CHANGING CAPITAL MARKETS AND THEIR IMPLICATIONS FOR COMMUNITY DEVELOPMENT FINANCE

Kirsten Moy
and
Alan Okagaki

A Capital Xchange Journal Article Prepared for

The Brookings Institution
Center on Urban and Metropolitan Policy

Harvard University
Joint Center for Housing Studies

© July 2001

Changing Capital Markets and Their Implications for Community Development Finance

By Kirsten Moy and Alan Okagaki

I. Overview

This paper summarizes research from the Community Development Innovation and Infrastructure Initiative (CDIII)[1], an 18-month project on the future of community development and community development finance.[2] CDIII asked two questions: where does the community development field need to be in order to have impact in the new economic and financial world, and how do we move the industry into this new position? CDIII research included interviews, site visits, and discussion meetings on various topics. All told, the authors received input from over 300 people.

The fundamental conclusion of this research is that economic restructuring, the emergence of telecommunications and information technology, and other national and global trends have dramatically changed the environments in which community development takes place. Capital gaps have changed, capital itself is becoming less "localized," and the financial services industry has evolved entirely new ways to transact business and service customers. These changes have significant implications for Community Development Financial Institutions (CDFIs). The CDFI industry will need to re-engineer, reposition and re-tool itself in order to be viable in the 21st century. In particular, the CDFI industry must critically examine its structure and invest significantly in its supportive infrastructure if it is to be an effective conduit for the flow of capital to low-income communities.

[1] We would like to acknowledge the ARCO, Citicorp, Ford, John D. and Catherine T. MacArthur and Surdna Foundations; J.P. Morgan; and the Neighborhood Reinvestment Corporation for their generous support of CDIII.

[2] CDIII findings are available (from the authors) in 5 PowerPoint Presentations: 1) *Macro-Financial Trends and Their Implications to Community Development Finance*; 2) *Savings and Consumer Services for Low Income Households and Communities*; 3) *Affordable Housing: Systems for Production, Finance and Community Development*; 4) *Telecom & Information Technology: The New Infrastructure for Community Economic Development*; and 5) *Financial Infrastructure: Pathways to the Capital Markets for Communities and CDFIs.*

II. INITIAL CONCEPTIONS

The current CDFI industry began taking shape in the late 1960s and early 1970s. Some of the earliest community development loan funds and venture capital funds were launched by first-generation community development corporations (CDCs) supported by the federal Office of Economic Opportunity "Special Impact Program." Two early examples were the Bedford-Stuyvesant Restoration Corporation ("Bed-Stuy") in Brooklyn and the Kentucky Highlands Investment Corporation (KHIC) in Appalachian Kentucky. Bed-Stuy ran a small business lending program as part of a comprehensive effort to rebuild the economy of that African-American neighborhood.[3] The cornerstone of Bed-Stuy's development strategy was recruiting large businesses into the neighborhood to create employment. But after several years of recruitment yielded only a single business (an IBM plant with 240 jobs), Bed-Stuy turned towards supporting indigenous entrepreneurs. Between 1968 – 1970, Bed-Stuy originated roughly $2 million in loans to 48 local businesses. Loan terms were often very favorable for the entrepreneur, including deferred interest payments for the first four to five years and forgiveness of the loan in exchange for training the "hard-core" unemployed. Those firms were reported to employ 470 Bedford-Stuyvesant residents by the summer of 1970.[4] In addition to this business lending, Bed-Stuy administered a $100 million home mortgage pool contributed by a group of New York City banks. While these mortgages were subject to conventional terms and qualifications requirements, they were explicitly ear-marked for the Bed-Stuy neighborhood at a time when mortgage financing was tight throughout New York City. By late 1970, 466 mortgages had been originated, totaling over $8 million.

In 1968 KHIC began making small grants to capitalize community businesses started by local Community Action Agencies.[5] At that time, creating small, community-based businesses was a popular strategy for reducing poverty. However, KHIC found these community businesses created few jobs; they had difficulty attracting strong management; and while they utilized local resources and skills, they generally lacked competitive advantages necessary to survive in the marketplace. Consequently, KHIC switched to a venture capital model in 1972 targeting firms with greater growth potential (projected sales in excess of $1 million), led by better-skilled entrepreneurs, and capable of overcoming local competitive disadvantages (relatively unskilled labor force, limited transportation, lack of business support services). KHIC favored manufacturing businesses that exported products outside the region over local service businesses that would compete with existing local businesses. KHIC has continued with this model, and now has invested $77 million in 155 businesses.[6]

The development financing programs of Bed-Stuy and KHIC were fairly typical of first generation CDCs. Unfortunately, the total number of CDCs funded under the OEO Special Impact Program was never large; less than 50 CDCs received SIP funds and not all of them were engaged

---

[3] Geoffrey Faux. *CDCs: New Hope for the Inner City.* Report of the Twentieth Century Fund Task Force on Community Development Corporations. New York: The Twentieth Century Fund. 1971. p 72.
[4] *Ibid.*
[5] Kentucky Highlands Investment Corporation. "25 Year Impact Statement." London, Kentucky: Kentucky Highlands Investment Corporation. Undated.
[6] Data from www.khic.org

in financing.

In the late 1970s, a number of new community development finance organizations were formed, capitalized with a broader range of public and philanthropic funds. Many business development loan funds were launched in the 1970s with federal funds from HUD, the Economic Development Administration, or the Department of Agriculture. Community development credit unions and banks were started in the 1970s, such as South Shore Bank in Chicago (1973) and the Santa Cruz Community Credit Union (1977). The Neighborhood Reinvestment Corporation (NRC), a national intermediary that supports local Neighborhood Housing Services offices, was created in 1973 and began financing affordable housing in 1978.

Another strand of early CDFIs consisted of grassroots organizations that recruited much of their capital from socially-minded individuals, churches and local institutions rather than federal agencies. Some examples were the Fund for an Open Society (Philadelphia) which made mortgage loans to promote racially integrated neighborhoods; Koinonia Partners Fund for Humanity (Americus, Georgia), which financed homeownership for very low-income people; the Southern Cooperative Development Fund (Lafayette, LA) financing low-income co-ops; and the revolving loan fund of the Institute for Community Economics (ICE) which financed community land trusts.[7] In the 1980s, Chuck Matthei of ICE helped a number of other community loan funds get started based on a model of local capital to meet local social needs. These loan funds were organized and controlled by local coalitions of potential investors and borrowers, in conjunction with people who possessed relevant technical skills.

Given their diversity in origin and philosophy, broad generalizations about these early CDFIs are dangerous. Nevertheless, many early CDFIs shared several common features.

- <u>Capital Gaps and Disinvestment:</u> Early CDFIs usually conceptualized their mission in terms of capital gaps and financial disinvestments. In the 1960s and 70s, inner city neighborhoods were routinely "red-lined" and racial discriminatory lending practices were common place. CDFIs believed capital gaps materialized when mainstream financial institutions failed to supply capital to minority and lower-income individuals and communities. The flight of capital – financial disinvestment – was thought to exacerbate neighborhood decline.

  > "As structural disinvestment proceeds, several important changes start to occur in the neighborhood economy. Jobs disappear, and with them the income for families whose members held those jobs. … [H]ousing values start to drop, so that even those families who have an investment in a house find that the value of the house is declining faster than their equity is building up. Taxes start to decline, and government is likely to cut back some of the normal maintenance. … Families and

[7] The Institute for Community Economics. *The Community Loan Fund Manual.* Greenfield, Massachusetts: 1987. p 1-13.

individuals who have lost some or all of their income base become dependent upon welfare and unemployment support. … [G]overnment expenditures will continue to rise while the job base erodes and financial institutions divert money out of, rather than into, the community." [8]

- Capitalization and the Parallel System: The early CDFIs received their capitalization from government or philanthropic sources rather than mainstream financial institutions. In fact, many CDFIs did not want a relationship with such institutions. (Bed-Stuy's home mortgage program was a notable exception.) CDFIs often saw themselves as a parallel system to conventional financial institutions, serving a population that was excluded from the mainstream. One can sense the "separateness" of this parallel system from this excerpt from an ICE publication:

  > "The third essential element of community investment is a commitment to an alternative set of democratic, community-based economic institutions that express the sense of local community and that promote social and economic justice through their allocation of equity, earnings and control. Community investment, for instance, channels capital into community-owned and worker-owned businesses rather than into companies owned by absentee shareholders … community land trusts and limited-equity coops rather than into market-rate land and housing projects … "[9]

- Autonomous, Direct Finance Institutions: The early CDFIs were strictly in the business of direct "retail" financing. They were autonomous, vertically integrated and largely self-contained. Lending and portfolio management functions were not out-sourced, and CDFIs did not sell loans on a secondary market. Autonomy and vertical integration were partly a reflection of the financial industry at the time, and partly a function of CDFI values. In choosing to be independent and autonomous, CDFIs were, in effect, imitating the dominant financial institution of the 1960s – the locally owned, locally managed and vertically integrated community bank.[10] Furthermore, many CDFIs believed strongly in local ownership and control, which led them towards retaining all lending and portfolio management functions in-house.

---

[8] Calvin Bradford, et al. "Structural Disinvestment: A Problem in Search of a Policy." *Expanding the Opportunity to Produce: Revitalizing the American Economy through New Enterprise Development.* (Robert Friedman & William Schweke, eds.) Washington, DC: Corporation for Enterprise Development, 1981. p 137.
[9] *Community Loan Fund Manual.* p 1-1.
[10] We are indebted to Clara Miller, Non Profit Finance Fund, for this insight.

III. Industry Changes and their Implications

While the CDFIs of the 1970s were well-adapted to their time, subsequent policy shifts and financial industry restructuring have undermined their early conceptual foundations. Policy changes in the 1970s and 1980s catalyzed the formation of many housing CDFIs, but also brought the industry into a new relationship with the private sector. Prior to the 1980s, the federal government played a dominant role in supporting and creating affordable housing for low-income persons. Federal support for affordable housing contracted during the Reagan administration. Between 1981 and 1989, total federal support for subsidized housing fell more than 70 percent.[11] The single most important program for producing affordable housing (the HUD Section 8 program) was largely dismantled. Meanwhile, the need for affordable housing (the gap between lower-income households needing affordable housing units and the number of such units available) was growing. Between 1978 and 1988, the number of poor renter households receiving no housing assistance grew from 4 million to 5.4 million, a 35 percent increase.[12]

As direct federal funding was reduced, the task of financing affordable housing development fell increasingly on local communities and states. Many communities responded, in part, by organizing CDFIs specializing in affordable housing. By combining various local public and private funding resources, a subsidized, financing "package" could be created that would enable non-profit and for-profit housing developers to reduce rents into the "affordable" range. Two federal policies were critical to these local project finance and subsidy packages. The Community Reinvestment Act (CRA), passed by Congress in 1977, was intended to curb redlining and put regulatory pressure on banks to make more loans in low-income communities. In many areas, this pressure translated into the willingness of banks to provide financing for affordable housing. The other federal policy was the Low-Income Housing Tax Credit, a provision of the 1986 Tax Reform Act, which provides a powerful incentive for corporate investment in low-income housing rental projects.

Over time, local and state-wide affordable housing finance "systems" evolved supporting non-profit (CDCs) and for-profit housing developers.[13] Affordable housing CDFIs became the institutional vehicles for assembling project financing, for underwriting and delivering "gap" financing for housing developments, and for generally organizing and improving local finance systems. For example, the Low-Income Housing Fund in San Francisco, pioneered new financing products and underwriting techniques, and catalyzed bank participation in affordable housing developments. The New Hampshire Community Loan Fund worked with state government to develop new public funding programs and provided training and technical assistance to emerging non-profit housing developers. In Applachian Kentucky, the affordable housing system was largely developed by HEAD, a consortium of church-affiliated non-profit organizations. (That system emphasized home ownership, through subsidized, low-interest mortgages, rather than multi-family rental.)

The proliferation of housing CDFIs was enhanced by the national community development

---

[11]Ford Foundation. *Affordable Housing: The Years Ahead.* New York. 1989.
[12]Diane R. Suchman. *Public/Private Housing Partnerships.* Washington, DC: Urban Land Institute, 1990 p 2.
[13] We acknowledge Daniel Leibsohn for his research and analysis of affordable housing systems.

intermediaries: the Enterprise Foundation, the Local Initiatives Support Corporation (LISC) and the NRC. The national intermediaries articulated a vision of community development centered around community-based non-profits as developers, managers, and financers of affordable housing. They raised hundreds of millions of dollars in grants and loans for community development. They were pioneers in syndicating low-income housing tax credits for corporate investors and were enormously successful in raising investment for affordable housing.

In summary, policy change set the stage for many new CDFIs servicing the affordable housing industry. However, beyond the growth in scale and number of CDFIs, there were several other significant consequences:

- CDFIs were brought into a new relationship with mainstream financial institutions. Banks were no longer simply the perpetrators of disinvestment; they became "partners." The complex financing of affordable housing required participation from many institutions and tended to break down the walls separating CDFIs as a parallel financial system.

- The housing finance systems lent themselves to greater volume and some functional or niche specializations. CDFIs no longer had to fill every financing need in redlined communities. They specialized on certain niches of the financing spectrum while other institutions took complementary niches.

- The interactions between CDFIs, financial institutions and housing developers often brought about innovations, greater sophistication and, generally, higher levels of performance. CDFIs served as connecting points between the mainstream finance world and low-income communities. They brought private sector expertise and resources to focus on community issues and accelerated innovation and learning.

- Over time, the major banks evolved well-established community development lending departments with portfolios concentrated in affordable housing. In the process, many banks took over lending niches that originally had been pioneered by CDFIs. CDFIs found themselves competing against banks with more resources and more cost-efficient systems.

In addition to these policy-induced changes, CDFIs have been profoundly impacted by trends in the financial services world.[14] The most obvious trend has been the wave of mergers and consolidations. Approximately 8,000 bank mergers occurred between 1980 and 1998 involving almost $2.4 trillion in acquired assets.[15] In addition to mergers within the banking industry itself, consolidation occurred across industry lines. Prior to the 1990s, the financial services marketplace was compartmentalized into distinct industries: banks, other depository institutions, securities firms, non-bank finance companies, and investment bankers. Today, the financial services marketplace

---

[14] We are indebted to Steve Davidson, America's Community Bankers, for this analysis.
[15] Stephen A. Rhoades. *Bank Mergers and Banking Structure in the United States, 1980-98.* www.federalreserve.gov/pubs/staffstudies/174/default.htm

has evolved from distinctly defined industries to a financial space without clear industry boundaries. Thus, a CitiBank (banking institution) merges with the Travelers Group (insurance company) and with Smith Barney (securities firm). These mergers have created huge financial institutions that offer banking, insurance, securities, pensions, investment banking, and non-depository lending services under the same "roof." Simultaneously, smaller niche financial companies now offer specialized products at both the high and low ends (e.g., sub-prime lending companies). In the midst of these transitions, traditional depositories have lost considerable market share to mutual funds, securities firms, retirement funds and secondary market entities. Banks, thrifts and credit unions now control only 23 percent of the financial services market (as measured by outstanding financial assets) compared to 55 percent in 1968.[16]

The second major trend has been increased functional specialization and the growth of securitization (secondary markets). Traditionally, conventional depository institutions originated loans, booked the loans, collected interest and principal, serviced their own loans and held loans to maturity. Now, these functions are "broken up" among multiple institutions or sites instead of residing exclusively in a single location. For large banks, functions such as underwriting and servicing are centralized in a small number of locations for greater efficiency. For smaller institutions, a new infrastructure of service businesses has grown so these functions can be "outsourced." The implication is that financial transactions and portfolios are managed with great efficiency by specialized, highly sophisticated institutions.

When CDFIs started, securitization was in its infancy. Now, it accounts for trillions of dollars of transactions. With securitization, loans no longer have to be funded by deposits. They could be originated and sold rather than held to maturity. Mortgage finance companies popularized this technique and opened the way for other specialty finance companies. Using financial "engineering" techniques, almost any pool of assets can be securitized and sold. This has had several implications for CDFIs. First, securitization of low-quality assets has turned sub-prime lending into a big business. Second, with the prevalence of financial engineering, a very high level of financial sophistication has become the norm in the capital market. Third, the combination of functional specialization and securitization have largely made the self-contained, vertically integrated financial institution out-dated.

Finally, technology has profoundly impacted financial services. Loan processing is increasingly automated and transaction costs have been reduced enormously. As transaction costs have gone down, lenders have moved "down market." One banker described the biggest change in the industry was that one could now "fax a piece of paper and get a $5,000 business loan."[17] However, an even more significant change might be the "de-localization" of capital. Telecommunications – instantaneous transmission of data across distances – make managing national and global financial companies possible. Loans and other financial products are available anywhere in the country from national and international corporations. Financial transactions can be

[16] Table calculated from data in Board of Governors of the Federal Reserve System. *Flow of Funds Accounts.*
[17] Participant at CDIII meeting on February 16, 1999, hosted by Federal Reserve Bank of San Francisco.

consummated irrespective of place by phone, machine, card or Internet. Even the poorest community can now access a global financial marketplace.

IV. RETOOLING THE INDUSTRY

If one were to compare the present CDFI industry with the CDFI world of 1980, one would observe the following:[18]

- The number and size of CDFIs have grown enormously. A recent study identified 365 certified CDFIs with an estimated $4.6 billion, minimum, in total assets.[19] These figures probably undercount many institutions that could legitimately be considered CDFIs but had not yet been certified by the federal CDFI Fund. By comparison, the members of the National Association of Community Development Loan Funds in 1987 averaged around $200,000 in size and had raised about $31 million for community development loan projects.[20]

- There are arguably fewer capital gaps now than anytime in the last 30 years. Conventional finance institutions have gone "down-market" and specialized "sub-prime" lenders have emerged. CDFIs are reporting more competition from banks and non-banks lenders in what had been their most dependable lending niches; e.g., business loans too small for a bank to bother with and entrepreneurs with poor credit histories.

- Lending niches are defined less and less by geography. With capital "de-localized," potential CDFI customers can look anywhere – not just local financial institutions – for financing. Previously, these niches could be legitimately described as capital gaps arising from discriminatory practices, disinvestment, and more or less deliberate exclusion from capital markets. Today, that analysis is overly simplistic.

- In an era characterized by transaction efficiency and precise risk management, the primary CDFIs niches tend to be: 1) products with high transaction costs; 2) customers who require a lot of handholding; and 3) capital needs which are relatively far out on the risk spectrum. These niches drive up CDFI expenses at a time when CDFI's funders expect them to be financially self-sufficient.

- The financial needs in today's low-income communities are primarily in equity (note the rise in community development venture capital), personal savings products (note the interest in Individual Development Accounts), and consumer financial services (note the prevalence of check cashing and "pay day" loan services). However, few CDFIs are positioned to do equity investing and few have the infrastructure to service a wide spectrum of savings products, investment products and consumer financial services.

---

[18] This picture of the CDFI industry is based primarily from interviews in the CDIII project.
[19] Brody, Weiser & Burns. *US CDFI Resource Study*. CDFI Fund Presentation June 29, 2000
[20] Neal R. Pierce and Carol F. Steinbach. *Corrective Capitalism: The Rise of America's Community Development Corporations.* Ford Foundation. New York. July 1987. p 83

- In an age when more and more assets are securitized and sold, CDFIs specialize in customized financing and generally hold their loans in portfolio. The conventional finance world has benefited from securitization through: 1) lower funding costs; 2) more liquidity; 3) more efficient use of capital; 4) better asset/liability management; and 5) greater profitability.[21] CDFIs have not similarly benefited.

- The technology gap between CDFIs and the mainstream economy appears to be widening, not narrowing.

- CDFIs remain largely vertically-integrated, self-contained, retail institutions at a time when mainstream institutions have moved away from this model. On the one hand, this structure can help CDFIs maintain closer relationships with clients, and offer them more flexibility and customized products and services. On the other hand, this model results in higher transaction costs, less specialization, and less efficiency.

- Although the CDFI industry has grown in scale and numbers, the industry segments into a small number of "star" institutions and a large number of organizations which are marginal or low-performing by today's standards.

Taken all together, this constitutes a precarious position for the CDFI industry. Ironically, the redlining of the 1970s gave CDFIs protected market niches. Today's CDFI industry is much less separate from mainstream capital markets, but with the exception of a relative handful of high performing institutions, it lacks the sophistication, supporting infrastructure and resources to compete with conventional institutions.

Thus, we believe the fundamental issue for CDFIs is not just growth (as measured by size and number of institutions), but also enhancing core capabilities, niches and positioning vis-à-vis conventional capital markets. The CDFI industry has moved somewhat in this direction by trying to: 1) professionalize itself as an industry with the mainstream financial services industry as a model; 2) copy specific tools and techniques from the mainstream capital markets to access larger amounts of capital; and 3) work cooperatively with mainstream institutions to channel private investment into community development projects. These efforts are manifest in:

- Training programs and conferences sponsored by CDFI industry associations and national intermediaries
- Multiple studies of CDFI "Best Practices"
- Recurring attempts to create secondary markets for retail CDFIs
- Creation of new financial products and services to facilitate more private investment into CDFIs
- Common reporting and database initiatives

[21] Taken from Capital Access Group, LLC. *Securitization: The Secondary Market and Communtiy Development.* (PowerPoint presentation). Arlington, VA. undated.

- Growing use of the Internet for information dissemination
- Attempts by CDFIs to position themselves as investment bankers for the community development field

One can find some successful efforts by CDFIs in these endeavors. There have been numerous attempts by CDFIs to access private funds for their own capitalization. Some receive direct investment of equity and debt from banks, prompted by their CRA obligations. Some of the more established CDFIs such as Coastal Enterprises, Inc., The Reinvestment Fund, Boston Community Capital and Enterprise Corporation of the Delta have attracted private equity investment for community development venture funds. For-profit institutions such as Shorebank Corporation have raised equity through limited private offerings. However, equity investors in CDFIs generally do not receive market-comparable risk-adjusted rates of return that can spark investor interest.

To attract more private sector capital, the National Community Capital Association (NCCA) has designed an equity-like investment product called EQ2 . It has also sponsored attempts to create a ratings system for CDFIs that would capture both financial performance and community development impact. The federal CDFI Fund and several national trade associations have also worked to develop common data bases to provide better information to potential investors.

CDFIs have had some success with secondary market transactions, but the volumes are still small. Neighborhood Housing Services of America (the secondary market arm of the NRC) and the Community Reinvestment Fund (based in Minneapolis) are two of the most experienced secondary market organizations in the CDFI world. CRF has purchased a cumulative $165 million of loans and recently completed a $11.75 million secondary transaction, the largest in its 11 year history.[22] NHSA has purchased or originated about $325 million of loans between 1974-1999 and now averages about $40 million of transactions per year.[23]

CDFIs have had much more experience performing the "bridging" function -- bringing private capital in to support community development projects rather than as investors into CDFIs themselves. Many CDFIs engage in loan packaging, loan brokering or sale of loan participations to mainstream institutions and investors that lack the capacity to find and underwrite community investments themselves. Syndication of Low Income Housing Tax Credits – including those done by national community development intermediaries such as LISC, Enterprise Foundation and Housing Assistance Council (HAC) – is a well-established mechanism for bringing in private capital for affordable housing. Limited partnerships and similar structures have exhibited some success in attracting corporate investors for inner-city real estate development. Finally, the Center for Community Self-Help's Community Advantage™ program purchases nonconforming single-family mortgages from a group of banks nationally and swaps them for Fannie Mae securities, which can easily be sold in the marketplace. Thus far, the program has purchased over 8,000 mortgages, totaling $545 million, in 38 states.[24]

---

[22] From www.crfusa.com
[23] From www.nshofamerica.org
[24] www.self-help.org/community impact

While these efforts are promising, their scale is still minuscule compared to conventional investment markets. We believe these efforts to access capital markets are constrained by several fundamental issues that have not been adequately and forthrightly addressed. These problems are rooted in CDFI industry's structure (which is an artifact of the CDFI's history) and the growing gap between CDFIs and mainstream institutions resulting from the trends identified earlier. They are:

Volume and Standardization

Efficient capital markets are based on large scale exchanges in order to manage transaction costs. Although almost any asset can be packaged and sold by Wall Street, there must be sufficient volume to warrant the effort of the packager and attract interest from investors. At their present scale, individual CDFIs have insufficient loan volume to justify a secondary market transaction. The key to creating larger volume transactions is standardization. Standardization allows loans from multiple originators to be aggregated efficiently and sold as a package. Conversely, the lack of standardization necessitates more staff time and higher transaction costs for financial advisors, brokers and investment managers.

The CDFI industry could take a number of steps to promote standardization. For example,

- Loan documents could be standardized, so they contain consistent and complete information for securitizers and investors.
- Due diligence and origination procedures could be standardized to obtain greater consistency in credit quality.
- Standards could be created for loan servicers to better protect long-term asset quality.
- Licensing and certification procedures could be created for institutions and for individuals that are understood and accepted in the mainstream financial community, not just the CDFI industry.
- CDFIs that meet specified standards could be organized into a network of originators to facilitate timely and efficient aggregation of loans.

The problem with standardization for CDFIs is that it flies in the face of customization, and more broadly, the CDFI model of autonomous, self-contained, vertically-integrated, institutions. This industry structure, combined with the value most CDFIs place on their "localness," mitigates against standardization or outsourcing specialized functions. One could argue that CDFIs have overemphasized customization, as it does not always lead to greater added value. Undoubtedly, some commonly-demanded products and services could be standardized sufficiently to be offered by multiple organizations. If even a third or a half of a CDFI's volume were "commoditized" products, scale and cost-efficiencies could be significant.

Technical Sophistication and Scale Efficiencies

In order to access conventional capital markets, most CDFIs need a much higher level of

financial sophistication. Sophistication is normally a function of specialization. It is very difficult for "generalist" institutions (wide range of products to a wide range of customers and performing support functions in-house) to be highly sophisticated unless they are very large, the Citigroups of the world. Smaller institutions, such as CDFIs, generally must find smaller niches where they have true competitive advantage and, thus, can gain sophistication through specialization.

Specialization can be developed with respect to products themselves or to the functions necessary to support those products. Like mainstream financial institutions, CDFIs do not have to "make" every product they sell. Any small bank can offer a credit card product, bearing its name, but which is designed, underwritten, supported and serviced by a larger, outside institution. Small credit unions can contract with "CUSOs" (credit union support organizations) which carry out functions beyond the scope of a smaller institution. Thus, a small credit union can "sell" a home mortgage product, but the underwriting, closing and loan servicing functions are handled by the CUSO. Consequently, these smaller institutions can concentrate on knowing their customers, selling appropriate products, and maintaining their customer relationships.

Selling products serviced by others is just one example of functions that can be done more efficiently through outsourcing. One can envision a new infrastructure of business services that carry out functions too difficult, too expensive, or too arcane for a single CDFI to do on its own. Some functions could be executed efficiently through collaboration among CDFIs or through alliances with mainstream financial institutions or technology companies. An obvious example is new product research and design, which is often prohibitively expensive but could benefit many CDFIs across the country. Other examples are:

- Marketing, advertising and outreach campaigns
- Electronic or shared underwriting
- Loan servicing
- Warehousing of loans
- Financial engineering
- Insuring or providing credit enhancement
- Common training to develop entrepreneurs
- Shared facilities (physical as well as electronic)
- Group "buying" of products or services from mainstream financial institutions or technology companies.

Greater Conformity with Capital Markets

Many CDFI financial instruments, procedures and informational reports do not resemble their analogues in the conventional investment world. This lack of conformity inhibits CDFIs from penetrating the network of conventional capital market institutions: investment bankers, brokers, traders, salespersons, investment advisors, institutional investors, research firms, and ratings agencies. As a result, potential investors usually cannot learn about or purchase CDFI financial instruments through conventional sales and information channels. The best examples of CDFI

financing instruments being sold and serviced through conventional channels are still concentrated in affordable housing. Low Income Housing Tax Credit products are commonly held by certain institutional investors such as utilities and insurance companies. Investment advisory firms such as Seix Advisors and LendLease have created affordable housing investment products for pension funds.

Lack of adequate performance data and objective third-party information on CDFIs is another issue for potential investors. Investors and their advisors are used to getting extensive information quickly and easily. They have certain expectations concerning the format, completeness, and timeliness of investment performance data. Even the most sophisticated CDFIs are often hard-pressed to respond to investor information requests quickly and completely. In addition, certain types of information (e.g., community impact) are not easily calculated, nor have terminology, definitions, and protocols for capturing and analyzing data been standardized. This standardization allows investors to make comparisons between investment options in the manner to which they are accustomed.

Although the CDFI industry is cognizant of these issues, its response has been to create its own parallel products, systems and services rather than to build off existing capital market structures. Thus, the CDFI industry seeks to conduct its own secondary market transactions, design its own ratings systems and build its own databases. Alternatively, the CDFI industry could incorporate its loans within mainstream secondary market transactions, rather than pooling and selling its loans separately. The National Co-op Bank took this approach and sold a pool of loans to low-income housing co-ops as part of a larger securitization of loans. Similarly, rather than creating its own ratings systems, the CDFI industry could attempt to more actively engage the existing rating agencies. In 1999, Neighborhood Housing Services of America took this approach and obtained an "AA" rating from Standard and Poors for a $75 million issue of non-conventional, affordable residential mortgages. But the NCB and NHSA examples are the exception rather than the rule.

To some extent, the Socially Responsible Investment (SRI) community is functioning as a bridge between mainstream capital markets and CDFIs. Franklin Research and Development (today known as Trillium), Loring Wolcott, and U.S. Trust were among the first to provide advisory services in Community Investments to their clients. Mutual fund managers such as Calvert and Parnassus have placed small amounts of Community Investments in their mutual fund portfolios. In 1995, the Calvert Social Investment Foundation launched a new product whereby a client can purchase a Community Investment Note of at least $1,000 and choose an interest rate between 0 percent and 4 percent, the proceeds of which are re-invested in CDFIs. Last year, Domini Social Investments launched the Domini Social Bond Fund, a socially and environmentally screened debt fund with a 10 percent allocation for community development investments. All of these examples help make investing in CDFIs a part of the mainstream financial world.

Technology

The improvements in scale, sophistication, standards and general conformity to the capital

markets are only possible with great improvements in information and communications technology. While modern financial institutions rely on sophisticated technology platforms, CDFIs by and large have been unable to keep abreast with standard technology. Technology is the key to greater volume, lower costs, efficient delivery of new products and services, and ultimately, greater effectiveness. Technology can strengthen accounting, communications, internal controls, internal systems and procedures, marketing, underwriting, closing, portfolio management, and servicing outside investors. Technology has become a learning tool; databases are rigorously and statistically analyzed so lenders better understand their customers. Finally, CDFIs without up-to-date telecommunications infrastructure will find it increasingly difficult to do business effectively with their mainstream "wired" counterparts. Telecommunication of data is becoming as basic to transacting business in the financial services world as the telephone.

V. CONCLUSION

As CDFIs move forward, three overarching points stand out. First, the issues of industry structure remain. The CDFI industry remains today a group of small, geographically based, autonomous, vertically-integrated institutions generating small volumes of customized products for local markets. In other words, they are like the community banks of 30 –40 years ago. But whereas the mainstream financial world has changed enormously over those years, CDFIs by and large have not. As a result, the gulf between CDFIs and mainstream capital institutions continues to grow in terms of size, sophistication, the range of financing tools and instruments, use of technology, and the degree and complexity of the supporting infrastructure. Even though CDFIs have grown larger, their mainstream financial counterparts have grown even faster. As one CDFI practitioner observed, "We used to be small, now we're microscopic." Because their structure envisions each organization performing all functions in house, it is far more difficult for relatively small CDFIs organizations to develop top-level, specialized expertise across all functions. As a result, there are only a very small number of top tier organizations.

Second, today's retail financial institutions are supported by a highly developed infrastructure. This infrastructure is partly institutional – investment bankers, brokers, traders, salespersons, investment advisors, institutional investors, research firms, ratings agencies, and other industry-wide resources. Part of this infrastructure is the technology platform that facilitates rapid exchange of information and makes quick transactions possible. Part of the infrastructure lies in standardized documents, procedures, protocols, methodologies, investment vehicles and products. Together, this infrastructure enables financial institutions to match users of capital with suppliers of capital accurately, quickly and efficiently.

By comparison, financial infrastructure in the CDFI industry is grossly underdeveloped. Partly, this is a function of industry structure; autonomous, vertically-integrated CDFIs rely less on external supporting infrastructure. More fundamentally, the language of "creating infrastructure" is relatively foreign to the non-profit world. The private sector talks about roll-out and infrastructure, while the non-profit sector talks about model-testing, best practice, and replication. "Replication" assumes that the merits of new innovations will be self-evident and that individuals, organizations or communities in one location will in isolation copy the innovation discovered or initiated in another situation. By contrast, "roll-out" assumes that widespread change must be actively fostered through appropriate incentives, systems and the supporting infrastructure to facilitate and institutionalize the change. The CDFI industry has many "best practices" but far fewer generally-accepted standards, protocols, methodologies, or technology applications, all of which would support and in turn be supported by appropriate infrastructure. Development of new infrastructure is the codification of new ideas into widely available systems, products and services. Without the development of supporting infrastructure, lasting change does not occur. The existence of infrastructure is a benchmark of wide-spread implementation of an idea. Without enabling infrastructure, promising demonstrations remain as nothing more than a series of "one-offs."

Finally, CDFIs need to innovate in conjunction with the mainstream financial industry, not in

isolation. There are several new initiatives to promote innovation that do connect the CDFI industry with private capital institutions. The Capital Markets Access Program (CMA), housed within the New School University's Robert J. Milano Graduate School of Management and Urban Policy, is a technical assistance initiative to help nonprofit organizations bridge the gap to capital markets. CMA is developing new debt instruments to facilitate sale of assets commonly held by CDFIs to mainstream investors, including: mortgage loans for low/moderate-income housing; small business loans; microenterprise loans; commercial real estate financing in brownfield areas; and receivables loans. The goal of the Financial Innovations Roundtable (FIR), hosted by the School of Community Economic Development (CED) at Southern New Hampshire University, is to promote innovation in community development financial institutions and instruments across the country. The FIR brings together community development finance practitioners to exchange ideas with the financial services leaders that have helped bring scale, efficiency, innovation and reasonable pricing to the field. The Milken Institute's Emerging Domestic Markets (EDM) project describes itself as a "market-directed public policy initiative that seeks to link the engine of modern corporate finance and capital markets to the unmet needs of traditionally disenfranchised entrepreneurs." The Institute facilitates financial innovation, originates demonstration projects, serves as a clearinghouse for research and information dissemination, and convenes leading thinkers in the field.

In sum, it is difficult to underestimate the significance of the changes that have swept the financial services industry over the last 30 years. While the community development finance industry is rightly concerned with increasing scale and impact, fundamental questions of industry structure, supportive infrastructure, and specialization have generally not been part of the debate. Industry re-tooling along these lines should be explored as an alternative to the more incremental approaches (e.g., demonstration and replication of best practices) more commonly proposed to build the field.