments, which offer community investments as a specialized asset class or as part of bond and money market funds. The minimum investment sizes vary. Calvert's community investment notes, which had raised $100 million as of June 2006, have a minimum investment of $1,000, while Trillium will not accept any individual clients with less than $1 million to invest (Calvert, 2006; Trillium Asset Management, 2006).

CDFIs also are borrowing from the higher education and foundation models and encouraging investors to dedicate the proceeds of a trust to them or to include them in their estate planning. TRF's investment application, for example, asks investors if, in the event of their deaths, they would consider donating any outstanding principal from their loans to the organization (TRF, 2006b).

The Social Investment Forum, an organization of socially conscious asset managers, estimated that by 2003, $14 billion dollars had been allocated to community investments. Most of this capital, however, has come from institutional investors as opposed to individuals. In order to attract more investors, the Social Investment Forum established the "1% or More in Community" campaign—to encourage individuals to allocate 1% of their investment portfolios to community investments. The campaign's current goal is to grow the community investing industry to more than $25 billion in assets by the end of 2007 (Community Investing Center, 2006).

Pension Funds

U.S. pension funds control over 7 trillion dollars in assets (Anand, 1998). This includes public pension funds, which manage the retirement assets of state and local government employees and have more than $2.3 trillion in assets (Moore as quoted in The Democracy Collaborative, 2005); Taft-Hartley pension funds, which are managed jointly by labor unions and employer groups and have approximately $420 billion in assets (Heim, 2002); and corporate pension funds, which manage the pension assets of corporate employees.

Historically, most pension fund assets have been very conservatively invested, due in large part to the prevailing interpretation of ERISA (the Employee Retirement Income Security Act of 1974), which Congress enacted in response to numerous private sector pension scandals. Prior to 1994, ERISA was interpreted to mean that investments could only be selected for their economic return and safety. In 1994, the Department of Labor issued an interpretive bulletin on the subject, stating that economically targeted investments (ETIs) were allowable as long as they met the benchmark financial return rate of comparable investments with comparable risks.[24] If the investment could not be expected to meet the risk-adjusted rate of return for the asset class, it was improper, regardless of the social benefits (Logue & Clem, 2006).

A number of public and Taft-Hartley pension funds have incorporated ETIs into their portfolios (Democracy Collaborative, 2005). Conservative estimates place the ETI commitments of just the public pension funds at more than $43 billion (Democracy Collaborative, 2005).

To date, most of the pension fund ETI investments have been in fixed income and real estate. The real estate focus has created an opportunity for CDFIs to access this capital, if they can provide the scale and rate of return that pension funds require. One example of a pension fund investment in a CDFI is the $25 million loan that the New York City Public Pension Funds made to the Community Preservation Corporation's Revolving Construction Loan Fund, which "makes short-term construction loans for affordable housing, mixed-use development and commercial properties in low- and moderate-income areas" (New York City Comptroller, 2006). An open-ended Request for Proposals for debt-based ETIs is posted on the web site of the New York City Comptroller, who advises the five New York City Public Pension Funds.

Capital Markets

Given the decreasing availability of subsidized capital, significant energy is being focused on finding ways to fund CDLF activities via market-rate capital and the traditional capital markets. Two possibilities that have potential for broader CDLF application are the use of structured financings and securitization.

Structured financings enable certain assets with more or less predictable cash flows to be isolated from the originator and used to mitigate risks, and thus secure a credit (Hew, 2006). One type of such structured financing is a pool of capital that includes a loan from conventional investors secured by a grant, program-related investment, or guarantee from a foundation or government entity. This is the model utilized in raising a fund to finance community child care center facility development and renewal in low-income communities in California, which resulted from a partnership between the Low-Income Investment Fund (LIIF), a national CDLF; Impact Community Capital, a consortium of insurance companies; and the Packard Foundation. The insurance company investors provided $10 million in long-term capital, the Packard Foundation provided a $1 million first-loss guarantee and $3 million for "technical assistance, systems building and infrastructure improvements," and LIIF provides origination, underwriting, and servicing expertise (Dunlap, Okagaki, & Seidman, 2005, p. 7).

Another type of structured financing is a pool of loans that includes senior and subordinate tranches.[25] The senior tranche is sold to private investors, while the subordinate tranche is held by the CDLF and secured by grants. An example of this type of transaction is the National Cooperative Bank Development Corporation's (NCBDC) Enhancement Fund for Charter Schools, which is using "an $8 million grant from the U.S. Department of Education (DOE) to leverage $80 million in private sector financing for charter school facilities development in four states" (Dunlap, Okagaki, & Seidman, 2005, p. 8).[26] NCBDC, a national CDFI, sells the A tranche to investors and uses the DOE grant as a first-loss reserve to back the subordinate B tranche, which it holds (Dunlap, Okagaki, & Seidman, 2005; NCB, 2005).

The second mechanism, securitization, consists of aggregating loans with similar characteristics and selling them to investors. It revolutionized the mortgage finance industry in the 1970s, dramatically increasing the supply of available capital and enabling millions more people to purchase a home. It also holds the promise of significantly increased liquidity for CDFIs that have loaned out most or all of their available funds (Stanton, 2003).

Selling loans to free up capital is not a new concept for CDLFs, many of which have sold their loans to commercial banks and to the Community Reinvestment Fund (CRF), a national nonprofit headquartered in Minneapolis, Minnesota, which has operated a secondary market for CED loans since 1989.[27] Historically, however, these loan purchases were made by a socially motivated, and thus limited, pool of investors.[28] Furthermore, despite their historically low loss rates, CDLF loans continued to be perceived as high risk. CDLFs thus have had to discount their loans in order to make them attractive to banks and to the CRF, reducing the amount of capital produced by such transactions.

The industry needed to bring nonsocially motivated investors to the table and to make them comfortable with the CED loan product, which was perceived by them as lower performing than the loans made by conventional financial institutions.[29] To make their loans a viable option for institutional investors, the industry also had to offer a product at a scale of $50 million and above, which is the size necessary to make a public placement cost efficient (Dunlap, Okagaki, & Seidman, 2005). The solution was to combine loans from multiple organizations and to have them rated by a Wall Street rating agency, making the investment attractive to mutual funds, insurance companies, and pension funds.

This happened for the first time in 2002 when Impact Community Capital LLC obtained a Standard & Poor's rating on a pool of low- and moderate-income multifamily housing loans. Almost 90% of the pool, worth approximately $145 million, was rated, with 90% of that receiving a rating of AAA. The loans in the pool came primarily from Bank of America, with an additional 10% originated by the California Community Reinvestment Corporation, a nonprofit multibank lending consortium (Standard & Poor's, 2002).

A second milestone occurred in 2004 when the CRF obtained Standard & Poor's rating on a $46 million pool of community development loans originated by various CDLFs, CDCs, and government lenders. Fifty- seven percent of the pool obtained a rating of AAA (Swack, 2004). In both Impact's and CRF's transactions, the highest risk portion of the loans was not rated and was held by the aggregators, with the support of subsidized capital from socially oriented sources. In 2006, CRF obtained a Standard & Poor's rating on a second pool of loans. Both of CRF's offerings were oversubscribed, attracting a number of new insurance, banking, and pension fund investors to community development finance (Swack, 2004).

While the Impact and CRF examples demonstrate that the traditional capital markets can be used to bring new investors to community development finance, there still are obstacles to making this an ongoing source of capital for more CDLFs. The most significant of these is a lack of standardization in loan performance data, documentation, and underwriting procedures. Each CDLF handles these functions in its own unique way, which complicates the securitization process and is perceived by investors as increasing risk (GAO, 2003).

A second major barrier is the lack of infrastructure to support these types of transactions. To make securitization a viable alternative for more lenders, there needs to be consistent ways for lenders to sell loans to aggregators and for aggregators to achieve the volume of loans needed for a securitization. There also needs to be a way of insuring quality control throughout the process (GAO, 2003).

A third barrier is the lack of mechanisms for forecasting future borrower demand for community development loans (GAO, 2003). This leaves open the possibility of low future demand, which could reduce loan volume and hamper securitization. Additional barriers to securitization include lack of capacity on the part of some community development lenders and the belief on the part of many lenders that their loans will be substantially discounted in the securitization process (GAO, 2003).

A number of initiatives are under way to overcome the remaining barriers and make securitization a viable, ongoing way for CDLFs to access capital. Already, Frank Altman, CRF's President and CEO, notes that CED lenders' knowledge of and comfort level with securitization has grown. "When CRF first began operating, many lenders only sold loans on an as-needed basis. Increasingly, CED lenders are selling loans before they run out of loan capital. 'That has led many groups to be repeat sellers,' says Altman. 'They've developed a schedule.'" (Pohlman, 2004)

Repositioning and Rethinking

In addition to identifying innovative ways to attract capital to make growth possible, CDLFs are rethinking their business models in order to become more sustainable and less reliant on subsidized capital, and to increase the scale of their impact. Toward that end, many of them have undertaken strategic planning processes to determine how to reach these objectives. The resulting innovations have included:

(1) Forming partnerships, networks, and mergers to increase impact and cut costs.

Historically, CDLFs were autonomous, vertically integrated institutions that performed all their functions internally. Many of the larger CDLFs in particular have recognized the limitations of that model and are heeding the advice of those urging them to utilize partnerships, networks, and mergers to reach scale and sustainability (Moy & Okagaki, 2001; Ratliff & Moy, 2004).

CDLFs are using partnerships and networks for many purposes. The Enterprise Corporation of the Delta has partnered with alt.Consulting, a nonprofit business consulting firm, to provide technical assistance to its borrowers. Coastal Enterprises and the Community Reinvestment Fund each have created networks of organizations through which they source new investment opportunities. The Housing Partnerships Network, a cooperative of nonprofits that focus on affordable housing, created an insurance company for some of its members as an alternative to the high costs and unpredictable coverage in the existing property and liability insurance markets.

Mergers, once reserved for failing organizations, have become a way to increase impact and cut costs. The 2006 merger of ShoreBank Enterprise Pacific and the Cascadia Revolving Fund is the most high-profile example to date. The new entity—ShoreBank Enterprise Cascadia—has more than $71 million under management and plans to grow to $250 million over the next 5 years. ShoreBank Enterprise Cascadia has raised $7 million since the merger was announced in the fall of 2006, which it attributes to the merger's positive reception by foundation and bank funders (Holtzman, 2006).

(2) Identifying and focusing on the most lucrative and socially meaningful activities, while outsourcing others, such as loan processing and back office operations, in order to cut expenses.

After realigning its organizational priorities around the goal of growing market share, the Illinois Facility Fund exited several unprofitable programs that did not directly support that goal and dramatically cut back technical assistance, particularly to organizations that were not ready to borrow. A number of CDLFs, such as the New Hampshire Community Loan Fund, have outsourced their loan servicing, often to local banks, to cut costs. Boston Community Capital staffed a new program by contracting out everything but the two aspects that were most important for its mission (Dunlap, Okagaki, & Seidman, 2005).

(3) Increasing their levels of off-balance sheet transactions, in which CDLFs invest funds for other organizations in exchange for origination and servicing fees.

In 2005, CDLFs underwrote $68 million and serviced an additional $295 million in off-balance sheet loans. Organizations such as the Low Income Investment Fund have comparable levels of capital both on and off their balance sheets, enabling them to increase significantly their lending activities and reach, while also generating operating income.

(4) Finding ways to utilize market-rate capital.

New Jersey Community Capital set up a nonprofit subsidiary, to finance "the portion of community development initiatives that mainstream financial institutions deem credit-worthy but choose not to underwrite because of the size of the transaction or the specialized knowledge required to comprehend non-standard risk." The subsidiary relies on market-rate warehouse lines of credit for its capitalization and its legal documents are structured so that new investors can be added "easily" in the future (New Jersey Community Capital, personal communication, January 12, 2007).

(5) Diversifying their base of borrowers and mix of products.

As discussed previously, entities such as Boston Community Capital, which previously focused its housing lending principally on serving Community Development Corporations, now include public housing authorities, private developers, and other community organizations among their borrowers. Organizations such as the Low Income Investment Fund and the Rural Community Assistance Corporation, which previously were primarily housing lenders, now finance a range of community facilities as well.

CONCLUSIONS

Community development loan funds are at a critical junction. The economic and political environment of the late 1990s, which facilitated their most dramatic growth, is unlikely to return. The last few years also have brought increased competition for capital in the form of new financial products that promise both community impact and market-rate returns. Even some CDLF successes, such as demonstrating the financial viability of low-income communities, have created new pressures for CDLFs. As conventional financial institutions have become more willing to invest in CDLFs' more profitable transactions, CDLFs are forced to find new and sustainable ways of serving low-income communities at a time when the subsidies necessary for such innovation have become rare.

At the same time, the problems of economic inequality and poverty that CDLFs are trying to address have worsened. Additionally, many predatory financial service providers have come to view low-income communities as market opportunities, reversing the wealth-building efforts of community development financial institutions.

In order to address these issues, CDLFs must grow the scale of their activities, by finding ways to operate with significantly less subsidy than the industry has utilized to date or by developing new sources of subsidized capital. Some of the largest and most sophisticated CDLFs have led the way in rethinking and restructuring the way they do business, in order to identify "a sustainable business model that meets the mission" (Dunlap, Okagaki, & Seidman, 2005, p. 12).

However, the industry, and most critically, its government and foundation funders, must not lose sight of the ongoing importance of subsidy. Subsidy is necessary for the continual innovation and risk taking that have enabled CDLFs to demonstrate repeatedly the financial viability of new products and markets. Such innovation and risk taking require organizational reserves, generated either internally from profits or externally from subsidy. Yet most CDLFs operate without benefit of the ongoing profits that successful innovations merit in other contexts. This is due not only to the overall challenge of maintaining profitability when making high-risk investments, but also to the tendency of funders to view growth in a CDLF's retained earnings as an indication that the CDLF no longer needs additional capital.

Subsidy also is necessary to enable CDLFs to maintain an in-depth knowledge of the low- and moderate-income communities that they serve, a critical component of the CDFI model. Furthermore, many CDLF activities—such as the provision of microloans, nonprofit operating loans, extensive technical assistance, and predevelopment financing—are not cost efficient. Without ongoing subsidies, CDLFs will be forced to abandon such activities, diminishing their ability to serve low-income communities.

In a no- or low-subsidy environment, it is likely that only the largest and best capitalized CDLFs will survive. More critically, as these "leading" CDLFs increasingly move toward market models and methods, they will be under growing pressure to modify their missions and the nature of their activities, as has been the case with other nonprofit organizations (Salamon, 1993, 2002; Bowie, 1994; Dees, 1998; Weisbrod, 1998, 2004; Alexander et al., 1999; Eikenberry & Kluver, 2004; Young, 2005).

In order to access subsidized capital in the current environment, CDLFs need to better understand and document the social outcomes of their work. This includes their roles as policy advocates on behalf of low-income communities; as innovators that demonstrate to conventional financial institutions the viability of this market; as intermediaries that bring together other sources of capital to make projects and programs possible; and as direct providers of financial products, services, and education. Foundations, governments, and universities should help provide the financial and academic resources necessary to make these evaluations both rigorous and effective.

Government has a critical role to play in serving the financial needs of low-income communities. CDLFs recognize the importance of public policy for the industry's future as well as its past. Both individually and through their trade association, they are continuing to advocate for critical regulatory changes and additional funding at the federal and state levels.

The most important of these regulatory changes are those related to the Federal Community Reinvestment Act, including the need to reverse the 2004–2005 regulatory changes related to intermediate-small banks and thrifts; shifting CRA exam emphasis to loan quality versus quantity; and expanding the act to include multiple types of financial institutions, such as mortgage and investment banks and insurance companies, to more accurately reflect the current financial landscape. Expansion of the CRA, in combination with the shift in exam emphasis to loan quality versus quantity, would not only provide significant additional resources for low- and moderate-income communities; it also would reduce the role that the mortgage-banking affiliates of conventional financial institutions are playing in predatory financial activities that strip wealth from low-income communities.

Regulatory changes to the Employee Retirement Income Security Act (ERISA) also are needed to make pension funds more accessible sources of capital for CDLFs and other types of CDFIs. Such changes could enable a limited amount of pension capital to be invested at a somewhat lower financial rate of return in exchange for substantial social benefits. This would be consistent with the 1994 Department of Labor interpretation of ERISA, which highlighted the relationship between risk and return. As an industry, CDLFs have more than 20 years of extremely low loss rates to offset their relatively more modest financial returns. In light of the appetite to date among pension fund and other institutional investors for pools of subprime mortgage loans, and the current default rates within that class of investments, encouraging pension funds to invest in CDLFs can be seen as a financially conservative option.

The CDFI Fund also is a critical resource, and should be capitalized at a significantly higher level than it has been during the Bush administration. Returning to the Fund's peak capitalization level of $118 million is a good start, but future funding should reflect the dramatic growth in the CDFI industry's scale of financial activities and in the level of need within low-income communities.

Finally, CDLFs must continue to look to individual states for capital. California provides a good model for how states can make capital available for community economic development and of the important role that public policy plays in spurring private investment.

The low- and moderate-income communities that CDLFs were designed to assist are facing an increasingly difficult environment. The U.S. poverty rate has grown since 2000, while funding of services for the country's neediest has shrunk. The products, services, and knowledge that CDLFs provide are needed more than ever, and the innovation and usefulness of these organizations should not be allowed to dim.

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ENDNOTES

1 For purposes of clarity, this article treats CDLFs as a distinct type of entities. However, many of the most successful CDLFs are part of larger organizations that may also include a community development venture capital fund and potentially also a depository institution, such as a community development bank or credit union.

2 Some CDLFs require that potential borrowers first apply to a conventional lender, and will only accept applicants who have been rejected at least once by banks and traditional financial institutions.

3 CDLFs are nondepository, unregulated financial institutions. Thus, they do not have access to federally insured deposits for their capital. CDLFs also are not subject to the financial rules and audits that apply to regulated institutions, enabling them to take on more risks and potentially to be more innovative.

4 Loan securitization consists of aggregating loans with similar characteristics and selling them to investors. For more on securitization see Part III of this article.

5 Community Development Loan Funds offer a range of financial instruments. Products offered to businesses include senior and subordinate debt; working capital loans; machinery and equipment loans; loans for purchase and renovation of commercial real estate; loan guarantees; and equity or near-equity (subordinated debt with equity features such as warrants or interest payments based on company performance). Products offered for housing and facility construction include acquisition/predevelopment loans and grants, which enable the project developer/sponsor to gain control of the property in question and cover the preconstruction costs (environmental assessments, architectural and legal fees, permitting, etc.) associated with development and/or rehabilitation. CDLFs also provide short-term construction loans or lines of credit, which often are repaid by more conventional capital (a first mortgage from a bank, for example) once construction gets to a certain stage and the project's overall completion risk has diminished accordingly. Some CDLFs offer "mini-perms," mortgages with terms of up to 10 years, to higher-risk projects. For the most part, these loans feature regular principal and interest repayments, although amortization schedules may be based on extended maturities (Sean Zielenbach, Personal Communication, February 25, 2006).

6 The CDFI Data project is an industry collaborative comprised primarily of membership organizations representing the various CDFI institutional types and a group of project funders. CDP data are self-reported by the participating organizations. For more information on the CDP see www.opportunityfinance.

net/industry/industry_sub2.aspx?id=236. CDP began collecting data for fiscal year 2002. Information on CDLFs prior to that year comes from the Opportunity Finance Network (previously known as the National Community Capital Association), a CDFI trade association that has been surveying its members since the 1990s.

7 In 2005, the CDFI Data Project (2005) surveyed 151 of the approximately 500 CDLFs in existence. This article focuses on a subset of those CDLFs for whom microloans (loans of $35,000 or less) constituted less than 50% of their financing activities. There were 98 such organizations in the 2005 CDP sample. Unless specified otherwise, the CDLF data presented in this chapter are based on this subset of 98. Although 41 of the 98 CDLFs made some microenterprise loans, these loans represented only 1% of their total dollars outstanding as of the end of 2005. Loan funds that primarily or exclusively make microenterprise loans have a different economic model than CDLFs that make larger loans. For more on microenterprise funds see Servon (2007).

8 The total number of community development loan funds is an estimate provided by the Opportunity Finance Network in the 2004 CDP report. This figure includes microenterprise funds. The approximately $3.5 billion in assets reflects the cumulative assets reported by the subset of 98 CDLFs.

9 Direct financings outstanding refers to debt and debt with equity features for which principal was outstanding, as well as equity investments that have not been exited, as of the last day of the 2005 fiscal year. These loans and investments may have originated during the 2005 fiscal year or in a previous year. This number includes any loans that have been restructured, but not those that have been written off.

10 Several of the early CDCs still include large CDLFs as part of their operations, including the Kentucky Highlands Investment Corporation and Coastal Enterprises of Maine. For more on revolving loan funds see Seidman (2005), Chapter 12.

11 Chuck Matthei, the President of ICE, was frustrated by the lack of capital available to finance the Institute's work. Drawing on his extensive network of friends and colleagues, Matthew began to raise money for a loan fund via small investments and donations. Within 2 years, the ICE fund grew to over $200,000, and by 1984, ICE had helped start community development loan funds in New Hampshire, Massachusetts, and Pennsylvania. In 1985, Matthei organized a national conference for those working in the field of community development lending. The conference led to the creation of the National Association of Community Development Loan Funds (NACDLF) (Chuck Matthei, Personal Communication, April 2, 1998). By 1996, NACDLF, which in 1997 was renamed National Community Capital and in 2005 The Opportunity Finance Network, had 46 members, with more than $286 million in funds under management (Stearns & Threlfall, 1997). By 2006, membership had expanded to 167 institutions with more than $3.6 billion under management (Opportunity Finance Network, Personal Communication, February 15, 2007).

12 CDLFs closed approximately $163 million in new community facility loans and investments in 2005, bringing the total loans outstanding in this area to $320 million (CDFI Data Project, 2007). Loans closed in 2005 consisted of educational loans (35%), which primarily went to charter schools; health care loans (11%) to clinics and other providers; child care loans (9%) for daycare provision; and cultural loans (6%) for arts organizations. Most of the remaining 39% consisted of loans to social service agencies (Opportunity Finance Network, Personal Communication, February 15, 2007). Relative to prior years, these figures indicate not only overall growth in facility financing but also a greater focus on charter schools.

13 The CDP data somewhat understate the magnitude of CDFI activity in this area. For example, they do not include NCB Development Corporation, one of the largest community facility finance providers.

14 Some of the larger CDLFs could compete successfully with banks for these transactions. Such competition is generally not practical, however, given that banks are the industry's primary source of capital and a critical partner that CDLFs do not want to alienate.

15 This also includes equity equivalent investments (EQ2s), "highly subordinated debt instruments with features such as rolling term and limited right-to-accelerate payments that enable them to function similar to equity. Banks are the primary investors in EQ2s because of the favorable CRA treatment . . . Lenders can receive

either enhanced lending test credit or investment test credit for making EQ2 investments in CDFIs" . . . EQ2s typically are "long-term capital (7–15 years) [that] allows CDFIs to leverage additional debt" (CDFI Data Project, 2006, p. 38).

16 Self-Help and Local Initiatives Support Corporation were not included in this analysis because their large capitalization levels and unusual sources of capital relative to the rest of the industry would have skewed the results.

17 The increase in capital between 2000 and 2005 also reflects a lag time between the change in environment that took place after 2000 and the timing in allocating capital to CDLFs by the various sources discussed in Part II of this article. Different sets of loan funds responded to the CDP survey during each of the years between 2000 and 2005, making it impossible to analyze the changes in capital by year.

18 This consolidation was referred to as the Strengthening America's Communities Initiative. In 2006, it called for eliminating 18 economic and community programs and consolidating their activities into a new program, to be administered by the Department of Commerce. It also called for cutting funding from the $5.6 billion the 18 programs received in 2005 to $3.7 billion for the new program. The 2007 version of the Strengthening America's Communities Initiative called for a similar consolidation and funding reduction, but the Community Development Block Grant program and a few smaller programs would remain at the Department of Housing and Urban Development. The consolidation proposals failed, following strong resistance from Congress.

19 Some NMTC transactions have used real estate as collateral for other types of business loans.

20 Although the review had been agreed to at the time of the 1995 amendments, the nature of the amendments reflects the political preferences of the Bush Administration, as the four regulatory bodies are controlled entirely by appointees of the President. The Director of the Office of Thrift Supervision and the Comptroller of the Currency both were appointed by President G. W. Bush. Both the Director of the OTS and the Comptroller of the Currency sit on the FDIC board, which also includes two other appointees of President Bush. President Bush also appointed all seven members of the Federal Reserve Board of Governors, which oversees regulation for the Federal Reserve.

21 This benefit has been watered down somewhat by the recent decrease in large-bank mergers, and the Bush administration's perceived reduction in CRA enforcement.

22 Thirteen of the 29 and 14 of the 39 stipulated that this information was not applicable to them. Some of them were inconsistent, however, providing data for either existing slots or new slots created while indicating that the other measure was not applicable to them.

23 States with CDFI Fund-like entities created to support community development finance through grants and investments include California, New York, Illinois, Maryland, Pennsylvania, and New Jersey. State-level CRAs applicable to state-chartered banks were enacted in New York in 1978 and in Massachusetts in 1997. The Massachusetts regulations are, in many ways, more expansive than the federal ones. Tax credits for which CDFIs are eligible were enacted in California in 1997 and South Carolina in 2000. In 1998, Massachusetts also legislated the creation of two large insurance company investment pools for the purpose of investing funds in community development efforts in the state.

24 ETIs are "investment programs designed to produce a competitive rate of return as well as create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy" (McNeill & Fullenbaum, 1995, p. 1).

25 A tranche is one of several related securities with different risk, reward, and/or maturity characteristics, which are offered at the same time.

26 As of September 2005, NCB had assembled and made available the first $40 million (NCB, 2005).

27 Another example of community economic development loan aggregation and selling is the earlier described Community Advantage Home Loan Secondary Market Program originated by Self Help.

28 Banks purchased CED loans as part of their obligations under the Community Reinvestment Act, while the Community Reinvestment Fund used grants and program-related investments from foundations and social investors to subsidize the portfolios it sold in private placements to banks, thrifts, insurance companies, pension funds, and other qualified institutional investors. Self-Help's program was supported by the previously discussed grant from the Ford Foundation.

29 The current subprime mortgage crisis highlights the subjective nature of such perceptions as well as of the way that rating agencies and institutional investors evaluate the safety of various securitized products. For an excellent analysis of this see Morgenson (2007).

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