Executive Summary

The research papers available here represent a year-long effort undertaken by several researchers to explore facets of the CDFI industry. In June 2007, the CDFI Fund of the U.S. Department of the Treasury launched a research initiative by announcing the availability of grants to fund research projects of relevance to the CDFI industry. In response to the request for proposals, more than 40 proposals were received. A total of twelve research projects were funded, with grants ranging from $45,000 to $100,000. The research projects covered a broad range of topics, including the interaction of CDFIs and the subprime mortgage market, CDFIs in underserved markets such as native communities, and the institutional development of CDFIs. While a number of well-known researchers were funded through the initiative, grants were also awarded to several new to the field. The research initiative also provided a first opportunity for researchers to obtain access to and to use the Community Investment Impact System (CIIS) data. These data are reported on an annual basis by CDFIs who have received a funding award, and until this time, had not been made available for research purposes to those outside of the Fund. In June 2008, the CDFI Fund hosted a one day conference in Washington DC to present findings from the research projects. The research papers developed under this initiative are briefly highlighted below.

CDFIs and the Subprime Mortgage Market

Each of the three papers in this group covers an aspect of the subprime mortgage market, and the responses of CDFIs to the crisis. In ***"An Analysis of Successful CDFI Mortgage Lending Strategies in Six Cities,"*** Neil Mayer of Neil Mayer & Associates and Ken Temkin of Temkin Associates examine two hypotheses: 1) CDFIs have a greater concentration of their home purchase loans in low-income and minority neighborhoods than mainstream lenders; and 2) CDFIs increase lending to underserved borrowers by demonstrating the profitability of these loans to mainstream lenders—what they refer to as a "demonstration effect." They explore these issues by developing cases studies of large CDFIs in five market areas that rely on interviews with key staff and analysis of CIIS and other data on CDFI lending activities compared to mainstream lenders as reported by Home Mortgage Disclosure Act (HMDA) data.

Mayer and Temkin confirm that CDFIs do have a higher share of their lending devoted to lower-income and minority borrowers and neighborhoods than mainstream lenders. Their case studies suggest that CDFIs are able to serve these markets by providing low-interest rate subordinate debt to improve the affordability of owning a home and by providing housing counseling to help borrowers through the purchase process.

They do not find evidence that CDFIs have a demonstration effect in leading mainstream lenders into new market niches. In addition, the scale of CDFI lending was generally quite small relative to the overall market, indicating the CDFIs also had little direct effect on lending activity. However, CDFIs did help mainstream lenders to reach underserved markets through the provision of housing counseling and by providing subordinate financing to support primary mortgages made by mainstream lenders.

In ***"The Role of CDFIs in Home Ownership Finance,"*** Sarah Wolff of Self Help and Janneke Ratcliffe of University of North Carolina address three questions:

1. What is the role of CDFIs in the residential mortgage market, which they explore by comparing data on mortgage lending by CDFIs as reported to CIIS with the broader mortgage market as captured by HMDA data;
2. Are homebuyers assisted by CDFIs successful in sustaining homeownership, which they examine using data on mortgage delinquency rates reported in CIIS and from First American Title; and
3. How are CDFIs responding to the current mortgage crisis, which they investigate through brief case studies of nine CDFIs.

Consistent with the Mayer and Temkin's findings, they find that CDFI lending activity is more concentrated than mainstream lending activity among low-income, minority, and low-credit score households. However, like Mayer and Temkins, Wolff and Ratcliffe find that the scale of CDFI activity in the residential market is very small relative to the overall market. Most CDFI loans are junior liens bearing below market interest rates, rather than loans made independent of mainstream financial institutions.

Wolfe and Ratcliffe find that CDFI loans have lower 90-day delinquency rates than loans insured by the Federal Housing Administration (FHA) or made by subprime lenders. However, the lower delinquencies among CDFI loans reflect the large share of these loans that bear below-market interest rates, are non-amortizing, or are subordinate liens. Therefore, a comparison of these delinquency rates to market benchmarks for FHA and subprime that consist largely of market-rate, first-lien mortgages is not fair. To compare delinquency rates only for first-lien, market rate loans, they use originations by CDFIs in two market areas (Cook County, IL and Durham/Wake Counties, NC). They find that 90-day delinquency rates for the CDFI loans are comparable to rates for prime, FHA mortgages of the same vintage in these market areas, but well below those of subprime loans.

The case studies of foreclosure prevention efforts identify three categories of responses: 1) those aimed at resolving delinquencies, 2) those designed to refinance delinquent borrowers into new loans, and 3) those aimed at purchasing and repositioning foreclosed properties to minimize impacts on surrounding communities. Wolff and Ratcliffe find that each of these approaches faces significant challenges. Efforts aimed at resolving delinquencies or refinancing delinquent borrowers both have difficulty connecting with borrowers early enough to preserve options for resolving the problem. Once the borrower has been reached, there may be difficulties reaching the right points of contact for lenders. Furthermore, CDFIs often do not have sufficient funding to make up borrower shortfalls or make new loans affordable. Funding constraints also hamper efforts to purchase foreclosed properties, as do the complexities of negotiating purchases with lenders and the staff expertise needed to manage the process of purchase and repositioning.

In "***The Role of CDFIs in Addressing the Subprime Mortgage Market",*** authors Carla Dickstein, Laura Buxbaum, Hannah Thomas, and Kimberly McLaughlin, of Coastal Enterprises, Inc., address questions similar to those in the other two papers in this group, including the role that CDFIs play in expanding access to mortgage financing for underserved borrowers and in responding to the foreclosure crisis. The study focuses specifically on CDFIs in the New England region and relies primarily on interviews with 17 CDFIs and other industry stakeholders.

Similar to the findings of the other two studies in this group, Dickstein and her co-authors find that CDFIs primarily provide gap financing to make homeownership more affordable and rely on existing mortgage products from mainstream lenders to provide the bulk of the financing. Some CDFIs are attempting to expand their role as a conduit for primary mortgages by acting as mortgage brokers, but the authors observe that this role does not seem to expand greatly the range of loan products available to the target communities. They conclude that CDFIs cannot expand their lending role without greater access to capital that can be used to take on more risk or to subsidize borrowers.

Dickstein et al. come to conclusions similar to Wolff and Ratcliffe's regarding the role of CDFIs in responding to the foreclosure crisis. They focus on the potential role of affordable loan products to help troubled borrowers, including second liens to help resolve mortgage delinquencies and new first lien mortgages that can provide borrowers with long-term affordable payments. However, they note that the amount of capital that would be needed for these mortgage products is substantial, with roughly $1.2 billion needed to meet New England's needs alone. They also discuss efforts to purchase foreclosed properties for re-use, noting that CDFIs are well positioned to lead such efforts but that they will require capital as well.

Dickstein et al. conclude by arguing that one of CDFIs' best opportunities for having an impact on broader markets may be through a research and advocacy to influence policy making at the state and federal levels. CDFIs' active role in underserved communities gives them a unique perspective on the needs and challenges in these markets that can help inform policy discussions. As an example, they cite the successful efforts of Dickstein's own organization, Coastal Enterprises Inc., to help pass an anti-predatory lending law in Maine several years ago. However, CDFIs will have to partner with state and national intermediaries that have both the resources and the access to policy makers that are needed to effectively participate in these policy debates.

Community and Economic Development and Lending

The group of papers under this heading covers various aspects of community development and community lending. In ***"The Experience of New Hampshire Community Loan Fund in Mainstreaming of Acquisition Loans to Cooperative Manufactured Housing Communities"*** Michael Swack of University of New Hampshire and Jolan Rivera, Southern New Hampshire University, begin by making the case that manufactured housing is an important source of affordable housing, especially in rural America, and that cooperative ownership of manufactured housing parks is superior to commercial ownership because of greater security of tenure and greater control over the management and maintenance of the park. They then describe a CDFI program in New Hampshire that has made it possible for residents of manufactured housing parks to convert them to cooperative ownership through technical assistance and through loans that cover 100 percent of the acquisition cost of the land used for the park.

The hypothesis tested by the paper is that the New Hampshire Community Loan Fund's program has attracted mainstream financial institutions to participate in these loans to Cooperative Manufactured Housing Communities at favorable terms, including willingness of the banks to fund a high percentage of the acquisition cost, interest rates that reflect a modest spread over the cost of funds, and other favorable loan terms. The authors' original hope was to show that terms for loans in which banks participated improved over time, as the program demonstrated that such loans perform well. While data limitations meant that the authors were not able to show that loan terms had improved, interviews with banks suggested that loan terms were competitive and favorable and that loan officers valued the technical assistance provided by The Loan

Fund, as well as its willingness to cover a portion of default risk for loans that have no down payment.

Swack and Rivera conclude that the success of this program in New Hampshire bodes well for an attempt to extend the program model to other parts of the country.

In ***"Competition and Collaboration between CDFIs and MFIs in Small Business Lending: Six Case Studies,"*** Geoff Smith, Sean Zielenbach and Jennifer Newon of the Woodstock Institute conducted case studies of three depository CDFIs and three CDFI loans funds that had a substantial volume of small business lending and examined the complex relationships that these CDFIs have with mainstream financial institutions (MFIs). Sometimes CDFIs and MFIs are in competition for small business customers, especially as consolidated national banks compete with CDFI credit unions and "de novo" banks are willing to take on risky small business loans. CDFIs must compete with technology-enabled, low-cost MFI products such as cash management services that replace the "high touch" services that were once the hallmark of CDFIs and small local banks.

On the basis of the interviews they conducted, the authors found an important distinction between depository CDFIs, which are in direct competition with MFIs, and loan funds, which sometimes compete but more often rely on MFIs as sources of funding. Smith and Newon warn that bank consolidation could reduce sources of MFI funds and increase the conditions placed by MFIs, such as a seat on the CDFI's board of directors or a commitment that customers be referred to the MFI once they have established a track record through CDFI financing. The authors recommend that CDFI loan funds work to develop non-bank sources of capital for small business lending.

In ***"CDFI Financing of Supermarkets in Underserved Communities: A Case Study"*** authors Ira Goldstein, Lance Loethen, Edward Kako, and Cathy Califano of The Reinvestment Fund (TRF), use their access to a unique data set from a regional supermarket chain to examine the impact of TRF's program of support for the development of supermarkets in distressed neighborhoods in Philadelphia. The data enable them to demonstrate the additional costs for both start-up and ongoing operations of supermarkets in inner city neighborhoods and, therefore, the need for a subsidy program. They use employee records to show that part-time employees of the supermarkets (the overwhelming majority of all supermarket jobs are part time) live close to where they work, so that this economic development effort is indeed creating job opportunities for neighborhood residents. They also show that pay and benefits are comparable or superior to those at suburban supermarkets operated by the same chain.

As for the effect of the subsidized supermarket development on the availability of fresh food in urban neighborhoods, the TRF authors use data on locations of all grocery stores to show that the new stores increase access to the high volume stores likely to have superior inventories and lower prices. They also use data from the chain's frequent shopper program to show that the stores are serving mainly nearby residents rather than serving as convenient stopping places for shoppers passing through the neighborhood. Finally, they use data on business location trends to suggest that the subsidized supermarkets may be having some anchor effect for attracting other employers to the neighborhoods.

CDFIs in Rural and Underserved Markets

The three papers in this section cover topics related to rural and underserved markets. Spencer Cowan and Danielle Spurlock of the Center for Urban and Regional Studies and Janneke Ratcliffe of the Center for Community Capitalism at University of North Carolina, in ***"Community Development Financial Institutions and the Segmentation of Underserved Markets,"*** note two primary goals for their research: to determine whether some CDFIs are more effective at serving racial and/or ethnic minorities, and if so, to examine the attributes and practices that make these CDFIs more effective. The research design included both a quantitative analysis of CIIS data to examine organizational attributes, as well as a qualitative case study analysis through key informant interviews.

While limitations in the data make conclusions of limited generalizability, the quantitative findings show some interesting patterns. Minority-owned CDFIs in the limited sample of CDFIs that provided transaction-level information on race are providing higher levels of service to historically underserved minorities, measured by the percent of transactions. Measured by the mean loan amount, however, all of the CDFIs in the sample are providing larger loans to whites. That suggests that minority ownership may help attract minority customers, but it may not affect the amount of the loan for which the customer is qualified. The key informant interviews with minority-owned CDFIs offer some tentative explanations for the percent of transactions. Those interviewed said that they did not specifically target minority borrowers, but pointed out that their CDFIs were located in target-rich environments. Further analysis of CIIS data that focused on the location of the borrowers rather than their race or ethnicity confirmed that minority-owned CDFIs are more likely to lend in census tracts with high minority populations. However, they are not more likely to lend in areas that meet the CDFI definition of a lower-income census tract. The key informants also suggested that familiarity with the cultural norms of potential customers is important. Interviewed staff of CDFIs noted that familiarity breeds a higher level of comfort among potential customers, allows the marketing approach to resonate with the customer, and bestows an aura of trust that might not otherwise exist.

Julia Sass Rubin, in "***Community Development Venture Capital in Rural Communities,"*** begins by noting that access to equity capital is a critical component of business entrepreneurship. Rural economies, however, rarely attract traditional venture capital. Community development venture capital (CDVC) has evolved to address the patient capital needs of such underserved geographies. Like traditional venture capitalists, CDVC providers make equity and near-equity investments in small businesses. However, their investments are predicated on a company's potential to contribute to the betterment of a low or moderate-income community as well as its likelihood for rapid economic growth. This paper examines the universe of CDVC providers that invest in rural geographies, to understand the various organizational models that they utilize and determine which ones appear best suited for which environmental factors.

The twenty six CDVC providers that invest in rural geographies have used one of three approaches: 1) primarily equity investing via a for-profit limited life partnership or limited liability corporation structure, capitalized primarily by external equity investors; 2) primarily near-equity investing, (e.g., debt with warrants), via a non-profit community development loan fund structure; and 3) equity and near-equity investing via a range of legal structures. Funds formed after 2001 have used only the first two approaches. There are benefits and drawbacks to both of these. Which approach a particular organization chooses is dependent on the kinds of investments that it believes to be most appropriate for its target market and its capacity to raise capital for such investments. The paper concludes with policy recommendations designed to increase the supply of developmental venture capital in rural areas.

In ***"Investing in Native Community Change: Understanding the Role of CDFIs"*** authors Sarah Dewees of First Nations Development and Stewart Sarkozy-Banoczy of Oweesta note several goals for the research: to learn more about native financial institutions (NFI) – organizational types, age, loan products and services – as well as usage of CDFI Fund resources. In addition, they attempt to learn how well Native CDFIs are meeting the needs of their markets.

The paper begins by observing that the CDFI Fund of the U.S. Department of the Treasury has invested millions of dollars to increase the number of community development financial institutions (CDFIs) in Native communities. Yet, over four years later, there is little information about basic characteristics about the Native CDFI field and the contribution of CDFIs to the Native communities they serve. Furthermore, there is a lack of a consistent framework for understanding CDFI development in Native communities.

The paper presents a theoretical framework for understanding the unique challenges that face Native CDFIs in their work. The research provides quantitative and qualitative information about the characteristics of active and emerging CDFIs serving Native communities. The five case studies provide information about how well Native CDFIs are meeting the needs of their markets and explore the relationship of CDFIs to job creation and entrepreneurship development in Native communities. The case studies also describe the role of Native CDFIs in providing financial education, repairing credit, reducing predatory lending.

The authors' analysis of the a dataset on Native financial institutions compiled by Oweesta suggests that the universe of Native CDFIs consists of mostly unregulated loan funds, and, it appears that Native CDFIs have pursued a range of legal structures for their financial institutions. The limited dataset suggests that Native CDFIs may be younger, on average, than non-Native CDFIs. The case study research suggests that Native CDFIs are effectively meeting the needs of their market and are offering innovative financing and development services, although more research is needed to confirm this.

Institutional Development of CDFIs

The final group of papers focuses on institutional and organizational development of CDFIs. In ***"Approaches to CDFI Sustainability"***, Kirsten Moy and David Black of The Aspen Institute (as well as numerous others on the project team) begin with the observation that, despite reductions in some of their traditional funding sources, there has been considerable growth in the CDFI field. Nevertheless, the authors conclude that the need for subsidies for CDFIs will not go away. In addition, each type of CDFIs continues to face challenges in the market: competition for customers and investors for banks, restructuring for credit unions, and finding equity for loan funds. While there is consensus that sustainability requires balancing mission and market, there is no agreement on how to accomplish this balance, on the importance of self-sufficiency, on the relationship between growth and sustainability, and on the use of subsidy in sustainability strategies.

Through a series of eight case studies of CDFIs that the researchers determined were strong, innovative and growing, the paper describes several approaches to obtaining this balance.

The paper reaches the following conclusions about the art of attaining and maintaining sustainability:

- Sustainability is not a permanent state
- No models can be replicated in their totality
- Sustainability requires many things
- Subsidy and sustainability are not polar opposites

Victoria Salin (and others) of Texas A&M focus on the risk exposure of CDFI's loan portfolios in ***"Riskiness of Sector Dependence in CDFIs."*** The paper measures the riskiness of portfolios using the Value at Risk (VaR) concept, and then compares the riskiness resulting from concentration in a single industry with riskiness from a diversified portfolio.

Value at Risk is defined as the portion of the portfolio that is at risk at a given probability level based on historical performance of similar portfolios. For example, to calculate the 5 percent risk in a housing portfolio, one would look at the performance of a comparable housing portfolio over history, and sort by monthly loss (or profit level). The 5 percent risk would identify the lowest 5 percent point on the distribution. For each CDFI sector (housing, business, commercial lending), the paper uses a trend of an available measure of returns (such as REITs for housing) to estimate Value at Risk.

Contrary to expectations, the paper finds that more diversified CDFI portfolios are ***more*** risky than CDFI portfolios that are more concentrated in the housing market. The paper finds that risk increases with portfolio size, but the marginal impact diminishes as size goes up. Institutions in urban and suburban areas have a greater VaR than those in rural areas, as do minority-owned or controlled institutions relative to those that are majority-owned. They find no effect from type of institution, ownership by women, or operations by a faith-based group.

Salin and her co-authors note that Value at Risk estimates would be a useful supplement to other measures used by CDFIs to assess their business strategies and report to their boards of directors.

Julia Sass Rubin and Sean Zielenbach, in ***"Assessing the Systemic Impacts of CDFIs,"*** aim to accomplish three things: define systemic impacts, identify types of systemic impacts, and help improve our understanding of what enables CDFIs to have systemic impacts.

The authors distinguish between traditional impact measures, such as jobs created or housing units rehabilitated, and systemic impacts. Systemic impacts include impacts on conventional financial institutions, philanthropic institutions, public agencies, and public policy.

Based on a series of case studies with a diverse group of CDFIs and additional interviews with industry experts, Rubin and Zielenbach find that CDFIs have an impact on mainstream financial institutions (MFIs) by reducing risk for the conventional institutions (CDFIs take subordinate debt positions), by demonstrating the viability of particular markets, and by educating conventional financial institutions about underwriting loans to small and medium sized non-profits. CDFIs affect philanthropic institutions by promoting program related investments and greater understanding of the market for community development lending, and they help shape foundations' response to emerging issues (such as triple bottom line "green" initiatives). CDFIs have an impact on public agencies through increased resource allocation to target communities, and they influence public policy through advocacy for broader changes in financial services delivery, such as anti-predatory lending and payday lending legislation, and through the work of internal research centers at CDFIs.

The ability of CDFIs to have systemic impacts increases with size, financial stability, social mission, organizational leadership and culture of risk-taking and innovation.