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# Scaling Community Development Finance: Examining Traditional and Innovative Methods

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# Scaling Community Development Finance: Examining Traditional and Innovative Methods

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# Abstract

## Scaling Community Development Finance: Examining Traditional and Innovative Methods

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Community Development Finance refers to the vast array of financial services and products created and delivered specifically to those individuals and groups that are not being served by traditional financial institutions. While this is not a new field, with some Community Development organizations in existence for decades, it is certainly an evolving one. There is a wide variety of products and models for this type of work, catering to the myriad needs of different communities. However, almost by nature, these individual organizations remain highly localized and operate on small scales of economic development.

This report examines three major types of community development financing, spanning the public and private sector, as well as traditional and evolving products. The models examined will be Community Development Finance Institutions, New Markets Tax Credits and Social Impact Investing. A thorough description of each type of financing will be followed by an analysis of its strengths and weaknesses. Once the merits and challenges of each model are identified, this report will examine different methods of scale, highlighting the adaptability to each model.

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# INTRODUCTION

Access to responsible and affordable capital to individuals is a lynchpin of long-term community sustainability. Basic financial services, such as Checking and Savings accounts or access to credit, provide the infrastructure for much of an individual's and community's development, providing a means of savings, continuing education, homeownership, retirement, property development and rehabilitation, to name a few. Those communities that lack this critical access often find themselves struggling to maintain their neighborhoods, businesses, homes and people. The creation of economic opportunities empowers populations that often feel underserved by traditional financial institutions. Though once a niche product, responsible alternative financial services have experienced tremendous growth in scope, variety and feasibility, exposing low-income neighborhoods as places of great potential. This report presents an examination and analysis of several different models in order to better understand this evolving industry.

For decades now, the community development finance field, specifically Community Supported Loan Funds (CSLF) and Community Development Financial Institutions (CDFI), has relied on limited government and individual funding to support the great needs of underserved communities. Despite funding challenges, this industry has evolved and matured to become a widely recognized mechanism towards economic stability for low-income communities, injecting much needed responsible capital into these communities. The field of community development lending has grown and developed into an industry with billions of dollars of transactions annually.

These established funds have taken different forms, utilizing both traditional and non-traditional financing mechanisms to grow wealth. Some funds operate strictly by and for the community in which they exist; others rely on federal grant monies. Despite the progress made over 40 years, the industry still faces great challenges.

One of, if not the, biggest obstacle to deep paradigm shifts in community development financing is scale of operations. That is to say, these products often have high-quality impact on small groups of individuals, but have trouble increasing the quantity of individuals served in a meaningful way. In any industry, going to scale requires substantial capitalization and significant investment in infrastructure and technology. According to Mark Pinksy, president and CEO of National Community Capital Association as well as Opportunity Finance Network (the national membership-based CDFI organization), the [current] community development industry has neither a system to meet the demand nor the power to significantly influence policies that affect its constituents.[1] He argues that to be sustainable, CDFIs must expand their sources of capital and change how they use it.[2] While it is true that the nature of this non-traditional lending and financing requires a "high touch", relationship based approach that is often difficult to scale, there are certainly aspects of this industry that could be improved in order to generate greater social impact. These include increased access to institutional investors and their capital,

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[1] Reeves, Monica, Editor. Community Development Finance." "*Perspectives: Banking and Community Perspectives, Federal Reserve Bank of Dallas,* 2005. Accessed February 2013. http://www.dallasfed.org/assets/documents/cd/bcp/2005/bcp0501.pdf

[2] ibid

which in turn can help stimulate greater process efficiencies, sophisticated data warehousing or even higher paid staff.

This report examines three major types of community development financing, spanning the public and private sector, as well as traditional and evolving products. A thorough description of each type of financing will be followed by an analysis of its strengths and weaknesses. Once the merits and opportunities are identified, the report will address the following question: Under which circumstances is each of these financing models best utilized? That is to say, which model works best for which communities and why? Through simplifying comparison and analysis, this report may serve as a reference for individuals, neighborhoods or practitioners who are exploring news means of community development.

This examination begins with an analysis of Community Supported Loan Funds, Community Development Financial Institutions, and a discussion of secondary markets for community loans. Once examination of traditional community development models is complete, two emerging models of injecting capital into underserved communities will be examined, one regulated and administered by the public sector, the other by the private sector – The New Markets Tax Credit Program and Social Impact Investing. Neither of these mechanisms is new, nor fully developed, which makes them interesting case studies. While both models may share a fluid sense of development, they employ different financial, political and social tools to accomplish community development. However, unlike the more traditional mechanisms, these two new models have the capacity and potential to scale and

expand the ways in which underserved communities access financing. The origins, mechanisms and evolutions of each of models the will be analyzed independently, and also contrasted to the others.

As is true for any type of "capital" growth (whether social, cultural or financial), each community has different needs, strengths and resources. As fund diversity grows, there is reason to believe that any community seeking sustainable economic development should be able to find the model that works best for them, as well as be given the opportunity to scale the positive social impact that results from effective and well-organized community development finance.

# ESTABLISHED COMMUNITY DEVELOPMENT FINANCE MODELS

## Community Supported And Managed Loan Funds

Because CDFIs adhere to mandated federal guidelines and reporting standards, there structure and organization is considered rather formalized. However, other loan funds exist with similar, or identical, missions and visions that operate under less formal regulation. These funds, Community Supported and/or Community Managed Loan Funds ("CMLF") can take a variety of forms and sizes and serve a variety of demographics.

CMLFs are most often found in areas that CDFIs or certified MFIs do not, or cannot serve (e.g.. rural areas, conflict zones or urban neighborhoods of extreme poverty)[3]. Typically group members manage CMLFs, requiring significantly less "professionalization" than one can find at CDFIs. Lending, administration and collection guidelines are often self-determined. The Consultative Group to Assist the Poor ("CGAP") has identified three types of models within which CMLFs can fit highlighted below[4]

- Externally Funded –
  - External funding sources are used to initially create loan pool. Individual donors, foundations or governments are all potential funders.

- Savings Based –
  - Members' own savings finance the creation of loan funds. There is little to no external funding.

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[3] Jessica Murray and Richard Rosenberg, "Focus Note - Community Managed Loan Funds: Which Ones Work?", May 2006. Accessed February 2012. http://www.cgap.org/gm/document-1.9.2577/FN36.pdf

[4] Jessica Murray, "Supporting Community Managed Loan Funds", May 2006. Accessed April 2012 http://www.cgap.org/gm/document-1.9.2736/br_supporting_community_managed_loan_funds.pdf

- Self-help Groups (or Hybrids) –
    - Include both external and savings-based funding. Typical models begin with members' savings, and after successful operations these funds are leveraged to acquire larger loans from commercial banks and grow the fund.

**EXTERNALLY FUNDED**

These funding distinctions play out in several different ways, in term of management and operations, most obviously in who creates and administers terms and structure. Externally funded groups must adhere to the standards and requirements established by the funder. This reporting is often cumbersome and rigorous, almost always requiring "professionalized" staff. Thus creates a self-perpetuating (and somewhat ironic) cycle of increased costs and external funding. Although there is some possibility of scale here, if the relationship between the fund and the funder is managed well, typically this more institutionalized cost structure prohibits success in communities where loan size and term limits are unconventional. CMLFs and their corresponding cost structure allows for transaction sizes below what is feasible in more formal institutions.[5]

In addition to misaligned cost structures, externally funded CMLFs face the challenge of the communities psychology. As previously mentioned, CMLFs operate in communities that are often isolated and disenfranchised. "Outside" money (sometimes called "cold" money) is often treated with a sense of distance – there is little to no real repercussion for default (For two reasons: 1. Financing is rarely asset-

[5] Jessica Murray and Richard Rosenberg, "Focus Note - Community Managed Loan Funds: Which Ones Work?", May 2006. Accessed February 2012. http://www.cgap.org/gm/document-1.9.2577/FN36.pdf

based, so no collateral is at risk, and 2. If the funding disappears, the community feels it will be no worse condition than it was previously). A CMLF member's main motivation to join the organization is the desire to access external funds.[6] For these reasons, it has been observed that externally funded CMLFs have a tendency to fail – CGAP studied 20 of these types of funds and found only one to be successful (a 5% success rate).[7]

**INTERNALLY FUNDED, SAVINGS BASED AND HYBRIDS**

Savings based and Self-help (or hybrid) models tend to be more viable than externally funded CMLFs.[8] As one might suspect, when one's personal money, along with that of one's neighbors, forms the entirety of the loan pool, both trust and personal accountability is strengthened. Actually, arguably more important than what is created, it is what is destroyed that appears to make a significant difference – that is the boundary between borrower and lender. A common form of savings-based CMLF is the "Rotating Credit and Savings Association" or ROSCAs.[9] As with most member-funded lending, ROSCAs require a high level of trust, as there is typically no hard collateral required to access the funds, but a low level of administration and financial literacy (members arrive at each meeting with an agreed upon amount of money, which is fully distributed to a chosen member). ROSCAs can take two forms, *random ROSCAs or bidding ROSCAs.* Random ROSCAs select a new member to

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[6] ibid
[7] ibid
[8] ibid
[9] ibid

whom the entirety of the funds is distributed, with a new borrower each week until all members have taken a loan. In bidding ROSCAs, the receiving member "bids" for the funds (all members receive the pot once, however priority is established in this system).[10] "Savings" takes the form of systematic contributions to a communal pot that to which a member will one day have access. This form of low-income financing requires unique community relationships, as high levels of trust must be coupled with healthy and supportive peer pressure in order to avoid social castigation or worse, socially pressured suicides. Perhaps it is because of this particular set of circumstances that most ROSCAs are either found in the developing world, or, when located in the U.S., are especially common in immigrant communities.[11]

The other primary type of savings-based CMLF is referred to as an "Accumulating Savings and Credit Association" or ASCA, whose main difference from ROSCAs is that not all the money collected at each meeting is distributed, thereby creating personal savings mechanisms outside of the group-savings loans. Due to the depository nature of ASCAs, more technical and administrative capacity is required. This provides an opportunity for donors or volunteers to play an important non-financial role in training and service provision.

As the name suggests, Self-help, or Hybrid CMLFs, combine aspects from both of these models. Groups seeking this structure have two options. The first

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[10] Timothy Besley, Stephen Coate and Glenn Loury, "Rotating Savings and Credit Organizations, Credit Markets and Efficieny", October 1994. Accessed April 2012. http://sws1.bu.edu/gloury/papers/Besley,%20Coate%20and%20Loury%20(RES)%201994.pdf.

[11] Michael S. Barr and Rebecca Blank, Insufficient funds - savings, assets, credit, and banking among low-income households (New York: Russell Sage Foundation, 2009), 174.

option is to create the loan fund using both internal and external funding. The other, typically more viable option is to initiate the fund using only internal (members' savings) funding. Once ability to pay has been established, or members' financing needs outweigh internal resources (or both), the CMLF can seek external funding. This model works to link members with traditional capital that once was out of reach.[12] Once social capital and administrative capacity is demonstrated (Stage 1), financial institutions can be engaged to further increase a community's access to credit and other financial services. While this external capital can come from an injection from a donor organization, a longer-term option is for the CMLF to establish its own relationship with a formal lending institution, so as to maintain the sense of ownership and responsibility cultivated from Stage 1 of this model.[13] If a Hybrid CMLF has the ability to successfully operate this model and properly utilize both internal and external resources, its success will be both sustainable and of a larger scope than a simple Savings-based CMLF.

There are advantages and disadvantages to CMLFs and its varying forms. Generally speaking, these types of financing mechanisms are reserved for communities with slim to no access to formalized institutions (whether they are financial, or in the case of CDFIs, governmental). This ability to reach highly impoverished, often very rural communities is a primary benefit of CMLFs.[14] That is,

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[12] Jessica Murray and Richard Rosenberg, "Focus Note - Community Managed Loan Funds: Which Ones Work?", May 2006. Accessed February 2012. http://www.cgap.org/gm/document-1.9.2577/FN36.pdf.

[13] ibid

[14] Jessica Murray, "Supporting Community Managed Loan Funds", May 2006. Accessed April 2012. http://www.cgap.org/gm/document-1.9.2736/br_supporting_community_managed_loan_funds.pdf.

if a community is internally motivated and bonded and lacks access to traditional financing, they need not give up, but rather self-organize and realize that external capital injections are not their only option. Secondly, CMLFs offer flexibility that financial institutions and even donor organizations cannot.[15] Repayment and Use-of-Loan terms can be negotiated with members who are likely aware of an individual's personal situation. Thirdly, because of the lack of regulations typical of CMLFs, informal savings and deposit accounts can be established for members.[16] These accounts (perhaps voluntary) may be the first small step towards asset-building for many CMLF members. Taking a step further, CMLFs may also act as a launch pad for other types of community development, as trust and ability and commitment to organize have been established.

While informality and lack of regulation can, at times, serve as an advantage of this model, it can also hinder sustainable growth. Regardless of model, all financing mechanisms require organized record keeping in order to survive. Yet, given the populations most often served by CMLF type organizations, this administrative capacity is typically lacking.[17] This can cause problems internally (accurate records of account amounts, repayment schedules, etc) and externally (hinder future ability to establish relationships with formal financial institutions). Also, external funding can be unpredictable and distortive.[18] Reliance on distant or

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[15] ibid
[16] ibid
[17] ibid
[18] ibid

disconnected funding sources often skews a community's true capabilities and weaknesses, making financial growth and stability volatile.

In conclusion, CMLFs can serve disenfranchised communities advantageously, when implemented correctly. As a first step towards financial opportunity, small, self-funded and constrained loans seem to be most effective for isolated communities, and while some may think that these communities need large capital injections for development and rebuilding, slow and steady tend to win this race.

## Community Development Financial Institutions

Community Development Financial Institutions (CDFIs) are perhaps the most well known mechanisms for financing low-income communities. A discussion of their political and regulatory history, the different types and an analysis of their benefits and challenges follows. Understanding the background of the CDFI Fund and industry will contextualize the product and clarify which communities it was originally intended to serve.

### HISTORY

Not all CDFIs are the same, rather they encompass a wide variety of organizations including Community Development Credit Unions (CDCU), Community Development Corporations (CDC), Community Development Loan Funds (CDLF) and Community Development Venture Capital Funds (CDVC). Although these CDFIs are subject to different types of government regulations, no

CDFIs can rely on federally insured deposits for their capital.[19] Again, the relevant regulatory framework varies among the types of funds, and CDLFs and CDVCs have the ability to take more risk and potentially be more innovative as they are not subject to federally mandated rules and audits. The history of the latter two funds will be discussed in more detail below.

The CDFI Fund was established as part of the Riegle Community Development and Regulatory Improvement Act (a bipartisan initiative) in 1994, under the Clinton Administration and is housed within the Department of Treasury. The Fund was "created for the purpose of promoting economic revitalization and community development through investment in and assistance to community development financial institutions."[20] CDFIs primarily fund businesses, housing and real estate developers and nonprofit community groups with the objective of furthering economic development of distressed communities through quality job and infrastructure creation.[21]

Although, in practice, CDFIs began emerging in the late 1960s and early 1970s through early community development corporations, the creation of this fund provided not only a critical source of equity for these institutions, but important political support through legislative mandate. Coupled with this political and financial support came certain federal regulations to which these funds had to adhere.

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[19] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 123.
[20] "Community Development Financial Institutions Fund: About the CDFI Fund", last updated August 2011. Accessed April 2012. http://www.cdfifund.gov/who_we_are/about_us.asp.
[21] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 123.

The size of CDFIs varies greatly, including portfolios ranging from tens of millions of dollars to several hundred thousand. Larger organizations have substantially less administrative burden in terms of adhering to reporting requirements, relative to their smaller counterparts.

Although the CDFI Fund was born under bipartisan support, the actual funding levels are products of political persuasion. During the last year of the Clinton Administration, the Fund held $118 million and then witnessed a steady decline, with a low of $29 million in 2008 during the last year of the Bush Administration.[22] In the post-recession economy faced by President Obama, which included revitalized public support of small business and community recovery, the CDFI Fund enjoyed a significant increase to $247 million in FY 2010.[23] The volatility of such a critical funding source is a primary concern for CDFIs, who have had to seek and pursue alternative and diversified funding. Like most other nonprofit organizations, CDFIs do rely on foundations for support, though often to a lesser extent than traditional nonprofits. Several national foundations serve as important sources of capital for CDFIs, in both operating support and equity dollars.[24] CDFIs are in a unique position among nonprofits to have access to large loans from private banks at below-market value, primarily through "CRA Credits".

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[22] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 135
[23] "Opportunity Finance Network Newsletter", February 2011. Accessed April 2012. http://www.opportunityfinance.net/newsletter/feb11.html
[24] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 138

The Community Reinvestment Act (CRA) was established in 1977 and provides impetus for regulated financial institutions to promote banking services to all members of a community, prohibits redlining and increases efforts to meet the credit needs of residents in low- and moderate-income neighborhoods.[25] While good in theory, for decades the CRA suffered from poor oversight and lack of real enforceability. However in 1995, despite significant opposition, the CRA was strengthened to include specific performance measures that could ultimately affect a banks ability to merge or acquire, as well as expressly recognize CDFIs as qualifying for CRA investments.[26] This amendment allowed banks to maintain their traditional lending practices and give a one-time loan to fulfill their CRA requirement.

**INDUSTRY STATISTICS**

As of 2009, there were close to 1300 CDFIs operating in the US, including more than 500 CDLFs, 80 CDVCs, and the remaining combination of community development banks and credit unions.[27] The true strength of these institutions was proven as the national and international economy plunged during the economic recession of 2008. While banks and financial institutions of all sizes faced collapse or near collapse, CDFIs remained stable and solvent, and in many cases held common lending metrics stronger than traditional financial institutions. A survey conducted by the Opportunity Finance Network (the nationally recognized membership

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[25] Office of the Comptroller of the Currency, "Community Reinvestment Act (CRA)", no date. Accessed April 2012. http://www.occ.treas.gov/topics/compliance-bsa/cra/index-cra.html.

[26] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 132

[27] "Opportunity Finance Network: Industry Statistics", no date. Accessed April 2012. http://www.opportunityfinance.net/industry/default.aspx?id=234.

organization of CDFIs around the country) of 148 CDFIs revealed membership's 90+ day delinquency rate stood at 5.3% at fiscal year end, the net charge-off rate in FY 2009 was 1.6% and while this was up from 0.9% in FY 2008, it was substantially lower than the FDIC-insured institutions at that time.[28]

**COMMUNITY DEVELOPMENT LOAN FUNDS (CDLFS)**

CDLFs are the most common type of CDFI and lend capital primarily to businesses, nonprofits and real estate developers that create low-income housing, jobs, and economic opportunity, especially for women and minorities. As of 2005, there were approximately 500 CDLFs in the US with more than $3.5 billion in assets.[29] As previously mentioned however, their sizes vary – in 2005 the five largest CDLFs accounted for 52% of total loan fund capital – and most CDLFs are relatively small with median capital of $8.9 million.[30] CDLFs use grants and the below market loans, then re-lend this capital, typically at rates slightly above market to account for the increased risk of their clients and use the difference to help finance their operations.[31] Traditionally these loan funds extended credit for business and housing needs, however, CDLFs are beginning to diversify their product offerings to encompass a broader set of traditional community development goals. Construction loans for community centers such as childcare facilities, charter schools, arts organizations and social service agencies (in amounts that can be double or triple

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[28] "Opportunity Finance Network: Inside the Membership", no date. Accessed April 2012. http://www.opportunityfinance.net/store/downloads/insideTheMembership.pdf.
[29] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 124
[30] ibid, 24
[31] ibid, 24

typical loan limits), as well as forays into personal mortgages are just some of the new products being developed.[32] These products require flexibility and innovation as well as strategic partnerships and are creating exciting new models. However, the reality is, that many products that meet the specific financing needs of low-income communities come with prohibitive administration and risk costs. Consequently, in order to provide certain new services, especially in the arena of personal lending, costs must be heavily subsidized. However, rather than funding lending directly, foundations and financial institutions are increasingly providing capital specifically for loan loss reserves. Loan loss reserves act like insurance for lenders and can be leveraged by CDLFs to loan at higher levels than would have been possible with direct funding.

**COMMUNITY DEVELOPMENT VENTURE CAPITAL FUNDS (CDVC)**

While CDLFs support their clients through debt investments (in the form of loans), CDVCs make investments of equity, specifically to small businesses in underserved markets. These equity investments are given in exchange for partial ownership of the company, often in the form of preferred or common stock. Equity capital is often referred to as "patient capital", "giving young firms the funds they need in their early years without requiring the immediate repayment of those funds, as is the case with most loans".[33] CDVCs invest in companies in a variety of industries and at different stages of development, from seed to expansion, unlike most

[32] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 125
[33] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 128

traditional venture capital funds that tend to specialize by stage or industry. Utilizing a number of legal structures, from for-profit corporations to not-for-profits to limited liability companies, CDVC funds are mission-driven organizations that benefit low-income communities by creating quality jobs, increasing financial capacity and working to earn solid financial returns.[34] Dual-bottom lines allow for this flexibility. CDVCs tend to have higher operating expenses than traditional VCs because they often provide their portfolio companies with technical assistance – in order to meet the requirements of their social objectives, CDVCs invest in clients that may have less management or operating experience.[35]

Unlike loan funds, all venture capital funds must exit their investment to both realize a profit as well as free up capital for new investments. Exits are more complicated for CDVCs than traditional VCs and in general, CDVCs tend to hold their investments longer than traditional venture VCs, tying up capital and management time and limiting financial returns.[36] A primary reason for more complicated exits is the unwillingness of many CDVC fund managers to force an exit that would be detrimental to their social objectives of high-quality job creation for low- and moderate-income individuals and economic development for rural geographies.[37]

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[34] "Community Development Venture Capital Alliance: CDVC Funds", copyright 2012. Accessed March 2012.. http://www.cdvca.org/index.php?option=com_content&view=article&id=52&Itemid=58.

[35] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 129

[36] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 130

[37] Julia Sass Rubin, "Financing Rural Innovation with Community Development Venture Capital: Models, Options and Obstacles, December 2006. Accessed April 2012. http://www.frbsf.org/publications/community/review/122006/rubin.pdf.

In terms of funding, much like other community development organizations, CDVCs rely on a variety of sources. Financial institutions, in large part thanks to CRA, can account for 40 – 90% of a CDVCs overall capital.[38] The federal government also plays an important role, through both the New Markets Venture Capital program and the CDFI fund mentioned above.[39] Larger CDVC funds with more experience and expertise may also attract institutional investors.

**COMMUNITY DEVELOPMENT BANKS AND CREDIT UNIONS**

As mentioned previously, Community Development Banks and Credit Unions (CDBs and CDCUs) make up an important part of the CDFI industry. CDBs and CDCUs operate in a fashion similar to their private, strictly for-profit counterparts, however specifically target underbanked and low-income communities. The CDFI Fund must certify CDBs and CDCUs with an express mission to promote economic development primarily in underserved areas.[40] These institutions are an important component of community development finance due to the retail and depository services they provide (unlike loan funds). In 2012, the Community Development Bankers Association claimed over $5 billion in loans to low and moderate income households and over $11 billion in deposits that help support those loans.[41] Creating

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[38] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 130
[39] Ibid, 130
[40] "CDFI Certification Frequently Asked Questions", no date. Accessed January 2013.. http://www.cdfifund.gov/docs/certification/cdfi/CDFIcertificationFAQs.pdf.
[41] Community Development Bankers Association, "By the Numbers". Accessed April 2013. *http://www.cdbanks.org/numbers*

savings and building assets is vital to the long-term economic health of any individual and community and CDBs and CDCUs offer avenues towards these ends.

## Strengths, Weaknesses, Opportunities and Challenges of CDFIs and CDLFs

The most obvious strength of CDFIs is their creation of credit markets and access to capital for hundreds of thousands of small businesses and individuals that have no other financial alternative. Since the inception of the CDFI Fund, more than $23 billion has been financed to underserved communities around the country.[42] An equally important, though often overlooked, strength that has resulted as a consequence of this financing is the role CDFIs play in demonstrating the financial viability of low-income communities to traditional financial institutions[43]. The CDFI model is based on high-touch, thorough analysis of loans, recognizing opportunity that may have slipped through traditional cracks. Neighborhoods and districts that were once red-lined have proven to be areas of untapped financial potential and more and more accredited financial institutions are entering into these once neglected markets, replacing often predatory and usurious alternative financial institutions.

CDFIs also face a diversified funding stream, including their own service-generating earnings. However, these earnings and other sources come under pressure with economic cycles. Mainstream financial institutions have reduced their support

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[42] "Opportunity Finance Network: Inside the Membership", no date. Accessed January 2013.. http://www.opportunityfinance.net/store/downloads/insideTheMembership.pdf.

[43] Julia Sass Rubin (editor), Financing Low-Income Communities (New York: Russell Sage Foundation, 2007), 126

of CDFIs, both by providing less direct funding and smaller loans, but also by extending less credit in support of projects done in partnership with them[44]. And, although it is incredibly unlikely that elected officials would support abolishing the CDFI Fund, funding levels do seem to be tied to political leadership, with Democrats typically increasing the budget allocation and Republicans typically decreasing it. Seeking and cultivating nontraditional funding sources is a constant task of CDFIs. Recently there has been an increased interest by socially motivated individual investors that has great potential to expand the pool of investment capital for CDFIs.[45]

An often under appreciated strength of CDFIs is the strength of its social relationships. There are formal and informal networks that can prove valuable to CDFIs, not only as respected allies who can "vouch" for the organization, but also serve as risk mitigation. A CDFI closely tied with labor organizations, trade associations or chambers of commerce, for example, will soon get a sense of different relationships between community members and who the prominent and influential players are. This social capital arms CDFIs to make more personalized and contextualized loans, as well as demonstrates "good faith" commitment and interest to community members who may view CDFIs as "outsiders" for long periods of time.

One of the most prominent challenges to deep community development faced by CDFIs is the degree of professionalization and efficiencies required to create, operate and maintain this type of organization. Making effective and prudent use of

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[44] Chairman Ben Bernanke, "Community Development Financial Institutions: Challenges and Opportunities" (Global Financial Literacy Summit, Washington, D.C., June 17, 2009 (speech accessed January 2013. http://www.federalreserve.gov/newsevents/speech/bernanke20090617a.htm)

[45] ibid

capital in low-income communities requires high-level financial skills, the ability to navigate bureaucratic labyrinths and access to quality legal and operational aid, among other things. More often than not, the communities targeted by these lending organizations lack these skills, requiring individuals from outside communities (typically wealthier) to deposit themselves within the underserved area. CDFIs use the money they earn and are given to make loans – however, if there were greater, or different, financing opportunities, investments in infrastructure and technologies could be made. Additionally, more financial resources could be used to educate and train members of the community in the necessary "professionalized" skills required of this work. Both human capital and operational investments are means towards sustainable expansion.

In summary, CDFIs have proved effective in completing the task the industry was assigned. CDFIs have maintained comparable, if not favorable, financial stability to corporate and conventional banks through economic recessions, while reaching customers that are not served by these very institutions. CDFIs range in size, loan structure and product, indicating their ability to adapt to the communities in which they work. Beyond providing relevant financial services to these communities, successful CDFIs often have strong social networks, which can act as a positive feedback loop for loan repayment. However, CDFIs continue to face funding volatility challenges and do not enjoy government guarantees or federally funded insurance programs. Once capital is deployed, there is no way, as of yet, to retain the asset while reusing the money. In addition to restricting the flow of capital into these

neighborhoods, tight budgets can limit the human capital attracted to this line of work. CDFI employees require high levels of professional sophistication and skill. These institutions are paving the way for more traditional, often more affordable financial products to enter into communities lacking these basic services. Ironically, CDFIs could benefit from an increased access to capital, much like their clients.

# NEW MARKETS TAX CREDITS

## Origins

New Markets Tax Credits were created by Congress as part of the Community Renewal Tax Relief Act in 2000. Enjoying significant bipartisan support, primarily by a Democratic President Clinton and Republican Speaker Dennis Hastert, the initiative was in large part inspired by former Housing and Urban Development Secretary and Republican Congressman Jack Kemp, who argued for greater private sector incentives to promote revitalization.[46] The program uses market forces to invest capital in low-income, underserved communities around the country by providing federal tax credits to investors who help finance large scale economic development projects in these areas.

The origins of this tax credit can be traced to the success of the Low Income Housing Tax Credits of the 1990s, which prompted lawmakers to consider other uses of this type of financing structure.[47] Policymakers had familiarity and demonstrated success with tax credits. Additionally, the 1990s were an era of robust economic growth and, as in any other "hot market", institutional economists worried about rising inflation and increased interest rates. By tapping underutilized productive capacity in inner cities and economically distressed rural areas, it was believed that a simultaneous effect of job creation and a larger labor market as well as expansion of

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[46] Rapoza Associates (Preparers) for New Markets Tax Credit Coalition. "The New Markets Tax Credit: Progress Report 2012", June 2012. Accessed February 2013. http://nmtccoalition.org/wp-content/uploads/NMTC-2012-Progress-Report.pdf

[47] Roberts, Benson F. "The Political History of and Prospects for Reauthorizing New Markets." *Community Development Investment Review*. Accessed February 2013. http://www.frbsf.org/publications/community/review/122005/article3.pdf

domestic consumer demand would follow.[48] At the same time, there was a growing movement to increase access to capital into low-income neighborhoods and minority communities and President Clinton had demonstrated commitment to this cause during his term. The President summarized these two dynamics, as he spoke at a community economic summit organized by Rev. Jesse Jackson when he stated, "The only way to keep the growth going without inflation is to find both new businesses and new employees and new customers at the same time".[49] Clinton wanted to prove that private sector investment could in fact be spurred by public sector incentives.

To this day, New Markets Tax Credits (NMTC) continues to enjoy bipartisan support, appealing to the ideology of both sides of the aisle. Among Republicans, the initiative is appreciated by business-minded members and considered more of a hand-up than a hand out, as well as the critical fact that there is no cash expenditure from the federal budget, but rather a loss of unclaimed tax revenue. Democrats tout the program's strict compliance obligations in regards to the types of communities in which the investments must be made. The political viability of the program is evidenced by the most recent round of tax allocations that were approved in the fall of 2012 – the tenth round of approvals since the program's inception.[50]

This section of the report, presents an in-depth analysis of the different models, structures, risks and impacts of New Market Tax Credits. These transactions

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[48] ibid

[49] President William J Clinton, "Remarks at the Wall Street Project Conference in New York City", January 13, 2000. Accessed March 2013. http://www.gpo.gov/fdsys/pkg/PPP-2000-book1/html/PPP-2000-book1-doc-pg45.htm

[50] Community Development Financial Institutions Fund. Modified September 2012. Accessed February 2013. http://cdfifund.gov/news_events/CDFI-2012-36-CDFI-Fund-Releases-Application-Demand-for-2012-Round-of-NMTC-Program.asp

are complex, comprised of many active variables and a diverse host of players. The following will identify the necessary inputs, outputs and outcomes of NMTC in order to gain a better understand of the product, and thus better identify whom it might best serve.

## How Do New Markets Tax Credits Work?

The New Markets Tax Credit incentivizes private investment to low income communities by permitting individual and corporate investors to receive a tax credit against their Federal income tax return in exchange for making equity investments into economic development projects operating in distressed urban and rural areas.[51] The credit totals 39% of the original investment amount, to be claimed over the next 7 year period, divided as 5% for each of the first 3 years and 6% for each of the next 4 years.[52] Within the Treasury Department, the Community Development Financial Institution Fund (CDFI Fund) and the Internal Revenue Service (IRS) jointly administer the program.[53] Since the Program's inception, the CDFI Fund has made 664 awards, allocating a total of $33 billion in tax credit authority.[54]

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[51] Community Development Financial Institutions Fund. Modified September 2012. Accessed February 2013. http://cdfifund.gov/what_we_do/programs_id.asp?programID=5

[52] ibid

[53] "New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

[54] Community Development Financial Institutions Fund. Modified September 2012. Accessed February 2013. http://cdfifund.gov/what_we_do/programs_id.asp?programID=5

The program required an intermediary between the investor and the non-profit organization that administers the large-scale economic development project, called a Certified Development Entity (CDE). The CDFI Fund allocates tax credits through a competitive process to qualified CDEs, which, in turn, seek out investors who are interested in receiving tax credits in return for equity capital.[55] The proceeds from the investors are referred to as Qualified Equity Investments (QEI).[56] The CDEs provide and administer the loans and investments and ensure compliance with the regulations of the program over the 7 years. CDEs also tend to provide financial counseling in low income areas to complement the investment.[57]

Once a CDE has received the Qualified Equity Investments, it makes a loan to an eligible business or organization, known as a Qualified Active Low-Income Community Business (QALICB). The recipient CDE must deploy "substantially all" (defined as 85% of the QEI within one year.[58] CDEs are responsible for much more than structuring and executing the transaction. They are often called upon to ensure compliance throughout the life of the investment, and perform asset management, complex accounting, and investor reporting.[59] *See Figure 1*

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55 "New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

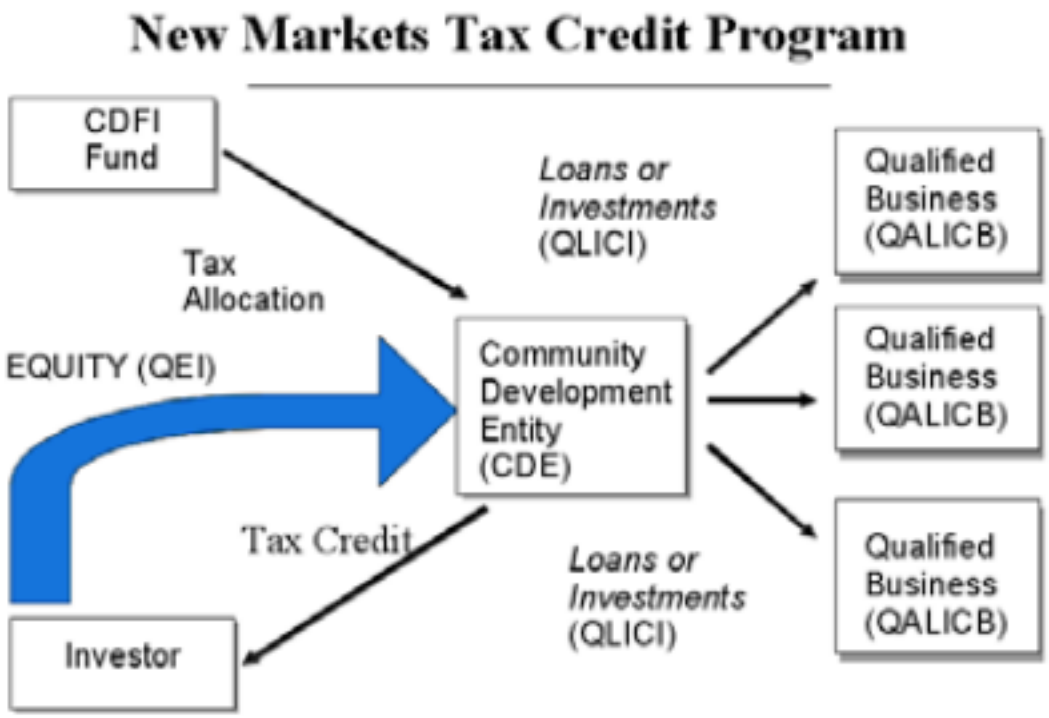
56 ibid

57 "New Markets tax Credits: An Overview of Equity Investing." *New Markets Support Company,* no date. Accessed February 2013. http://www.liscnewmarkets.org/HelpFiles/NMTCs%20for%20Investors.pdf

58 "New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

59 Enterprise Community Investment, Inc. "New Markets Tax Credit Overview" Last Modified 2011. Accessed January 2013. http://www.enterprisecommunity.com/servlet/servlet.FileDownload?file=00P30000009vb9HEAQ.

Figure 1 – How Does It Work?[60]




While tax credit allocations can go to any private or individual investor, 86.1%[61] of the applicants, and ultimate investors, are banks. There are several reasons why banks are interested in making investments through NMTCs. First, because almost all qualifying projects are located in low-income communities, banks often receive Community Reinvestment Act (CRA) credit for these investments.[62] The Act requires depository institutions to record their efforts to expand access to

[60] New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

[61] Rapoza Associates (Preparers) for New Markets Tax Credit Coalition. "The New Markets Tax Credit: Progress Report 2012", June 2012. Accessed February 2013. http://nmtccoalition.org/wp-content/uploads/NMTC-2012-Progress-Report.pdf

[62] Interagency Questions and Answers Regarding Community Reinvestment." (publication of the Federal Reserve Bank of Dallas, January 2009. Accessed February 2013. http://www.minneapolisfed.org/news_events/events/community/060810/qa.pdf

credit to all of their constituents ("CRA Credit") and the record is taken into account during negotiations of expansion, mergers or acquisitions requested by said depository institution. There are several financing structures to NMTC deals that banks can use to receive CRA credit, which will be discussed later.

The average yields on NMTC have proven to be competitive, further incentivizing banks to include these investments in their portfolios. Typical after-tax internal rates of return range from 6% – 12%, (some report rates as high as 20%) depending on the institution's level of involvement and the timing of the deal.[63] As mentioned, the two main types of financing structures will be discussed in detail in the next section.

Lastly, banks enjoy both qualitative and measurably quantitative positive community benefits. According to CDFI Fund data, in the second round of NMTC allocations, 92% of loans and investments were made in geographic areas experiencing economic distress.[64] Also, all loans associated with NMTC allocation were made at below-market rates and more flexible terms than typical conventional credit products. These terms include equity and equity equivalent terms, deeply subordinated debt, discounted origination fees and higher than standard loan-to-value

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63 "New Markets tax Credits: An Overview of Equity Investing." *New Markets Support Company*, no date. Accessed February 2013. http://www.liscnewmarkets.org/HelpFiles/NMTCs%20for%20Investors.pdf

64 "New Markets Tax Credits: Unlocking Investment Potential" *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

ratios.[65] The General Accountability Office reports that investors have been injecting more dollars into low-income communities as a result of the credit. Much like the CDFI Fund before it, the NMTC allocation has a proven track record of successfully, if not actually beating the market by, making investments in areas that are historically thought of as risky or low valued, providing financing products that possess relaxed terms and conditions.

## Models and Financing Structures

There are two primary structures an investor can use in a NMTC deal. (For purposes of this paper, an investor will be assumed to be a bank, and therefore interchangeable). They are the Bank-Operated CDE Model and the Third Party Model. After discussing these two models, two types of financing structures will be presented (either model is capable of investing under either structure that will be discussed).

### BANK-OPERATED CDE MODEL

If a bank feels it has the resources, staff and internal expertise, they can manage and control their own NMTC portfolio under the *Bank-operated CDE Model.* The bank can establish a wholly owned CDE and apply directly for CDFI Fund tax credit allocations, and if successful in its application, the bank investor can use the

[65] "New Markets Tax Credits: Unlocking Investment Potential" *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

CDE subsidiary to invest directly in to QALICB, managing the portfolio itself, through the subsidiary.[66] Advantages to this model include the ability to control the pipeline of QALICBs (again, through the subsidiary CDE), and ensuring the quality of the underwriting performed on the deal.[67] However, the bank CDE is also responsible for all the administration duties and tax compliance reporting requirements. Yet, some banks have reported that the investment of time and resources required to structure successful NMTC deals has resulted in the development of other important customer relationships, ultimately leading to other credit opportunities.[68]

**THIRD PARTY MODEL**

As its name suggests, this model is suited for investors who prefer limited participation in the details of the NMTC program. In the *Third Party Model,* banks conduct due diligence on CDEs in their area, seeking proven experience and demonstrated ability to manage the administration of a NMTC deal. This model allows bank investors to benefit from the underwriting and compliance management expertise of an established CDE.[69]

**NON-LEVERAGED STRUCTURE**

This financing option is structured as a pure equity investment, from the bank to the CDE – all of the funding is in the form of capital contributions. In turn, the

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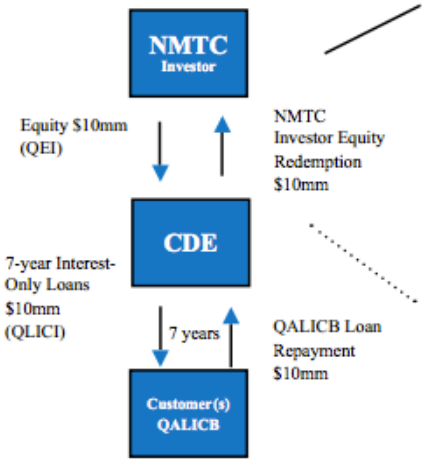
[66] ibid
[67] ibid
[68] ibid.
[69] ibid

CDE provides financing to the QALICBs, typically structured as either debt, or a combination of debt or equity.[70] Because the CDE receives the money as equity from the investor, they are generally able to offer the QALICBs more favorable terms than if the bank were making a standard commercial loan. The loans are structured to mature in 7 years, during which the qualified business makes interest only payments, and at the end of the 7 years, the loans are repaid, or more typically refinanced.[71] For its part, the bank receives tax credits equaling 39% of the original investment over the period of 7 years. The cash-equivalent value of the tax credits helps NMTC investors meet their expected risk-adjusted returns.[72] *See Figure 2*.

[70] ibid
[71] ibid
[72] ibid

Figure 2 – Non-Leveraged Model[73]

**Example of NMTC Non-Leveraged Transaction**




**Transaction Summary**

- The bank investor(s) provides $10 million in equity capital to the CDE in Year 1.
- The CDE provides $10 million in debt financing to the QALICB(s) structured as $7 million in senior debt and $3 million in subordinated debt.
- The loans are structured to mature in seven years, consistent with the schedule of tax credits to investors.
- The qualified business borrower makes interest-only payments during the term of the loans. The loans are repaid or refinanced at the end of the seven-year compliance period, at which time the CDE redeems the QEI.

**Tax Credit Schedule for NMTC Investors**

| | | |
|---|---|---|
| Year 1 | $500,000 | 5% |
| Year 2 | $500,000 | 5% |
| Year 3 | $500,000 | 5% |
| Year 4 | $600,000 | 6% |
| Year 5 | $600,000 | 6% |
| Year 6 | $600,000 | 6% |
| Year 7 | $600,000 | 6% |
| | $3,900,000 | 39% |

[73] New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

**LEVERAGED STRUCTURE**

This financing option relies on an investor's willingness to use debt as an additional source of financing. In the leveraged structure, the funding provided to the CDE is given in the form of both debt and equity and generally consists of a two-tiered investment.[74] These transactions have to set up an "Investment Fund" (the upper tier) to gather the different sources of financing, which can include debt, equity and even grant funding. The Investment Fund aggregates all the capital and invests it into the CDE (the lower tier).[75] So, for example, in a $10 million deal, the investor may contribute $7 million in debt financing and $3 million as an equity contribution (and will still receive tax credits on the entire $10 million). Next, the Investment Fund will funnel the full $10 million to the CDE, who will in turn provide $10 million in debt financing to the QALICB, structured as $7 million in senior debt and $3 million in deeply subordinated debt.[76] The CDE earns interest on the $10 million, however only channels interest on the $7 million in original debt financing through the Investment Fund back to the original investor.[77] Like the non-leveraged structure, the loans are either repaid or refinanced at the end of the 7 years and the investor claims 39% of the total original investment in tax credits. *See Figure 3*

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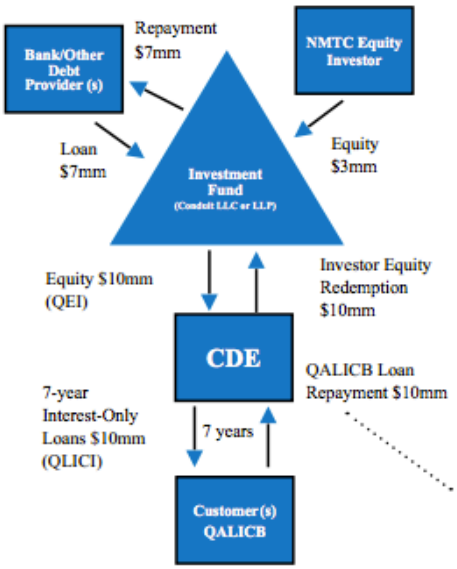
[74] ibid
[75] ibid
[76] ibid
[77] ibid

Figure 3 – Leveraged Model[78]

**Example of NMTC Leveraged Transaction**




**Transaction Summary**

- The investment fund, the conduit LLC, obtains lender financing of $7 million and an equity contribution of $3 million.
- The investment fund, using those combined proceeds, provides a QEI to the CDE totaling $10 million in Year 1.
- The CDE provides $10 million in debt financing to the QALICBs, structured as $7 million in senior debt and $3 million in deeply subordinated debt.
- The loans are structured to mature in seven years, consistent with the schedule of tax credits available to investors.
- The CDE earns interest on the $10 million, although the investment fund LLC pays interest only on the $7 million debt financing portion to the LLC.
- The loans are repaid or refinanced at the end of the seven-year compliance period, at which time the CDE redeems the QEI.

| Tax Credit Schedule for NMTC Investors | | |
|---|---|---|
| Year 1 | $500,000 | 5% |
| Year 2 | $500,000 | 5% |
| Year 3 | $500,000 | 5% |
| Year 4 | $600,000 | 6% |
| Year 5 | $600,000 | 6% |
| Year 6 | $600,000 | 6% |
| Year 7 | $600,000 | 6% |
| | $3,900,000 | 39% |

[78] New Markets Tax Credits: Unlocking Investment Potential." *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

## Risks

### UNDERWRITING

Whether an investor chooses the Third Party Model, or creates its own subsidiary CDE, underwriting risks emerge. These types of loans do not at all resemble traditional loans institutional investors administer, where underwriting is typically automated and centralized. NMTC are designed specifically for economically distressed and underserved communities that can pose increased risk. Great care must be taken that there are sufficient resources to balance responsibility both to the investor and the QALICB. Additionally, given the recapture risk (discussed below), an investor is wise to monitor, and assess the lending viability of the CDE's pipeline.

### LIQUIDITY

Similar to what has been discussed in the cases of traditional CDFIs, NMTCs face liquidity challenges. There is currently no secondary market for NMTC, so once an investment is made, it cannot be sold – the investor must be willing to forego any alternative use of that capital for the 7-year period. Consequently, before entering into a NMTC deal, the investor should predict their future taxable income as accurately as possible.

### TAX COMPLIANCE, RECAPTURE AND REDEPLOYMENT

NMTC are subject to recapture by the CDFI Fund during the 7-year compliance period if one of the following occur:

- A CDE ceases to be a certified CDE

- "Substantially all" of the equity investment (as previously noted this has been defined as at least 85% of the original investment) proceeds are no longer deployed in Qualified Low-Income Community Investments
- The CDE redeems the Qualified Equity Investment (QEI)[79] (and does not redeploy the capital if it is repaid earlier that the compliance period[80])

In Third Party models, investors must be confident that their chosen CDE's have both the ability to comply with all requirements the appropriate resources and controls. Creating, maintaining and monitoring an active pipeline (or requiring their third party CDE to do so) is one option investors have to mitigate this risk. Another mitigation technique some investors and CDEs have used is applying prepayment penalties to discourage early repayment.[81]

**REFINANCING**

Investors must be cognizant of the risks associated with the potential inability of qualified businesses to refinance, or repay, their debt at the end of the 7-year compliance period.[82] As illustrated in the financing structures above, the QALICB must repay the CDE the full amount of the loan, whether through its own devices, or

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79 "New Markets Tax Credits Fact Sheet" *Community Developments (*publication of the US Department of the Treasury), August 2005. Accessed March 2013. http://www.cityscapecapital.com/files/CCG%20Website%20-%20Tax%20Credits%20-%20Industry%20Links%20-%20NMTC%20Fact%20Sheet.pdf

80 "New Markets tax Credits: An Overview of Equity Investing." *New Markets Support Company,* no date. Accessed February 2013. http://www.liscnewmarkets.org/HelpFiles/NMTCs%20for%20Investors.pdf

81 "New Markets Tax Credits: Unlocking Investment Potential" *Community Developments Insights* (publication of the US Department of the Treasury), February 2007. Accessed January 2013. http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

82 ibid

through a refinance, during the 7-year period, QALICB are making interest only payments. Again, the underwriting ability and relationship between the QALICB and the CDE is of critical importance.

## Impact

New Markets Tax Credits were designed with the specific intention of spurring private investment into low-income communities that result in job creation and material improvement in the lives of residents in these areas. Congressional Intent, as enumerated by the IRS, defines a low-income community as any census tract where the poverty rate for such a tract is at least 20%, or the median family income for such a tract does not exceed 80% of statewide median family income.[83] In the 12 full years the program has operated, more than 72% of all NMTC investments were made in communities with severe the economic distress that exists in communities with unemployment rates more than 1.5 times the national average, poverty rates of 30% or more, or median incomes at or below 60% of the area median.[84] According to Treasury Department data, between 2003-2010, the NMTC program generated over $20 billion in private investment, which in turn leveraged an additional $25 billion from other public and private sources, financing almost 3,000 projects and generating over 500,000 jobs, including 200,000 permanent jobs.[85] The economic theory behind this type of low-income community financing is that the foregone tax revenue that

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[83] Internal Revenue Service. "New Markets Tax Credit. Accessed January 2013. http://www.irs.gov/pub/irs-utl/atgnmtc.pdf

[84] New Markets Tax Credit Coalition. "New Markets Tax Credit Fact Sheet" Accessed February 2013. http://nmtccoalition.org/fact-sheet/

[85] ibid

results from these tax credits will be more than made up for through the new taxable income created by the economic activity in these "new markets". The NMTC Coalition found that that, in fact, the federal tax revenue generated by NMTC investments more than covers the cost of the program to the federal government in terms of this foregone tax revenue. According to the Coalition, in 2010 alone, NMTC investments in operational activities generated almost $1.1 billion in federal tax revenue, offsetting the estimated $720 million cost of the program.[86]

In summary, the NMTC program can provide unprecedented levels of government sponsored capital to community development efforts. However, this model is certainly the most financially and logistically complex of those examined in this report, and the actors must be fully aware of the conditions of this long-term commitment before engaging in the deal. Likely for this reason, large institutional banks are most often the "investor" in the transaction, as they have the financial and professional resources required. Additionally, they experience multiple benefits, including CRA credit, competitive returns and both qualitative and quantitative community benefits. If a bank decides to partake in enough NMTC deals, it would be wise for them to utilize the bank-operated model, directing underwriting control and, pipeline management and general decision making authority internally. However, Investors must remember that, unlike CDFIs, there are strict redeployment conditions that must be met. And although the long-term economic activity generated by these deals does eventually make up for the initial costs, it may seem daunting and

[86] ibid

prohibitively expensive to certain community development organizations. Yet, for the right organization, at the right time, NMTC deals provide much needed access to a high volume of credit.

# SOCIAL IMPACT INVESTING

## Origins and Meaning

Thus far, the discussion of financing underserved communities has revolved around products and programs initiated or supported by the public sector, either directly or indirectly. Although these products and programs are modeled directly after private sector methods of doing business, each one depends heavily, if not exclusively, on the federal government for funding and viability. This report's final analysis of an innovative community development financing tool will center on a model that is private sector based, but strives for positive social impact (specific improvements in community development are one of several social impact metrics used in this model). Broadly speaking, Social Impact Investing (SII) is an investment made into a company or organization with the intention of generating positive, measurable social or environmental impact in addition to the financial returns expected of traditional investments. SII bridges the gap between philanthropy and commercial finance.

In traditional commercial finance, portfolio management aims are centered on creating financial wealth and mitigating the risks associated with generating that wealth. On the other hand, philanthropy portfolio management is dedicated creating tangible social or environmental value. For decades, these two disciplines were deemed to be mutually exclusive. A perceived choice arose, "either make money or do good"; doing both seemed implausible. However, in the last 30-40 years a new paradigm has begun to emerge.

It is difficult to trace the origins of this movement. The late 1960s gave way to a widespread feeling of disenchantment with the institutional economic structures governing the market, both in terms of social and environmental consequences. Large organizations and groups of people started making earnest efforts to create an alternative approach. Around that same time, some religious groups began realizing their influence on social issues. For example, in 1970, a group of several Protestant denominations came together in opposition to the Vietnam War. Progressive clergy questioned whether certain churches were profiting off the war, challenged military contractors and their development of nuclear weapons, foreign military sales as well as longstanding opposition to South African apartheid. This movement eventually evolved into the Interfaith Center of Corporate Responsibility (ICCR).[87]

However multi-faceted its origins may be, SII has taken flight. In the last 15-20 years especially, prominent leaders are calling on businesses to use their financial acumen and influential power to play a proactive role in addressing social and environmental challenges at a scale unreachable to individual investors or donors.[88] Generally, impact funds seek to invest in companies that make positive contributions to society, including those that have strong environmental protections, strong employer-employee relations or operations that respect human rights and community

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[87] Interfaith Center of Corporate Responsibility. "About ICCR: FAQ" Accessed March 2013. http://www.iccr.org/about/faq.php

[88] Global Impact Investing Rating System. "What is Impact Investing" Accessed February 2013. http://giirs.org/about-giirs/what-is-impact-investing

preservation ("positive screening").[89] Conversely, impact investors will avoid products or businesses that are harmful to individuals or communities and/or the environment ("negative screening"). This screening has shifted from searching for companies with a lack of negative metrics, to a search for those who are leaders in adopting exceptional social practices.[90] Most large corporations now have "Corporate Social Responsibility" (CSR) officers or departments in response to this movement. Typically, the CSR performance of a particular company can affect whether or not it will be included in socially responsible investment funds. The growth and performance of SII funds demonstrates the powerful contribution of the private sector to help develop healthy communities.

## Growth and Performance

SII has grown exponentially in just the last 20 years. Understandably, there are different ways in which SII is defined, but according to the reputable Global Impact Investing Rating System (GIIRS), SII assets in the US alone rose 324% from $639 billion in 1995 to $2.71 trillion in 2007[91]. And these are not just funds specifically created and designed to make impact investments. Almost all the large institutional pension fund investors, including CalStRS, CalPERS, TIAA-CREF and

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[89] US Sustainable Investment Forum. "Sustainable and Responsible Investing Fact Sheet" Accessed February 2013. http://ussif.org/resources/sriguide/srifacts.cfm

[90] ibid

[91] Global Impact Investing Rating System. "What is Impact Investing" Accessed February 2013. http://giirs.org/about-giirs/what-is-impact-investing

Taft-Hartleys have made impact oriented investments.[92] Globally, financial giant Deutsche Bank manages approximately $20 billion in impact oriented investment, "positively screened" funds.[93]

SII has become so mainstream that it has its own index (comparable to DOW or the S&P) that was started in 1990 called the FTSE KLD 400.[94] And while some investors may still believe that in order to invest responsibly one must sacrifice market returns, the FTSE KLD 400 offered returns of 9.51% from inception, versus 8.66% for the S&P 500 over the same period.[95] Observing this strong trend, large investors such as university endowments, foundations and state pension funds are beginning to increase their investments in SII.[96] The inclusion of these big players has the synchronous effect of further strengthening growth rates by enlarging the financial pool that social impact organizations have access to. As the notion of conscious capitalism continues to permeate our collective attitude towards the market, the SII space is bound to continue delivering strong growth rates.

## Community Development

The US SIF is the U.S. membership association for professionals, firms, institutions and organizations in sustainable and responsible investing. The

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[92] Kipp Baratoff. "Impact Investing: The Secret Marriage Between Philanthropy and Finance", *Sustainable Industries*, November 3, 2010. Accessed March 2013. http://sustainableindustries.com/articles/2010/10/impact-investing-secret-marriage-between-philanthropy-and-finance

[93] ibid

[94] The Forum for Sustainable and Responsible Investment. "Performance". Accessed 2013. http://ussif.org/resources/performance.cfm

[95] ibid

[96] ibid

association has identified three approaches utilized by investors to help identify SII. First is the "Screening" process mentioned above. Second, is Shareholder Advocacy, referencing responsible investors who take an active role as "owners" of corporate America, including dialoguing with companies, filing shareholder resolutions on such topics as pollution or discrimination, and thus assert pressure on company management to act socially responsible.[97] The third approach, most relevant to this report is Community Investing.[98] US SIF defines community investing as a means of directing capital from investors and lenders to communities that are underserved by traditional financial services institutions, thus providing access to credit, equity, capital and basic banking products.[99] These investments make it possible for local organizations to provide financial services to low-income individuals and provide capital to small businesses and community services such as affordable housing, childcare and healthcare.[100] These are the same types of activities that all government sponsored community development financial tools that have been discussed in this report are encouraged and often required to invest in.

For the purposes of this report, the most compelling trend is the growth rates of SII that is specifically considered Community Investing. According to the US SIF, between 2009 and 2012 community investing has grown 47%, from $41.7 billion in

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[97] The Forum for Sustainable and Responsible Investment. "Resources: SRI Basics". Accessed March 2013. http://ussif.org/resources/sriguide/srifacts.cfm
[98] ibid
[99] ibid
[100] ibid

assets to $61.4 billion during that time.[101] US SIF has actively worked to increase investment in this area, and in 2001 launched the "1% in Community" campaign, encouraging all investors to direct at least 1% of their investments to community investing products that serve communities overlooked by traditional lenders.[102] Despite the years of government sponsored financial tools, community organizations continue to struggle with scale and expansion issues. The increase in private sector investment can help these organizations utilize cross-sector efficiencies and business practices that may in fact help them grow their ability to provide services.

## Standards

Compared to traditional financial investments, quantifying the positive social impact, and thus the overall quality of an SII is far less tangible. However, there are several critical reasons that conventional metrics and measuring tools must be created and generally accepted. First, while the industry experiences healthy growth, the amount of assets that are SII versus conventional is still a small percentage. While SIIs complement philanthropic investments and government funding, if solutions to community development challenges hope to expand and scale, greater financial investments are necessary. SIIs have to play a role, however, because in order to continue attracting institutional, traditional funding, there must be measurable and comparable data about these investments and their quality. Secondly, as mentioned previously, the term "social impact" or "socially responsible" is broad and can be

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[101] ibid
[102] ibid

interpreted in a wide variety of ways. In order to attract different markets, some funds may advertise themselves as an SII, however, with no quantifying or comparable data, there is no substantial way to determine varying levels of impact among investment options. Third, as this industry itself attempts to scale, there must be a common language among fund managers. Standardized information management systems that aggregate data can improve communication between SII fund managers and enhance the mobility of money within these networks.

While the idea of socially responsible investments may not be new, in many ways the industry is a nascent one and experts continue to refine evolving standards and systems. Three majors tools used for creating metrics and definitions are widely accepted among SI Investors, both domestically and globally: Impact Reporting and Investment Standards (IRIS), PULSE and the Global Impact Investing Rating System (GIIRS).

IRIS was born out of the Global Impact Investment Network (GIIN) and as a framework consists of 6 parts:

1. *Organization Description* – metrics that focus on the organization's mission, operational model and location
2. *Product Description* – metrics that describe the organization's products and services and target markets
3. *Financial Performance* – commonly reported financial metrics
4. *Operational Impact* – metrics that describe the performance and reach of the organization's policies, employees and environmental performance
5. *Product Impact* – metrics that describe the performance and reach of the organization's products and services

6. *Glossary* – definitions for common terms that are referenced in the metrics[103]

Further, the IRIS has created sector specific metrics so that investments in a particularly industry can be compared against one another. These sectors include agriculture, education, energy, environment, financial services, health, housing/community facilities and water.[104] In the arena of community development, there are several applicable sectors, most notably financial services, whose metrics have been designed to capture the performance of organizations providing financial services to underserved populations, including CDFIs.[105] The notion of institutional investors using standardized data to compare and invest in high performing CDFIs allows the possibility of not only expansive growth in community development, but also of increased awareness of the financial opportunity that exists within underserved neighborhoods across the country.

PULSE is a portfolio management tool, easily accessible to different clients and comes pre-loaded with IRIS metrics.[106] The more widely used this software becomes, the more radically improved the knowledge transfer will be between SI Investors. GIIRS is a comprehensive and transparent system for assessing the social

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[103] Impact Reporting and Investment Standards, "IRIS Metrics". Accessed March 2013. http://iris.thegiin.org/iris-standards

[104] ibid

[105] ibid

[106] Margot Brandenberg. "Impact Investing's Three Measurement Tools", *Stanford Social Innovation,* October 3, 2012. Accessed March 2013. http://www.ssireview.org/blog/entry/impact_investings_three_measurement_tools

and environmental impact of companies and funds with a rating and analytics approach analogous to Morningstar[107] and is based on IRIS definitions.[108]

While this multitude of acronyms and separately sourced tools may seem confusing or complicated to some, the specifics of this industry are important to remember. There is a broad range of both philosophies and functional requirements about social impact, financial return and responsible lending. These 3 tools have evolved over the past few years, as has the SII industry. Thanks to large institutional early-adoption of the Rockefeller Foundation who was willing to pilot these tools during early development, there has been steady improvement and efficiencies. These improvements are attracting new players and like the organizations it is trying to fund, the SII industry in general, and these tools specifically, are beginning to enjoy the benefits of scale.

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[107] Global Impact Investing Rating System. "What is Impact Investing" Accessed February 2013. http://giirs.org/

[108] Margot Brandenberg. "Impact Investing's Three Measurement Tools", *Stanford Social Innovation,* October 3, 2012. Accessed March 2013. http://www.ssireview.org/blog/entry/impact_investings_three_measurement_tools

## PRODUCT COMPARISON: ANALYSIS AND OPPORTUNITY

This report has presented a wide variety of community development financing tools, from small, highly localized loan funds to large, institutional investment vehicles. Just as no community is the same, each possessing different strengths and needs, these products' varying shape and style must be analyzed to create sustainable matches between needs and resources. The term "underserved", admittedly used frequently in this paper, is a rather general one that can cover a wide variety of populations. There is deliberate progression in the presentation of products in this paper that follows the progression of the varying degrees of underserved individuals and communities that exist. This progression refers to individuals and their financial sophistication. "Underserved", at its base, refers to those without even a bank account, or those paying above market, or even usurious prices for loans and other financial products. It stands to reason that these products also have different versions of scale, appropriate for the stage of development in which they operate.

### The First Tier

Serving the most rudimentary step of the economic development ladder are Community Managed and Supported Loan Funds. This model requires little or no advanced infrastructure or professionalization, can ostensibly operate with no federal regulation and typically only serve basic financial needs. Designed for individuals and groups with no access to bank accounts or the general financial mainstream, this model replicates community lending of the oldest variety. While individuals can self-

organize to create these lending circles, organizations do exist that formalize the operation. In terms of scale for these organizations, there is movement towards legitimizing and documenting their financial transactions. For example, Mission Asset Fund (MAF) out of San Francisco has been diligently working to weave these informal loans into the conventional, digital world by working with credit bureaus to begin accepting the timely repayment of these loans as evidence of credit maintenance. Now, individuals with thin or no credit files can watch their scores appear and improve, thus gaining access to a host of conventional loan products. MAF reports average credit score improvements of 26-30 points within 6 months for many of its clients.[109] Also, like any other stage of development, these primary products and processes could benefit and scale with improvements in technology and infrastructure. Economic behavioral patterns among this particular group of underserved tend not to vary, so creating software that can be used anywhere to improve access and options can efficiently raise financial proficiency. Providing individuals with a chance to create or rebuild their financial lives in a replicable and efficient way is the form that scale takes at this level of economic development.

## The Established and the Evolving

The remaining sectors of the financially underserved population are less categorically defined than the "first tier" referenced above. While variation certainly exists, the following section of analysis will compare the two evolving models

[109] Mission Asset Fund, "Lending Circles". Accessed March 2013. http://missionassetfund.org/programs/lending-circles

(NMTC and SII) with the more established, general CDFI industry, as all 3 models serve diverse underserved populations.

**CDFIs AND NMTCs**

Generally speaking, CDFIs (including loan funds, venture capital and both banks and credit unions) operate at a fraction of the scale of their private sector counterparts. Although all types of CDFIs are revenue generating, none are self-sustaining (all rely on federal money to continue operations). And while the number of CDFIs continues to grow, the CDFI Fund federal budget allocation is not growing at a comparable rate. In other words, more organizations are competing for only slightly more federal funding. With median capital assets of $8.9 million, CDFIs are unable to act as a primary funder for large-scale community development or infrastructure projects. NMTCs on the other hand were designed specifically to catalyze projects of this scale. The magnitude of a single loan administered through the NMTC program is often greater than the net assets of a CDFI. The economic impact, in terms of scope, is hard to compare.

That said, some doubt the economic efficiency of the NMTC program. At minimum, hundreds of thousands of dollars are spent on legal, administration, compliance or consulting fees to close a NMTC deal. The many key players and structures can overwhelm even the savviest financial experts. So, while CDFI loans may not reach the scale of a NMTC deal, as a ratio, administration cost to loan value is often lower at CDFIs.

These two government-sponsored programs share two important similarities; CRA credit and lack of secondary markets (the latter will be discussed at length below). The CRA was an incredible boon to the community development finance industry. Requiring private sector funds to be injected into low-income communities helped dramatically grow the capacity of CDFIs and provides a second incentive for banks to participate in the NMTC program (the first of course being the tax credit). It is unlikely that either program would create the positive social impact it does without the CRA.

**Secondary Markets For Community Loans**

Traditional and private lenders have long used secondary markets for their loans as a standard business practice. In the simplest terms, secondary markets are mutual beneficial exchanges of capital between lenders and institutional investors, both of whom have different needs and objectives. When utilized responsibly, secondary markets can help develop efficient capital markets by connecting a lender's desire for liquidity and increased cash flow, with which to make more loans, with an investors' preference of using their capital for longer periods of time.[110] Each loan a lender makes is an additional asset to the company, however it also commits the funds for the terms of the loan. Having to keep the loans in portfolio contributes to a

[110] "Finance Maps of the World: Secondary Market", no date, <http://finance.mapsofworld.com/secondary-market/>, (accessed April 2012)

mismatch between the terms which lenders prefer to lend (shorter terms, variable rate) and those that are sustainable for this type of borrower (longer term, fixed rate).[111]

While secondary markets have witnessed a near collapse since the economic recession of 2008 (lack of appropriate regulation of these markets was a primary culprit in the recession itself), they provided viable options for private financial institutions for decades. However, there are several obstacles to creating a secondary market for community development loans, including lack of data, standardization of documents and loan process.[112]

Lack of standardization across the industry is a great challenge and several efforts have been made towards mitigating and improving this issue. As Federal Reserve Chairman Ben Bernanke commented in a 2009 speech,

> "*Prior to the financial crisis, some CDFIs had been making progress in gaining access to secondary financing markets. Although these markets remain disrupted, such efforts hold promise, especially to the extent that CDFIs are able to produce high-quality data and analysis of proposed investments. Good data, together with qualitative knowledge, is critical for identifying previously unrecognized market opportunities,*

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[111] David J. Erickson, "The Struggle to Establish a Vibrant Secondary Market for Community Development Loans", June 2006, <http://www.frbsf.org/publications/community/review/062006/erickson.pdf>, (accessed April 2012)
[112] ibid

*assessing investment performance, and helping guide investors to make better decisions*".[113]

While the federal government already has several loan guarantee programs (including Fannie Mae and Freddie Mac, as well as different SBA loan guarantees), the CDFI Fund might consider a CDFI-specific loan guarantee program, that would serve both CDFIs as well as NMTC. The program could create standards regarding acceptable risk levels and impact measures, while acting as a resource for potential investors. Institutional investors are interested in financial history and expected performance, thus providing information on default rates, delinquency and average returns, for example, will expose the quality of CDFI loans, often higher than expected by traditional investors. Additionally, this response to the complications presented by community loans would provide investors with a credit enhancement that ensures the investor against losses stemming from the underperformance of the underlying assets.[114] Perhaps banks could even qualify for CRA credits by investing in a community loan fund secondary market.

Loan flipping and irresponsible loan sales are challenges of particular importance to this industry. Given the disaster of the mortgage lending market several years ago, investors are hesitant about loans with even a hint of "sub-prime" borrowers. In terms of transactions, both the buyer and seller of the loan are

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[113] Chairman Ben Bernanke, "Community Development Financial Institutions: Challenges and Opportunities" (Global Financial Literacy Summit, Washington, D.C., June 17, 2009 (speech accessed April 2012, http://www.federalreserve.gov/newsevents/speech/bernanke20090617a.htm)

[114] David J. Erickson, "The Struggle to Establish a Vibrant Secondary Market for Community Development Loans", June 2006, <http://www.frbsf.org/publications/community/review/062006/erickson.pdf>, (accessed April 2012)

responsible for assessing the solvency of the asset. Limiting refinancing as well as creation of accessible and recognized standards of community loans can help bring confidence to an area of lending that is often misjudged. In summary, responsible, measurable efforts to standardize community loans and create a secondary market would grant CDFIs and NMTC CDEs the necessary liquidity to help expand and scale their operations.

### SOCIAL IMPACT INVESTMENTS

Social Impact Investments are a somewhat different category of community financing tools, due to their lack of government regulation or support. As discussed previously, the lack of definition or standards of what "positive social impact" means is a challenge to the industry. In terms of standards, there is considerable interest and energy being committed to resolving this issue. The standards being designed specifically for the CDFI industry, via IRIS, may serve a critical role in creating secondary markets for CDFI loans, as there will be ample and comparable data available.

Addressing loose definition of "social impact" presents a different challenge. Community development organizations seeking private investment through SII may find themselves making more safe loans, or loans with both low risk and low community impact, in order to meet the investor's expectations. Depending on the relationship between the investor to the CDFI, there may arise a misalignment of motives – financial return or increased impact? Expectations of both impact and financial requirements must be fully understood by both parties to mitigate this risk.

There are also important points of similarity between NMTC and SII. For one, they both enjoy long-term viability, which presumably will lead to refinement and improvement in the systems. NMTC generates support from multiple political perspectives and SII relies on private sector financial acumen to continue to meet investor expectations. Second, both models are built for scale. The sheer size of transactions in either case is something traditional CDFIs have rarely seen. The ability to invest these large sums of money into community development projects and organizations opens the door for widespread improvements in technology, efficiency and infrastructure – in other words, places these projects and organizations further down the road to sustainable scale. And third, both models require massive professionalization. The amount of financial, legal and administrative expertise needed to carry out either a NMTC transaction or a SI Investment reaches far beyond the professionalization a CDFI requires.

# CONCLUSION

Community development lending takes different forms and serves different needs. Some models utilize grassroots organizing and social capital to operate, others adhere to federal and private equity standards to continue lending. Some funds rely strictly on the human resources and capacity that exists within the community; some funds require the intellectual prowess of financial analysts and political will of high ranking elected officials. Objectives also vary across funds, as CMLFs typically work to create small savings mechanisms and often one-time loans within a social network, while CDFIs and NMTC projects aim to grow viable community businesses and infrastructure, creating jobs and wealth on a much larger scale. It is important for both communities and products to find the right fit in order to meet with success.

Regardless of the stage of development in a community, access to affordable credit and financial services allows individuals and neighborhoods to begin thinking long term and planning their growth in a stable and intentional way. For decades, both private practices and public policies neglected to serve communities that were under-employed, low-income, or otherwise considered "fringe". Beginning with federal legislation, private banks were mandated to service these areas, and funds started to trickle into these "new markets". Overtime, and through creative variations of public, private, internal and organizational revenues, community development lending gained traction. Community loan funds, when properly managed, expose traditionally underserved communities as places of potential and viable investment.

And the private sector began recognizing these untapped markets, thus the explosion of Social Impact Investing.

However, there are recurring challenges to scale and expand these vital services. For one, dealing with constant funding pressures and financial constraints makes it difficult to focus solely on streamlining and improving the actual lending process. NMTC and CDFIs, while operating on massively different scales, face liquidity challenges. Most CDFIs feel this crunch, and as the momentum grows, NMTC deals will also – there are more deals than available capital, limiting the growth rate of a community that may be primed and ready.

Additionally, there is a tangible lack of clearly defined standards of social and community impact. This lack of generally accepted metrics limits important avenues for potential scale. For one, it hinders institutional players from investing in CDFIs, NMTCs, or even SII. While some returns on these products are competitive, there is strong incentive to quantify the social element of the investment, to increase access to private equity. Secondly, Investors must be able to compare CDFI and NMTC loans in order for a viable secondary market to exist. If these loans are to be bought at sold (albeit with limited refinancing), they must be easily comparable.

Creating both translatable data metrics and a viable secondary market for community loans are two avenues that regulators, advocates, investors and politicians should examine when and if seeking tools to scale community development finance. Initially, design and implementation of these tools will be costly, both in terms of time and money, however, the benefits will likely outweigh the costs over time. It is

difficult to speculate on actual costs and size of a secondary market, given the large number of factors that would affect that decision (e.g. Would it just be for CDFIs? NMTCs? Open to all? Etc). However, it is undeniable that market demand for more long term, reasonable yield investments exists.

When underserved communities possess strong social and cultural capital, access to financial capital can initiate sustainable development and increased economic activity. For decades now, communities and neighborhoods once considered "unbankable" are proving themselves to be stable, even lucrative places of opportunity. Community Development Finance, when fostered alongside responsible social and political engagement, can transform lives and neighborhoods, not just one by one, but by the thousands.

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