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COMMUNITY DEVELOPMENT BANKING

Techniques and Practices of Community Development Financial Institutions

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INTRODUCTION

Community development banking is a term that has been coined to describe an emerging group of disparate entities that use credit to combat economic stagnation and poverty. In the past, national governments, the World Bank and others have provided credit to large scale projects aimed at industrialization, the building of infrastructure and other sectoral investment strategies. However, the provision of credit to small, community-based projects, such as micro-enterprise programs for self-employed in informal sectors and affordable housing loans for low-income families, is a relatively new approach to development finance. What is most innovative about these projects is the use of local or regional non-governmental organizations as the delivery agent of credit to community-based projects. These NGO credit organizations, or Community Development Financial Institutions (CDFIs) have begun to proliferate to provide credit for anti-poverty and income generation programs.

Since the 1980's CDFIs have played an ever-larger role worldwide in economic and community development efforts. Begun as individual experiments in local areas, these institutions have become an emerging industry, albeit a diverse one. The community-based institutions grew out of private efforts. They often began in NGOs that had a human service delivery mission, but found a need for other approaches to community needs. Many arose from private development organizations that had originally focused on building housing for the poor, employment training, or the provision of family services. In most of these organizations, access to credit was determined to be a major impediment to their constituency's economic improvement.

Over time, the common thread discovered among these emerging organizations was the critical role of credit in the health of a local economy. When credit is not available for everyday investment and reinvestment, the local economy begins to deteriorate. Housing and commercial buildings deteriorate and new structures are not built to replace old ones. Small businesses are not able to start-up or expand to meet local demands and employ the local labor force. The opportunity for local ownership of land, housing and small businesses becomes harder to come by, creating a lack of cycle of disinvestment, discouragement and disinterest in the community.

However when credit is available, it serves as a catalyst for renewal in the community. The extension of credit by a financial institution is a statement of confidence in the stability of the economy. The visible signs of the availability of credit, in the construction and renovation of the built environment, become symbols of the health of the community. Credit also creates a multiplier of economic impacts leading to the creation of more jobs, more income and more investment. For these reasons, many NGOs have turned to the provision of credit as a major tool for community development.

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

Today there are a wide variety of CDFIs whose primary mission to provide credit to promote community and economic development. They offer credit for housing for low-income families, job creation, the development of small businesses and for general revitalization of economic distressed communities. In addition, many offer other ancillary services that enhance their ability to address a broad range of community development needs. This paper will describe the work of CDFIs in the United States in general, and specifically reference one of the leading U.S. models - the Center for Community Self-Help.

Definition of Community Development Financial Institutions

CDFIs have been able to find gaps in the credit markets, lending to niches in which a specialized knowledge of local conditions and cultural differences make it possible to have an advantage over larger conventional financial institutions. Some CDFIs have a very defined focus on one type of loan program, while others have a broad economic development mission with a variety of products and services. However, these diverse institutions share several common characteristics which serve to define the CDFI sector:

- Their **primary mission** is to create new economic opportunity for communities, businesses and individuals who do not have access to the mainstream economy and are experiencing some degree of economic distress.

- Their **primary means to achieve this mission** is the provision of credit for housing and business needs. They lend to communities, businesses and individuals that are not served by conventional financial institutions.

- They are **private institutions**, often not-for-profit NGOs, but are not public agencies. They derive their financial support chiefly from the provision of financial services but supplement this income from a diverse base of community, foundation and governmental sources.

- They often **provide more than credit** in order to make their lending activities successful. Ancillary services include training, technical assistance, housing development and construction, real estate development, and credit and home ownership counseling.

- They are **successful lenders**, managing to lend to borrowers whom conventional lenders shun, and they achieve a high degree of repayment. Loan losses remain at, or slightly above, rates in conventional banks, despite the difficult circumstances in which they lend. Unsuccessful CDFIs generally do not remain in operation for long.

- Either through demonstration or involvement in policy making, they **advocate for change** in the behavior of the conventional financial industry and government to better serve the credit needs of their markets.

Types of Community Development Financial Institutions

CDFIs take many forms because they have grown organically out of a variety of anti-poverty and economic development programs. In the United States the various forms can be classified as follows:

Micro-enterprise Funds: These organizations provide small amounts of credit to self-employed individuals to start or expand very small (hence the name micro) businesses. These Funds are most often components of micro-enterprise development programs that integrate both economic and human development strategies. They are designed to fight poverty, increase income, raise self-esteem, develop personal and technical skills, create role models and increase personal savings. The enterprises served by these loans are often in the informal sector, and sometimes provide supplemental income for families. More formal businesses may employ as many as 5-10 employees, but these firms usually outgrow the programs because their credit needs exceed the amount available from the programs. Loan funds are generally obtained from government or private charitable sources. Micro-enterprise funds were pioneered by groups such as the Grameen Bank in Bangladesh and Accion in Latin America, and have spread to virtually every continent.

Community Development Loan Funds: These are non-regulated financial intermediaries that aggregate funds from individuals and institutions that are willing to support the loan funds with below-market rates of return. The Funds re-lend these monies primarily to non-profit housing and business developers in low-income rural and urban communities. These Funds are often created by other NGOs. They may be spun-off into separate entities or integrated into the NGO organization. They have been leaders in financing land trusts, cooperative housing projects and other innovative forms of low-income housing.

Community Development Credit Unions: Cooperative and mutual savings and loan organizations are one of the oldest models of development finance systems. Community Development Credit Unions (CDCUs) are owned by and operated for low-income persons and typically provide consumer banking services not available within their communities. Until recently most CDCUs limited their activity to consumer banking services. Now a growing number of CDCUs are targeting their lending to community development projects. These credit unions are making home mortgages, home repair loans, micro-enterprise loans and general business loans. Unlike Community Development Loan Funds or Micro-enterprise Funds, these credit unions rely primarily on member savings as a source of funds for lending.

Community Development Banks: These are regulated banking institutions organized specifically for community development purposes. They are composed of a regulated banking institution (such as a bank, credit union or thrift) linked through a parent company to one or more affiliates (usually organized as NGOs) that undertake related development services. These affiliates include real estate development companies, venture capital funds, development loan funds, and technical assistance agencies. By combining a variety of development organizations and programs within one banking institution, they are able to provide a wide range of services and be considerably more pro-active in their development activities. These comprehensive banks use funds from savings deposits as well as bulk loans from the private and public sectors.

Information about the industry is scare because there has been no effort to study CDFIs as a worldwide industry. In the United States, it is estimated that there are more than 300 CDFIs managing more than $1 billion in investments and savings deposits for community development lending.

ORGANIZATIONAL STRUCTURE

CDFIs have a variety of organizational structures due to their different historic roots, yet management and staff requirements are remarkably similar for the different forms of

CDFIs. Since Community Development Banks are the most complex of the CDFIs structurally and offer the greatest breadth of service for a community, the discussion of corporate structure will be limited to these institutions.

Corporate Structure

Community Development Banks (CDBs) are constructed of several affiliated corporations, including a parent corporation, a regulated financial institution, and one or more affiliated corporations with special development functions. There are two models of this structure in the U.S. :

- A for-profit model based on a bank holding company and affiliated bank, exemplified by Shorebank Corporation and its South Shore Bank in Chicago; and

- A non-profit model featuring a non-profit parent corporation affiliated with a credit union exemplified by the Center for Community Self-Help and its Self-Help Credit Union serving the state of North Carolina.

These CDBs share the features of a CDFI, as described earlier. The only major distinction in these models is the use of a bank or credit union as the lead financial institution, which has some ramifications for raising capital and governance as described below.

In each of these models the parent corporation is the overall manager of the group of affiliated corporations. It controls the direction and programs of each affiliate through ownership, designation of board of directors, and appointment of management. Day-to-day management is generally carried out autonomously within each affiliate, and parental control is exercised though establishment of overall mission, purpose, and objectives. Ownership of a bank holding company is held by private stockholders, most of whom invest stock recognizing that their returns will be lower than comparable returns at other banks. Capital is raised from foundations, wealthy individuals, local banks and corporations that invest in these bank holding companies. The holding company controls all, or a majority of, stock in its affiliates, thereby controlling appointment of directors.

Non-profit parent corporations have no stockholders. They are public trusts with boards of directors selected because of their interest in supporting the mission of the CDB. These non-profit parent corporations will have some implicit and explicit control over their affiliate credit union, through identification of the credit union's membership base and by appointment of a large block of directors. The same sources are tapped to build the capital base of the non-profit parent, but instead of investing in stock they make grants and long-term loans.

In a *community development bank (CDB)*, the regulated financial institution is the largest entity and carries out the majority of activity in a CDB. It is also the public face of a CDB, since it is the main contact most customers will have with a CDB. The elegance of the CDB model is its ability to use ordinary depository capital and convert it into development credit. Regulated banks and credit unions are viewed as relatively safe places to save money because of the close oversight of their operations by the government and deposit insurance. Regulatory agencies have just begin to understand the unique mission of these CDBs and the financial support offered by their affiliates. CDBs do not get special treatment from regulators on safety and soundness issues, and often receive a more thorough review of loan documents, financial statements and management practices. However, US regulatory agencies have increasingly learned that community development lending is not necessarily more risky if done carefully.

Subsidiaries of the parent corporation carry out other development services such as employment training, real estate development, technical assistance and specialized development lending. These are either for-profit or non-profit corporations, entirely owned or controlled by the parent. It is often the case that these affiliates carry out the programs most effective in addressing community development needs, because they are more able to attract low-cost, subsidized funds and are not subject to regulatory limitations. On the other hand the scale of the subsidiaries' impact is much less than the bank's or credit union's because the subsidiaries are smaller in size than depository institutions.

Management and Staffing

Senior CDFI management are in general exceptionally strong in leadership, technical competency and overall management skills. They come from a variety of professional backgrounds, but most of them have extensive management experience in a related community development activity. The CDBs, particularly the banks, also generally require management with experience in a regulated financial institution because of the complexity of the regulatory environment.

Senior management in CDFIs are highly motivated by the mission of their organizations. Common to the most successful CDFIs is the degree of innovation, independent thinking and pugnacity embodied in senior management. This is a field in which these qualities are absolutely necessary. Nearly every major CDFI has been told by banking and finance experts that their products, programs and institutions are not feasible. Conventional wisdom indicates that if there were a market for loans to low-income communities, banks would be making them. Government agencies and foundations are often skeptical of the abilities and proposed programs of CDFIs. Management must be assertive, learn from industry practices and their experience, and react quickly to opportunities. Consequently, it is no surprise that CDFIs do not follow five-year business plans very closely, but rather react to opportunities for funding and lending that can arise without notice or planning. Senior management are paid less than their counterparts in conventional banking because CDFIs are under more pressure to reduce operating costs. Lower salaries are also a reflection of the organization's dedication to a mission of economic justice.

Middle level management and support staff are also attracted to these institutions because of their mission, though they are paid salaries more comparable to those of similar positions in other banks and credit unions. Technical skills are often learned through internal training, although the large CDBs also take advantage of traditional banking training in areas such as loan servicing, loan origination, accounting and deposit management.

Scale of Operations

A major factor contributing to CDBs' viability and success is the size of their operations. Banking is an industry that has significant economies of scale, particularly in the "back room" operations: loan servicing, deposit administration and loan origination. CDBs that have large loan portfolios are able to reduce the cost of administration considerably. Automation of these functions is more possible in larger institutions, which also reduces administration. In addition, they can afford to pay more for senior management because the cost of management can be spread over a larger revenue base.

Scale also contributes to the CDB's ability to address community needs and be an effective advocate for changes in government policy. The CDBs' variety of services, from lending, to real estate development, to technical assistance and training, give them more developmental tools than other community development financial institutions with which to solve local problems. They are able to combine, for example, home ownership counseling, mortgages, housing construction and small business finance to redevelop a specific community. Large-scale CDBs are more able than other CDFIs to help other NGOs develop their capacity to carry out development programs, and have a more credible voice in policy deliberations at the state and national levels.

THE GREAT BALANCING ACT: MISSION VS. MONEY

By their very nature, CDFIs operate in an arena that requires a careful balance between developmental goals (e.g. the creation of jobs and affordable housing) and financial goals (e.g. profitability and preservation of assets). Failure to achieve either goal is usually cause for the collapse of the organization.

A CDFI must be successful in achieving its overall mission: to create housing or jobs. If the CDFI is not able to show tangible results it will lose credibility with its customers, its depositors, and its funders. Ultimately, it may become irrelevant and ineffective. On the other hand, a CDFI may be extremely productive in achieving its mission, but if its loan portfolio performs too poorly to provide the income necessary to sustain operations, the organization will collapse.

The CDFI must carefully balance these two goals with each loan it makes and each new program it undertakes. Often, but not always, there is a direct trade-off between these goals: a project to house the homeless may present an unmanageable risk for a lender, while a home mortgage program for close-to-median-income families will provide a stable source of income for the CDFI. No one gains when a CDFI goes bankrupt, so it is crucial for these institutions to learn to accurately assess and manage the risk inherently associated with community development projects.

The remainder of this paper will discuss the management techniques which many of the more successful CDFIs have employed to achieve this delicate balance between mission and money. None of these techniques are foolproof; there has not been enough experience in the industry to document unqualified success. Nor is there agreement about each of the methods described below. However they have been tested, modified and re-tested in the field by CDFIs which have successfully maintained the delicate balance of developmental and financial objectives.

FINANCIAL MANAGEMENT

There is no doubt that the provision of development credit is a costly undertaking. No matter how efficient and productive a CDFI is, there will always be extra costs that a conventional financial institution will not have to bear. Compared to a bank, CDFIs take on additional risk, make smaller loans, lend in remote or difficult-to-serve areas, provide technical assistance, have higher delinquencies or default rates, are constantly developing and adding new programs and products, and are not able to achieve the economies of scale of banks. Each of these factors adds cost to the operation of a CDFI. Consequently, CDFIs must be even smarter than conventional financial institutions in their financial management in order to operate succeed.

Unlike other NGOs, **CDFIs make money from their development activities.** If CDFIs are managed wisely, interest derived from loans can support much of their operating costs. A common practice is to cover loan-related expense with interest revenue and allocate any available subsidies to technical assistance, development of new programs, and advocacy work. The fact that CDFIs earn their income from their loans makes them unusual among NGOs, and gives them a built-in incentive to be effective: their lending **must** be successful for the organization to survive. Some commonly used financial management "rules of thumb" are described in this section.

Improve Access to Credit, Don't Subsidize the Cost of Credit

Historically, governmental and private development programs have subsidized the interest rates of loans made to community development projects. Policy makers and elected officials quite naturally believe that if a program is targeting low-income people it should make interest rates more affordable. Yet many of the most effective community development financial institutions charge interest rates that are at or above the rate charged in the market. The major reason CDFIs are able to charge a "market" rate and still serve a low-income target population is because disadvantaged people need access to credit more than they need low-cost credit.

Indeed, in most economically distressed communities, conventional sources of credit are simply not available. In some cases, there are no banks or other traditional financial institutions nearby. Or, certain populations (such as minority groups or women) may be underserved by these institutions. In these cases, the **availability** of credit is the issue, not the interest rate. In some areas there may be money lenders offering loans at extremely high rates. In either situation, if a CDFI is providing loans at or slightly above banking rates, it is providing a real service to the community.

Looking at the interest rate issue from another angle, often an interest rate that is 5-10% lower does not make a great deal of difference to a borrower. For example, most small self-employed individuals borrowing short-term for their business can just as easily pay back a 15% loan as a 5% loan. In a one-year period, the difference between a 5% and a 15% rate for a $500 loan is only $2.30 per month. Clearly this amount of money will not determine the financial success of the business. What will make the difference to these borrowers is the fact that they have a reliable source of credit when they need it. In short, access to credit is the key requirement for a successful program. Also, by not offering a lower-than market interest rate, CDFIs discourage applicants who can qualify for a bank loan and are simply shopping for a better rate.

There are two other reasons that interest rates should not be subsidized. These affect the very survival of a development credit program. First, interest should be the major source of revenue for a CDFI. If a CDFI is to remain financially solvent, it must maximize their interest revenue. A 5% difference in interest rate on a portfolio of 5,000 loans can make the difference between a successful or a bankrupt CDFI.

Second, credit programs offered by CDFIs will remain small and marginal unless they can be done in a cost-effective manner. A low-interest loan program will simply require too much subsidy from some government or private source to ever be more than a small demonstration. In order for development credit programs to reach a scale necessary to address a nation's community development needs, they must use the limited amount of external subsidies judiciously.

Keep the Cost of Funds Low

The corollary of charging market interest rates is keeping the cost of funds to the CDFI as low as possible. Development credit is dependent on good sources of low-cost funds, whether they be bulk loans or savings deposits. Low-cost funds provide a broader interest spread between the interest earned on loans to borrowers and the interest paid to investors and depositors. This larger spread provides the CDFI an internal source of subsidy, since it generates more income on loans than banks can earn. CDFIs are usually able to earn 1%-5% more than banks on their loan portfolios.

Build Significant Net Worth in the Organization

Even better than low-cost funds, net worth (equity, permanent capital) offers CDFIs a permanent source of no-cost funds. Like an endowment, net worth provides a steady source of income protected from the frequent changes in interest rates paid on savings deposits or bulk loans. Internationally, banks maintain a ratio of net worth to assets of 8%. CDFIs, through a long-term strategy of seeking permanent capital, seek a ratio of 10%-20%. These funds are generally provided from foundation capital grants, government appropriations targeted for capital uses, other charitable sources, and retained earnings. Using government or foundation funds for capital purposes is somewhat uncommon among NGOs. This is an area in which a CDFI can effectively use external subsidies to support a development program (i.e., to make loans) and at the same time enhance the institution's long-term financial stability.

Match Assets and Liabilities

Like any financial institution, CDFIs must pay attention to maintaining a base of savings deposits, bulk loans and net worth to fund their loans. This is a common principle of banking, but one that is new to many NGOs that enter into the community development finance field. There are two features of liabilities and assets that must be matched. The most obvious is interest rate, as discussed earlier. CDFIs must insure that spread between asset yield (interest on loans) and cost of funds (interest paid on savings and bulk loans) remains constant. Thus if deposit rates adjust over time, the CDFI must take steps to insure that it can vary the interest on a loan to match deposit rate changes.

Adjustable interest rates are generally used by CDFIs that hold long-term loans, like mortgages. Rates are pegged to a fixed margin above a well-known index of cost of funds. For example, Self-Help Credit Union offers mortgages that adjust every year, every 3 years, or every 5 years, and use an index of US Treasury Bills with maturities of 1, 3 or 5 years respectively.. The rates are pegged at anywhere from 4% - 6% over the appropriate Treasury Bill rate depending on risk. Annual changes in interest rates are limited to a maximum of 2% to protect borrowers against severe changes. This method of pricing has allowed Self-Help Credit Union to almost entirely eliminate interest rate risk in its mortgage portfolio. Many borrowers, particularly self-employed borrowers, prefer these adjustable rate mortgages (ARMs) because they tend to have lower initial interest rates than fixed-rate mortgages. Self-Help Credit Union also offers a fixed-rate mortgage that is immediately sold to the secondary market upon origination. Due to standardized secondary market requirements, this product is not nearly as flexible in its underwriting and therefore is not as useful for serving the low-income market.

Perhaps more difficult is matching terms of assets and liabilities. Put simply, short term loans should be funded with liabilities with short terms, and loans with long term maturities should be matched with liabilities that don't have a short term payout. Of course, an institution's net worth has no maturity, thus is ultimately flexible when it comes to lending long- or short-term.

Maturity matching is especially difficult because the real maturity of a loan is often shorter than what is stated in the loan documents. On the other hand, there is often some degree of long-term stability in short-term liabilities. A good example is in home mortgage lending. Banks often fund 15-30 year mortgages with savings deposits, which by definition have a very short maturity (they can be withdrawn on demand or within a year or two). This apparent mismatch is able to continue for two reasons. A 20 year mortgage is almost never held to its full maturity. In the US, it is usually paid off in less than 10 years, because houses sell, people move, and other factors make mortgages pre-pay. In addition, banks have historically been able to maintain some deposit base for years on end. Thus even though specific deposits will be paid out frequently, new deposits are made to take their place. Because of the stability of a deposit base, banks are able to lend long-term against some percentage of their short-term deposits. Banks often will have between 10% to 40% of their deposits loaned in long-term mortgages.

In short, CDFIs should simply learn the tools banks use in their asset and liability management in order to maximize the use of their funds for their constituency. With careful asset/liability management, CDFIs can provide loans with terms much more favorable to the borrower, enabling them to reach lower-income families with their loan products.

IDENTIFICATION OF TARGET MARKETS

CDFIs have some ability to select the constituencies, geographic areas, and types of community development needs they choose to serve. Deliberate attention to these factors can permit the organization to increase or decrease its operating costs. It is important to recognize that **need** for development services does not always translate into a **market** for CDFI lending. Loan programs are limited in their ability to serve community development needs, because they do require repayment. There are many individuals and projects that are in desperate need of assistance, but could never repay a loan. Nonetheless, there are many market niches in which downmarketing can be an effective way of bringing credit to work for community development goals.

Focus On One Development Goal At A Time

Resisting the temptation to require each community development project to include a wide range of development impacts (hire low-income people, locate in distressed area, provide employment training, etc.) is difficult for many CDFIs. In general, the more developmental impact a project has, the more risk is associated with the loan. At some point the CDFI that attempts to "save the world" with each one of its loans will find an unacceptable amount of risk in its loan portfolio, and end up in financial ruin due to non-payment.

The CDFI which I help operate - the Center for Community Self-Help - learned this lesson the hard way. We first began lending to very small businesses, in an effort to provide jobs for poor people. We were intent on ensuring that each loan had a maximum development impact: the businesses we loaned to had to employ poor, unemployed people with low education levels, *and* be located in distressed rural areas. On top of that, these firms were owned and managed by these workers. These small businesses were the ideal embodiment of our organization's mission: to provide jobs and ownership opportunities for economically distressed individuals and communities. Unfortunately, each of these development goals made companies less able to compete with other firms in their market.

Needless to say, each of these firms went out of business within a year or two and defaulted on their loans. At that point, we realized that we would have to de-link our objectives, i.e., to be satisfied that only 1 or 2 objectives would be met with each loan. For example, we began making loans to low-income self-employed persons, but placed no other requirements on the business. We started a rural business loan program that focused on distressed rural areas. Loan programs for ethnic minorities and women were developed. In short, we addressed our targeted constituencies one at a time, rather than simultaneously. If we had not made this strategic change, our organization would not have survived another year.

Market Gaps and Developmental Needs

CDFIs give considerable attention to assessing and reassessing development needs and underserved credit markets. It is clear that a community **need** does not necessarily create a **market** for development loans, and that credit market gaps are not always located in low-income communities. (Corporate financial markets may be as frequently underserved as low-income housing markets.) Development lending only works where development needs and credit gaps exist simultaneously.

CDFIs use different means to identify potential markets for their credit. Most CDFIs start with some macro-economic analysis of regional credit markets. Much of this analysis is available from various university, corporate and government sources. To identify local demand, some groups use detailed studies of specific needs, drawn from secondary data sources and sometimes direct data collection through surveys. These can be very helpful in assessing the volume and nature of aggregate demand in specific markets, but fall short of precise market identification.

Once this material is digested, more targeted studies are sometimes commissioned. More often, the CDFI will use its own knowledge of its low-income borrowers to fashion a program that modifies conventional practices. Then, using trial and error, it modifies the practice, making it safe to offer it as a standard loan product. **Experience is the best informer of effective market demand.** Fortunately CDFIs can learn relatively quickly from their lending experience because payment histories are very good indicators of success. Through continuous monitoring, CDFIs can gauge whether they have found that place where need and market demand meet.

Develop Specialized Knowledge of Borrowers and Community

Conventional lenders often do not have the ability to learn the peculiarities of specific communities and therefore, treat all borrowers and communities as essentially the same. CDFIs, as community-based institutions, develop a much better knowledge of their low-income borrowers and the communities in which live. Better information about local real estate markets, economic conditions, employment patterns, and borrower behavior help ameliorate the perceived risk of community development lending. In addition, specialized knowledge of innovative development schemes (like low-cost house-building techniques, self-help housing efforts and land trusts) adds value to loan transactions, permitting CDFIs to participate in projects than banks shun.

Cross-Subsidizing Through Diversification of Lending Niches

Diversifying the loan portfolio is a standard banking practice that insures that management errors or other factors that negatively affect loan performance do not threaten the viability of the entire operation. Diversification can take many forms. Geographic diversification protects against local economic and political instability. Offering different types of loan products (e.g. home repair loans and mortgages) allows the institution to continue lending if families shift from buying homes to fixing up their existing houses. Sectoral diversification (i.e. lending to various industries) prevents an economic decline in a key lending sector from having a disastrous effect on the CDFI's portfolio performance.

Diversification can also be used to enhance the income of a CDFI, thereby providing additional income to support its more costly community development agenda. Many CDFIs have looked to a strategy of identification of profitable lending markets that are overlooked by conventional lenders. In the US, cooperative businesses are such a niche market. Banks often overlook cooperatives because they don't understand their unusual corporate structure, not because of their inability to repay. A lender that develops expertise in the structure and business of cooperatives can sometimes find a profitable lending niche. There may be other new and growing enterprises with which banks are not familiar that can temporarily be a viable lending niche. Although literature frequently advocates this approach, in practice these niches are very difficult to discover. In fact, apparent market gaps often reflect real difficulties in lending: a lack of local market and management experience in rural businesses; small and rural loans require higher transaction costs for lenders; or shifting economic trends that create temporary credit needs that fill again once economic trends settle down.

Market displacement is another diversification strategy aimed at enhancing income. Here the CDFI is explicitly competing with conventional financial institutions in certain commercial or mortgage markets in order to create a low-risk profitable portfolio that can offset the cost of its development lending. There are two approaches to market displacement lending. One is to originate conventional, non-development loans, thereby maximizing return and minimizing risk without consideration of development targets. Another approach is to participate fully in loans where typically a development lender would make only a higher-risk subordinate loan. In development banking, commercial and larger housing projects are usually financed with combinations of loans involving a fully secured senior bank loan and an unsecured subordinate loan taken by a development lender. If the development lender chooses to originate the entire financial package instead of just the higher-risk subordinate piece, it is able to gain some stable income from the lower-risk senior loan to support the higher cost of the high-risk piece. This strategy has worked well for CDFIs that are willing and able to make larger loans.

TECHNIQUES OF LENDING

Many would think that by now there would be consensus on the common lending practices used by CDFIs, but this is not the case. Since the community development financial industry is so new and diverse there has been little time to test, evaluate and compare the most effective lending techniques commonly employed by the individual institutions. Nevertheless some practices used by Community Development Banks have been consistently successful.

Loan Underwriting Policies

Seasoned CDFIs use the general underwriting techniques that banks have used for years, but usually with a slight deviation. Consistently CDFIs have found the "four Cs of credit" (character, capacity, capital and collateral) to be valuable criteria for making loan decisions, if used with flexibility. Many CDFIs combine these loan criteria with the use of "compensating factors". That is, a loan that is weak in one of the criteria can still be approved if a compensating strength can make up for the weakness. For example, technical assistance can help to compensate for inexperienced management skills. A co-signer or guarantor can compensate for weakness in the capacity of the borrower to make monthly payments. A group savings plan can take the place of conventional collateral in solidarity lending schemes. Determining the earnings history for a self-employed borrower can be used instead of the typical practice of verifying wage income. If foreclosure is not an option (which is sometimes the case in the US), a mortgage insurance pool can be used as a secondary source of repayment.

While it would be convenient to be able to state the one or two magic rules to turn "unbankable" loans into "bankable" loans, there is only one way to learn how to apply flexibility in underwriting standards: through experience. Each CDFI has found its own formula for success after trying several deviations from common practice and having lost several loans in doing so. Of course a knowledge of credit underwriting theory helps, but in reality through experience one must find the right combination of factors for each borrowing segment to judge when to allow flexibility and how far one can stretch loan criteria before loan performance is compromised.

Specialized Knowledge of the Market

One advantage CDFIs have over conventional lenders is their intimate knowledge of the market niches in which they lend. Increasingly banks are becoming more standardized in their practices, particularly as they rely more on secondary market institutions to fund their loans. The more standardization, the less loan officers are able to apply local knowledge and common sense to loan decisions. CDFIs can develop a unique knowledge about their borrowers, both because they are closer to the borrower as a community-based institution and because they have learned often through trial and error where additional flexibility can be used in loan underwriting without adding risk. The Center for Community Self-Help has been making home mortgages to low-income families for ten years using underwriting criteria that banks have not approached even in their most adventurous programs, yet we have yet to lose any money on these loans. Obviously banks and the secondary market institutions are applying more caution than necessary in the application of their standardized rules.

Incremental Lending

One clear way to limit risk is to limit the amount of funds loaned to a borrower. It is often the case that a home buyer seeks to buy a home that is larger or more expensive than necessary, or a businessman wants extra cash from a loan so he doesn't have to come back to the bank again for more funds later. Loan requests can often be reduced without jeopardizing the project, whether it be buying a home or starting a businesses. Smaller loans obviously have small payments, thus increasing the likelihood that the loan will be repaid. In addition, if the loan defaults, losses are less to the lender. Surprisingly, most banks either approve or reject loan requests without trying to size a loan to the borrower's ability to repay. Once again, specialized knowledge of the field in which the CDFI is working helps loan staff add value to the transaction in this manner.

Technical Assistance

All CDFIs provide some degree of technical advice to support their lending operations. The degree to which technical assistance is provided varies considerably, usually depending on whether the organization began as a technical assistance provider or a lender. In all cases, technical assistance services add cost to a lending operation. These costs cannot usually be covered by the spread income, so they must be subsidized from some other source. Most large-scale CDFIs focus their technical assistance on businesses, organizations and individuals that have a high potential for qualifying for a loan, and on existing borrowers. This strategy ensures that their technical assistance will probably lead to some income from an eventual loan. Thus the types of technical services provided are usually those that specifically enhance the ability to qualify for and repay a loan. Housing lenders, for example, will focus on home ownership counseling to help a borrower manage debts and living expenses to make repayment more likely.

CDFIs with many loan products find it impossible to be technically competent in all areas demanded by their clients. For example, a lender that provides a wide range of housing loan products will not be able to manage to provide home ownership counseling, construction management assistance, tenant management services and the host of other services that are necessary to make a housing lending strategy successful. In response to this problem, lenders try to find other providers who specialize in these areas, or they simply limit those to whom they provide their assistance. In the housing field, lenders are not able to master all the technical aspects of the housing process: land acquisition, financial packaging, construction, maintenance and family services. Instead, they will seek NGOs, private companies and other groups who can provide these services, while focusing their technical assistance on loan qualification issues (such as stabilizing income, securing credit enhancements, managing debt payments).

Effective Loan Collections

Most NGOs that begin lending are rudely awakened to the realities of the situation when their borrowers do not pay them back. They find the new task of collecting payments from delinquent borrowers to be unrewarding and offensive. However, a lending organization must carry out its legal right to collections if it wants to have any credibility with future borrowers. Once the practice of non-collection begins, the CDFI gains a reputation as the bank that doesn't have to be repaid.

The most important collection practice is closely monitoring loans when their first payment is late. At this point any problems the borrower is experiencing are probably not too severe to correct. Specialized technical assistance may be helpful to solve a financial problem, or maybe the borrower is inexperienced in the practice of making regular payments and simply needs more frequent reminders and assistance in budgeting. Once the loan becomes three to four payments late it is much more difficult to address these problems. A schedule of visits, phone calls or correspondence must be planned for borrowers who have not paid by certain predetermined dates. For this reason it is imperative that delinquency reporting be immediate and frequent, and be made available to the staff responsible for managing the loan portfolios.

Good delinquency information is also necessary to complete the feedback loop for development program evaluation purposes. It provides the information necessary to determine the success of specific loan products and the impact of changes in underwriting rules or external factors such as economic cycles. The lender must have an accurate and timely system for reporting on loan performance or the institution will not be able to make informed decisions to determine its success in carrying out its basic mission: making loans successfully to the "unbankable".

The actual performance of CDFI loan portfolios is difficult to characterize due to the lack of industry-wide data. Some observations can be made, however, from the segments of the industry in the United States that track these figures. Delinquency levels are slightly higher than conventional banks, as one would expect. Measured by the percentage of the loan portfolio delinquent by more than 30 days, delinquencies are usually in the 2%-8% range, which is close to conventional banks and credit unions. Loan losses (net charge offs) can vary significantly. CDFI charge-offs range from 5% of annual loan balances per year +0.5%. Micro-enterprise funds often have higher delinquency and charge-off rates, while community development banks may have rates at or below bank rates. Self-Help Credit Union, the affiliate of the Center for Community Self-Help, has never had a charge-off on its home mortgage portfolio, having made over $30 million in mortgages in the last 7 years.

DOWNMARKETING HOUSING LENDING

Most CDFIs provide loans for low-income housing. This section describes the aggregate experience of the industry in the United States as it now stands.

Types of Loans

In an effort to improve and increase the housing stock in low-income communities, many different types of loans are offered. The table below summarizes the four main types of housing loans offered by community development banks. Specific terms and conditions differ depending on local market conditions and the practices of a specific CDB.

	Terms	Interest Rates	Downpayment/ Equity Required	Loan/Value Ratio
Land Acquisition & Construction Loans	1-2 years	variable 9% over COF*	20%-30%	50%-60%
Home Improvement Loans	5-15 years	fixed 9% over COF variable 7% over COF	0%-20%	80%-100%
Long-Term Owner-Occupied Mortgages	15-30 years	fixed 4% over COF variable 6% over COF	1%-20%	80%-98%
Long-Term Rental Property Mortgages	15-20 years	variable 8% over COF	5%-30%	70%-90%

*COF = Cost of Funds

Housing-Related Technical Assistance

CDFI's in the United States generally provide home ownership counseling for first-time home buyers. They also package various sources of loans financing for rental housing projects. Development assistance is often provided as well, for example, estimating construction or rehabilitation costs, compliance with building regulations, assessment of innovative building techniques, and supervision of construction. In addition, many CDFIs help renter groups manage their properties. A few CDFIs operate their own subsidiaries whose function is to build housing or manage rental properties. Many of these services are paid through fees are that built into the cost of the project and paid out from the loan proceeds. As much as possible, CDFIs utilize organizations (very often NGOs) established to provide these related housing services, in order to reduce costs and build the capacity of local organizations.

Credit Enhancements

A few CDFIs have become quite nimble at using existing housing credit enhancement programs or creating new ones to support their housing finance efforts. Many use government and private mortgage insurance companies to protect themselves against mortgage losses. Mortgage insurance only provides limited protection however, so lenders are not shielded entirely from losses. In circumstances where there are several mortgage insurance companies and agencies, CDFIs have attempted to negotiate greater amounts of insurance coverage at lower cost, generally using their own specialized experience as evidence that insurance rates are too conservative. By striking more flexible insurance terms, low-income borrowers are more able to obtain affordable mortgages.

Several CDFIs have established their own internal mortgage insurance pools funded with foundation or government contributions. These are small programs and usually only insure one housing loan product offered by the CDFI. However small, they serve as examples to the larger mortgage insurers of how these schemes can be better tailored to the needs of low-income families.

Secondary Mortgage Markets

Secondary mortgage market institutions purchase large quantities of mortgages from banks and housing finance institutions, bundle them into some form of security, and resell them to investors. They have fairly rigid underwriting standards for the mortgages they purchase which are enforced uniformly across all sub-segments of the housing market. As a result secondary markets seldom serve low-income housing markets effectively. Several CDFIs have attempted, on a demonstration basis, to create a viable secondary market for downmarket mortgages. These experiments fashion mortgage underwriting terms that work for low-income families. The are then sold to either secondary market institutions or directly to interested investors, by-passing the mainstream secondary market institutions. It is too early to tell whether these efforts will make a substantial difference in the behavior of the secondary market and create a permanent conduit for downmarket mortgages. If successful, efforts like these can potentially provide a new source of low-income mortgages for millions of families in countries with developed secondary markets.

CONCLUSION

Poor communities have layers upon layers of social and economic difficulties that beset them. Among these problems is the lack of financial capital to improve the lives of their residents and revitalize the economy. Capital, a scare commodity in these communities, can be effectively imported into these communities through Community Development Financial Institutions. CDFIs have proven to be practical and productive agents for the provision of credit and other development services. Created from NGOs, and specializing in the special credit needs of low-income communities, these financial institutions have demonstrated that the poor can indeed repay loans and that poor communities can support viable businesses.

One must keep in mind that CDFIs are not a panacea for the problem of poverty. They are limited by the incomes of their clients simply because they provide credit, and loans must be repaid. CDFIs are generally not effective in addressing the needs of the desperately poor who have no economic means at their disposal. Yet CDFIs have been surprisingly agile in devising financing schemes that meet the needs of a variety of community development projects, from housing development and ownership to large-scale business development. Combining the market discipline of the private sector with the goals of a public agency, these private financial institutions support a broad range of housing and economic development at minimum cost to the public sector.

Community Development Financial Institutions are still evolving. Their products, strategies and management continue to change rapidly as they mature. Whether CDFIs come to be common institutions worldwide, or continue to be isolated experiments, remains to be seen. Regardless, this much is clear: CDFIs have demonstrated that credit can be extended to the "unbankable" in a financially sound manner, which has an extraordinary impact on the revitalization of poor communities.