

Loans to community development financial institutions earn big returns in social benefits.

BY ANN MONROE

STRATEGIES

Neighborly Lending

WHY WOULD ANYONE lend money to organizations paying below-market interest rates and backing businesses so risky they couldn't raise a nickel anywhere else? For a lot of reasons, actually. In fact, if you are one of the many people interested in using at least part of their investments to make the world a better place, the perfect vehicle might be one of these little-known community development financial institutions.

CDFIs occupy a middle ground be-

tween socially responsible investment organizations, which aim to give investors an above-market return, and charities, which give nothing back to contributors except moral satisfaction and a tax deduction. You don't give money to a CDFI; you lend it. (Some also welcome equity investments.) And despite the riskiness of the CDFIs' investments, the industry has a stellar track record when it comes to repaying its own investors. "No lender to us has ever lost a dime in principal or interest," says Julie Eades, president of the New Hampshire Community Loan Fund.

In return for your loan, the institution pays you interest—if you want it. Most offer a choice of rates between zero and 2.1 percent. (Like any other income, the interest is taxable; it's possible—though complicated—to set it up so that you can deduct the difference between what you're collecting and a market interest rate, but the tax savings usually aren't worth the trouble.)

The primary attraction of CDFIs, however, is not what they pay, but what they do: They bring capitalism and its benefits to the poorest members of the communities in which they operate. That's one of the things that attracted investor Hal Taussig. He lends directly to the kind of projects CDFIs fund and has lost money. "Then I found out that there are people who really know how to do that," says Taussig, who owns a travel business. "That was very inspiring to me."

CDFIs lend money to people who can make good use of it but who haven't a hope of getting it anywhere else. Indeed, many of the borrowers had never even thought of looking for a loan until



ILLUSTRATIONS BY MARK AND JACKIE

their local CDFI came calling. "Most of our loans don't come in by application," says Eades. "We go out and listen to people and talk to them and help them translate the problem they have into one that debt can help with."

One of the New Hampshire fund's main business lines, for instance, is giving trailer-park residents loans to buy parks and run them themselves. "When people are going to lose their homes because the park is for sale, or because the landlord isn't fixing the sewage system or has gone bankrupt, they don't think about borrowing money," Eades explains. "We bring in the solution. We tell them they can borrow the money to buy the park and pay back the loan for pretty much the same amount they're paying in rent right now."

Loans are not the only way the fund deploys its capital to address a problem—the plight of nurses' aides, for instance. "Their pay isn't good, working conditions are poor, they don't have benefits, and nobody is focusing on them," Eades says. So the fund started a for-profit company that hires health-care paraprofessionals to train certified

nurses' aides. "We did it to show by example how you might do the same job with a focus on the frontline workers, and when it becomes profitable, the employees will become the owners."

Modern CDFIs have their roots in the '70s, when community activists started creating loan funds to help finance projects such as low-income housing. But it was the federal government, in 1994, that turned the movement into an industry by setting aside a pool of money to be awarded, on a competitive basis, to the best-run, most financially solid CDFIs in the country. "They focused on the lender, rather than the project," says Mark Pinsky, president and CEO of the National Community Capital Association, a CDFI industry group. "And they asked those lenders what every venture capitalist asks: Do you have a good business plan? Do you understand the market and its risks? Do you have good management?"

Since then, the feds have poured more than \$215 million into CDFIs, which are required to match the funding. In addition, the government has encouraged financial-community backing by giv-

ing banks full financial Community Reinvestment Act credit for putting money into these institutions. As a result, many CDFIs now work in partnerships: They develop borrowers—and whole markets—nurture them to the point where they are bankable, and then hand them over to their local bank partners.

CDFIs come in many flavors, from credit unions and community banks to loan funds and even venture-capital funds. But all share two distinguishing characteristics: They are private institutions dedicated to the public purpose of economic development for low-income communities, and they are, with few exceptions, intensely local in their investing focus. Indeed, officials at many CDFIs say it's this local focus that helps them keep their loan default rates so low.

"Our losses have been virtually nonexistent," says Martin Eakes, CEO of Self Help in Durham, North Carolina, which operates a credit union that gives single minority mothers mortgages, allowing them to buy their first homes. "I used to say, tongue in cheek, that I did not know how to make a bad home loan, and I had tried."

How to explain this record? "Poor people will work two or three jobs to ensure that they never lose this American dream, the chance to raise their child in a place they can't be evicted from on 30 days' notice," Eakes says. Self Help has also learned how to assess the creditworthiness of borrowers who would not hit even the bottom rung on a bank's credit scoring system. "Our real secret," he confides, "is our ability to use their rental history and other alternative methods of determining their payment discipline."

The program has been so successful that Self Help has begun providing a secondary market for home loans to low-income people, feeding roughly \$500 million of financing into local banks, which do the actual lending. "We say to the lender, 'If you will use your distribution network to reach low-income family borrowers looking for

If You Want to Invest

You can learn about CDFIs in your area from the CDFI Coalition (215-923-5363) and the National Community Capital Association (NCCA; 215-923-4754), whose members include or represent almost all the 500 or so institutions in the country. But just as you wouldn't put money in your next-door neighbor's business without careful investigation, you shouldn't invest in your local CDFI without checking it out thoroughly. Not all CDFIs are equally well run, notes NCCA president and CEO Mark Pinsky. "There are CDFIs that no sane person would put money into."

How do you know if you've found a good one? "Look for the same things that make a good financial institution of any kind," he says. "Is it well run, disciplined? Does it understand its risk? Is it accountable to its investors and borrowers? A good CDFI knows its market, has a good mix of products and services, good management systems, and a governance structure and governors that can help it deal with a very difficult, rapidly changing market."

Much of the information you need can be found in the CDFI's annual report. The NCCA's 1999 annual report also gives financial parameters for its members that will let you compare the fund you're looking at with its peers. The association is planning a CDFI rating system, in addition to a Web-based training program for potential investors.

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their first home, we will buy those loans and take all the risk.' To make sure the banks do their homework, Self Help doesn't buy a loan until the borrower has demonstrated a satisfactory payment record for nine months to a year.

In the past year or two, many CDFIs have become aggressive lenders to charter schools, a surprising move for an industry whose leaders typically came out of left-wing politics. "I have some liberal friends involved in philanthropy who think I've gone over to the devil," says Jeremy Nowak, president of the Reinvestment Fund, in Philadelphia, which operates a venture-capital fund, a loan fund, and a bank-backed lending consortium. "But people like me who have had to invest in low-income neighborhoods and make the portfolio work have become pragmatists. We want to figure out what works, socially and financially."

The institution's venture fund recently invested in a chain of inner-city day-care centers located at transportation hubs, most operating 24 hours a day to accommodate shift workers. "They plan to open 25 by year's end in Philadelphia and another 5 in Pittsburgh," Nowak says. "When we are done with them, we'll have helped create quality day-care slots for 2,500 low-income kids."

Although they pay lenders below-market interest rates, CDFIs generally charge their borrowers the market rate,

or close to it. That doesn't mean they're bilking investors, though. Take the Cascadia Revolving Fund in Seattle, whose cost of funds is 3 to 4 percent and whose lending rate is roughly 12. A spread of 8 percent sounds generous, but executive director Shaw Canale points out that it pays for the generous services needed to make these loans work. At any given time, 15 to 20 percent of Cascadia's borrowers are not current on their loans. Rather than foreclose, the CDFI nudges delinquents into profitability by giving them the kind of intensive technical assistance that would bankrupt a conventional bank.

"Bank regulators and shareholders are very demanding, and when a loan slows, they say charge it off," notes Canale. "Because we're not federally regulated, we have the luxury of using our judgment. We can work with a borrower for months and months, or even for years and years. We balance our

rowers, one-on-one, and talk them through their accounting issues. "We decided to test it for a year and see if it could be valuable," Canale says. "After four months, it became a permanent part of our program, and we're hoping to hire a second [assistant]. I'll figure out how to raise [the money needed]. It's too critical not to have this."

Because their loans are so risky, and so demanding, successful CDFIs have developed a rigorous application process. Cascadia's, for instance, takes two to six weeks, and its loan officers prepare a six- to eight-page, single-spaced report based on hours of conversation with the potential borrower. "It talks about the applicant, the business, the strengths of management, and also its weaknesses," says Canale. "What are the hurdles, and what can we do to mitigate them? For our borrowers, sometimes a car breaking down can make the difference between making a loan payment or not, and we have to be very disciplined about saying to somebody that we see these things on the horizon that might make it difficult."

Giving this kind of personalized at-

Generous rate spreads pay for generous services needed to make these loans work

budget on the backs of our staff and the largesse of our supporters."

Cascadia, in fact, only just crept out of the red, and Canale expects it to slip back this year because of a new, and expensive, technical assistance offering. "One big gap we noticed was in our customers' ability to manage their financials," she explains. "They'd buy these software packages and then couldn't figure out how to get the information they wanted out of them." Because they are mostly rural, it's hard for them to get to a classroom setting for training.

The solution arrived with a Vista volunteer who was a trained accountant. She was sent out to sit down with bor-

rowers, CDFIs don't make the kind of profits that banks and other financial institutions make, or pay investors the same kind of returns. But the institutions offer other rewards, claims Morris Kellett, a retired lawyer who both invests in and volunteers for Philadelphia's Reinvestment Fund. "I walked yesterday by the child-care center that's part of our venture-capital fund," he says. "I saw little children being cared for, allowing their parents to go to work. You've got to be enthusiastic about those things." ■

Ann Monroe wrote "Shifting From Funds to Stocks" in the March 2000 issue.