CDFI

THE COALITION OF
COMMUNITY DEVELOPMENT
FINANCIAL INSTITUTIONS

PRINCIPLES OF COMMUNITY DEVELOPMENT LENDING & PROPOSALS FOR KEY FEDERAL SUPPORT

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1. Overview

President Bill Clinton has declared his intention to create a national system of 100 community development banks over the next four years. Fortunately, an emerging industry of community development of financial institutions (CDFIs) offers a solid foundation for this bold initiative, which might include new institutions, community organizations conventional lenders, and others, in addition to CDFIs.

The industry lends to low-income and, increasingly, to middle-income wage earners, small businesses, American Indian reservations, and community development projects, complementing the work of conventional lenders. Two factors argue in favor of the CDFI industry playing a lead role in a federally-assisted community development lending program.

(1) The successful track record of community economic development and growth fostered by affordable credit through CDFIs is evidence that good borrowers come in greater variety than traditional underwriting methods often recognize. It is worth noting that CDFIs often provide a bridge between conventional lenders and unconventional borrowers, by creating new borrowers and opening new markets for the lenders while giving the borrowers access to capital sources.

(2) Effective community development lending programs are rooted in the communities they serve and are customized to fit those communities.Such institutions can only be established and grown gradually.

This memo lays out the key principles that we, as community development lenders, believe must guide the Clinton Administration's community development lending program and suggests several ways that the federal government can support the growth of the CDFI industry. To date, with almost no public support , CDFIs have proved that it is possible to mobilize and lend significant amounts of capital for development in low- and moderate income communities. Our track record and experience can and should serve as a foundation for growth. With appropriate federal involvement, community involvement lending can help reduce poverty, counter social and political disenfranchisement, and stoke the engines of economic growth.

The CDFI industry has developed over the last fifteen years out of the determination and entrepreneurial spirit of thousands of community activists, social investors, non-profit developers, and small business persons who correctly perceived that lack of access to credit is a principle barrier to social and economic development. This industry comprises diverse institutions that serve a variety of credit needs in urban and rural communities. Included are :

Community Development Banks (CDBs),which are federally insured and regulated depository institutions that have been organized specifically to provide capital to rebuild lower-income communities. Just four community development banks operate in the U.S. today: South Shore Bank in Chicago, Elk Horn Bank and Trust in Arkansas, Community Capital Bank in Brooklyn, NY, and the Self-Help Credit Union in North Carolina. South Shore Bank, Elk Horn Bank and Trust, and Self-Help Credit Union are part of larger bank or non-profit holding companies that include independent, non-depository credit and support mechanisms such as venture capital funds , development loan funds, and technical assistance agencies. These non-depository institutions are able to be more pro-active in their development activities.

- **Community Development Credit Unions (CDCUs),** which are regulated financial cooperatives owned and operated by lower-income persons. Typically, CDCUs provide consumer banking services (e.g., savings accounts, check cashing) that may not be locally available to their members, as well as personal loans for consumer goods purchases, home rehabilitation, and car purchases. A growing number of CDCUs are making development loans for small business expansion and start-up, home purchases, and housing rehabilitation. Prominent development lending credit unions include the Self-Help Credit Union in North Carolina, the Alternatives Federal Credit Union in Ithaca, NY, First Americans Credit Union in Window Rock, AZ, and the Santa Cruz Community Credit Union in California. CDCUs offer deposit insurance up to $100,000 per account through the National Credit Union Administration, which regulates the credit unions' activities. CDCUs are represented nationally by the National Federation of Community Development Credit Unions (NFCDCU) in New York City.

- **Community Development Loan Funds (CDLFs),** which are unregulated financial intermediaries that aggregate capital from individual and institutional social investors at below-market rates and re-lend this money primarily to non-profit housing and business developers in urban and rural lower-income communities. CDLFs place strong emphasis on financing projects that provide new economic opportunities and resources to borrowers and others to their communities. Thjis generates economic leverage, enabling individuals and community groups to have a voice in community business, social, and political affairs. CDLFs have been leaders in financing community land trusts, cooperative housing (including mobile home parks), and worker/community-owned businesses. Prominent CDLFs include the Low Income Housing Fund in San Francisco, the Federation of Appalachian Housing Enterprises in Berea, KY, the Industrial Cooperatives Association Revolving Loan Fund in Boston, MA, and the Delaware Valley Community Reinvestment Fund in Philadelphia, PA. Loan funds are represented nationally by the National Association of Community Development Loan Funds (NACDLF) in Philadelphia, PA.

- **Micro-loan funds (MLFs)** are most often components of micro enterpris development programs that integrate both economic and human development strategies. These programs are designed to fight poverty, increase incomes, raise self-esteem, stabilize families, develop personal, business and technical skills, create jobs and role models, as well as to spark a process of community renewal. The individuals served by these programs are predominantly women, often people of color, and almost all low-income welfare recipients, unemployed, or the working poor. Loans to micro enterprises range typically between $250 and $10,000 to start-up or expand self-employment or micro businesses employing up to five people, normally family members. The ventures include home day care, alterations and repair, fashion design and tailoring, catering and food service, hair and nail care, engine repair, trucking, retail and merchandising. Many micro enterprise development programs also offer additional financial services through partnerships with local banks or credit unions. Micro loans funds usually are capitalized with grants or loans from foundations or government agencies r loans from banks or other financial institutions. Pioneered in the developing world by Accion International Bangladesh's Grameen Bank, micro loan funds' are relatively new to the U.S. Prominent micro enterprise development programs with MLF's include Women Venture (formerly WEDCO) in Minneapolis, Minnesota, the Lakota Fund in South Dakota, Micro Industry Credit Rural Organization (MICRO) in Tucson, Arizona, the Women's Self-Employment Project Chicago, Illinois, the Good Faith Fund in Arkansas, and the North carolina Rural Economic Development Center. Over 150 micro enterprise development programs are presented nationally by the Association for Enterprise Opportunity (AEO) in Chicago, Illinois.

There are also a number of hibrid CDFIs that do not fit exactly into these categories but that provide critical financing to community development efforts. These hybrid institutions include New York City's Community Preservation Corporation, which has mobilized capital from banks, insurance companies, and pension funds for low- and moderate- income multifamily housing, and First Nation's Development Institute's Oweesta Fund, which serves American Indian resevations. In addition, venture development funds like Northeast Ventures in Duluth, MN, Coastal Enterprises in Wiscasset, ME, and Eastside Community Investments in Indianapolis, IN, finance start-up businesses in urban and rural communities using equity capital raised through foundations and government grants. The institutions are very much a part of the CDFI industry. They serve as models for other community development lenders, and they will be important to any effort to expand credit access in underserved markets.

All of these CDFIs share certain public purpose values:

- to offer credit to the poor and to those whose credit needs are not otherwise being met;
- to spur the community-wide economic and social development;
- to provide the necessary technical assistance to borrowers to ensure the success of loans and to buil the capacity of borrowers;
- to use the lending process in a way that encourages borrowers to participate in decision-making within their organizations and communitites;
- to enale individuals to gain self-sufficiency;and
- to lend primarily for community development.

- Capitalized with more than $700 million--much of which is raised from within the communitites ot constituencies they serve--development banks, credit unions, and loan funds have extended more than $2 billion in loans. Loss rates are comparable to the best conventional lenders. These CDFIs are proving:
- that lower-income people and communities are credit-worthy;
- that efforts to overcome chronic poverty depend on both access to credit and resources for capacity-building by individuals and organizations, and
- that conventional approaches to risk assessment and security must be reexamined when serving borrowers with little or no credit history, business or development experience, or collateral.

2. Statement of Need

The need for CDFIs and the affordable credit they provide has never been greater. Much as access to credit is a precondition for growth in small to large businesses, local access to affordable credit is a ncessary antidote to poverty, economic disenfranchisement, and community economic stagnation. Chronic poverty continues to increase in America. Government statistics released in the last quarter reveal that more Americans live in poverty today than at any other time in the last twenty years. Common ideas about poverty often overlook the fact that it is as prevalent in rural communities as it is in urban ones, while recent riots in Los Angeles and

Washington Heights, NY, are evidence of the desperation such economic and social decline has caused.

Poverty results not simply from lack of resources or capacity but also from paaterns of ownership and control of land, housing, businesses, and financial institutions that draw resources out of lower-income communities and limit the ability of local residents and Tribes to invest in their own future. This is exacerbated by credit barriers and social divisions that limit or deny lower-income and working class communities access to capital for community economic development.

Providing development credit in low- and middle-income communities is vital to our nation's economic prospects. Small businesses will provide the greatest employment growth over the next two decades. CDFI lending programs encourage entrepreneurship, self-sufficiency, and creative solutions, qualities that will be essential to economic recovery. CDFIs measure their success not only by their own economic gains but also by their contributions to rebuilding the civic infrastructure of businesses, voluntary organizations, social services, and housing central to revitalization of America's working class and poor communities.

Current economic and political facts--the recent recession, astronomical government deficits, the savings and loan bailout, and the health care crisis--preclude significant increases in federal, state, and local aid for existing community and economic development programs. Bank industry mergers and proposed regulatory reforms have created and will create mega-financial institutions with minimal obligation, and ability to serve poor and middle-income communities. Financial institution consolidations will continue throughout the 1990's, reducing the number of banks in the U.S. from 12,000 to 8,000, while many of the remaining banks will focus not on the conventional banking and credit needs of new and small borrowers but on larger and more profitable customers. Most conventional lenders are further restrained by class and cultural barriers, the high cost of operations, and their commitment to profit maximization.

The 1992 elections made it clear that the American public is looking for new ways to rebuild the civic infrastructure of businesses, voluntary organizations, community services, and housing upon which a strong democracy rests. President Clinton's proposal for a National Service Corps is a reflection of this spirit. It also offers an opportunity to link public service to public support for community development lending by using the corps as the training ground for a new generation of community development lenders (see Section 5.C. below), one of themost important needs that must be met for community development lending to succeed.

3. A Vision for Community Development Lending

To serve the unmet and growing credit needs of local communities, a national network of CDFIs must be fostered. Existing public purpose lenders, particularly community development banks, community development credit unions, community development loan funds, and microloan funds, comprise a solid basis for a nationwide network of community development financial institutions.* Initially, efforts should be made to expand and adapt the models pioneered by North Carolina's Center for Community Self Help, Chicago's South Shore Bank, Arkansas's Elk Horn Bank & Trust, and Brooklyn, NY's, Community Capital Bank.

Multi-service CDFIs have the greatest potential for growth, community development impact, and self-sufficiency. The bank or non-profit holding company structure enables the development intermediary to aggregate capital from within and outside the community through an insured depository institution. It also allows the institution to set up another credit and technical assistance affiliates. This type of organization can then pursue a coordinated development strategy that achieves an economy of scale and the significant impact necessary for the revitalization of urban and rural communities. This multiservice model should be considered the first-tier of CDFIs.

* New organizations, conventional lenders, and institutions other than those mentioned here are also expected to be part of this network. This paper focuses on the types of CDFIs described in Section 1.

At the second tier, the number of CDFIs that have the capacity to step immediately into the multi-service model is limited to some 25-30 institutions. Indeed, significant support for capacity building will be needed to achieve President Clinton's goal of 100 multi-service CDFIs. This support will enable some micro-loan funds to evolve into loan funds or credit unions, small loan funds and credit unions to grow larger, and large, successful CDLFs and CDCUs to become multi-service institutions. A growth ladder of this type will provide an important legacy for President Clinton--a national network of more than 100 multi-service CDFIs, as well as strong and enduring local institutions and revitalized communities across America.

Pilot projects should be launched over the next four years to build on the foundation for 100 multi-service development financial institutions that will, in turn, demonstrate the value and feasibility of a broader community development banking system. These projects must include support at both tiers of the CDFI industry. Strong CDFIs should be selected for these efforts because they have:

- Clear missions of community economic development;
- Demonstrated development lending track records;
- Accountability to investors or depositors and to the communities they serve;
- Effective management, lending, investment, and technical assistance capabilities;
- Established networks of investors and borrowers from which to launch a large-scale community revitalization initiative; and
- Strong community support.

Five factors will be critical to the success of such pilot ventures and to a long-term effort to build a public purpose banking system:

(1) A base of equity or net worth capable of sustaining the organizations as they grow;

(2) Access to and control over longer-term, lower-cost capital;

(3) A long-term strategy for human capital develo-pment;

(4) Public sector grants to support borrower technical assistance services and new credit product development ventures; and

(5) Continued access to federal housing, enterprise, and social services development programs, as appropriate.

4. Key Principles in Meeting Credit Needs in Lower-Income Communities

Six key principles should guide Clinton administration officials and Congressional leaders formulating this initiative:

A) Community development "banks" should be defined to include the spectrum of community development financial institutions. A diversity of credit needs exist in poor communities; therefore, a range of institutions has evolved to serve these needs. To be effective, any Federal program must support a spectrum of institutions that have the following common attrubutes:

1) offer credit to low- and moderate-income people, small businesses, and community development projects whose need for credit is not otherwise being met;

2) provide the necessary technical assistance to borrowers to ensure the success of loans and to expand the capacity of borrowers;

3) make credit decisions within their own institutions so that local, regional, or state factors, as appropriate, are properly weighed;

4) foster community-wide economic and social development; and

5) empower disenfranchised individuals and communities to gain self-sufficiency.

B) Expand the scope of community development bank lending beyond small business credit. The Clinton plan articulated during the campaign seems to assume that community development lending would be primarily, if not entirely, business oriented. We strongly recommend that a successful program must also include housing lending, consumer lending, retail banking, and other credit needs (e.g., working capital and facilities developement loans for non-profit social service providers and Tribes) in working class and low-income communities. Healthy Communities are made up of a variety of institutions and persons with diverse credit needs. Failure to respond to this broad range of credit demands will needlessly limit any community revitalization strategy.

C) Consult experienced community development financial institutions in crafting legislation and operating the CDFI network. 41 loan funds, 100 community development credit unions, and 4 development banks manage approximately $700 million in private capital and have proven lending track records.

- South Shore Bank in Chicago, Community Capital Bank in Brooklyn, NY, Elk Horn Bank & Trust in Arkansas, and the Self-Help Credit Union I North Carolina have loan loss rates at or below the level of their peer depository institutions.
- According to the National federation of Community Development Credit Unions (NFCDCU), community development credit unions have loaned more than $2 billion. NFCDCU's members' loss rate on loans on average is less than 2%.
- NACDLF members have loaned more than $100 million, which has leveraged $760 million in public and private capital to finance 15,000 housing units and to create 3,500 jobs for poor Americans. NACDLF members loss rate on loans is less than 1%.

D) Emphasize expansion of existing community development financial institutions rather than simply undertake wholesale efforts to create new development banks. Existing institutions should be supported to expand their activities because they know their markets and because they have proven that they can lend successfully in low- and moderate-income communities. Most CDFIs are undercapitalized and operate with inadequate net worth levels, requiring them to divert resources from working with borrowers to seeking potential funding sources. At the same time, the demand for affordable credit in most cases far outstrips the supply.

An attempt to franchise or otherwise mass produce CDFIs is not likely to be able to meet this demand. Successful CDFIs are, as we have noted, rooted in the communities, states, and regions as they serve. Most draw their lending capital from their service areas, and their board or directors reflrect the composition of their communities. This makes it possible for them to gain the requisite understanding of credit needs and borrower capacity to gauge their lending properly. Institutions created without these strengths and operating with a mandate to lend quickly and in a safe and sound manner will carry a heavvy burden of unachievable expectations. In areas not presently served by a CDFI, the federal government might consider fostering development of a new one.

E) Recognize that successful development lending institutions are built over time and with incremental performance-based financial sup-port. South Shore Bank in Chicago and the Center for Community Self-Help in North Carolina have reached their current levels after 20 years and 10 years respectively. Development finance is a highly specialized enterprise requiring uniquely skilled personnel, detailed market knowledge, and local institutional credibility. This skill and trust cannot be bought with massive federal appropriations but must be built over time through sound lending and borrower capacity-building programs. Any other approach invites repetition of past federal antipoverty initiatives that produce fraud and abuse.

F) Clarify the different interests and responsibilities of conventional lenders, public

agencies, and CDFIs. The notion that CDFIs will take business away from conventional lenders is not likely to come to pass. Loan funds, credit unions, and development banks, operate lamost entirely in separate markets from those served by conventional lenders. Historically, CDFIs have been breeding a ground for new borrowers from conventional institutions, serving as bridges giving banks and tohers access to new markets. The difficulties of gauging credit risk among new or unestablished borrowers,lack of market knowledge, inadequate development lending expertise, and changes in the global finacial system pose significant--though not insurmountable--hurdles for conventional lenders interested in playing an expanded role in these communities under the Clinton Administration's community development lending initiative.

Public agency programs often are bureaucratic and highly politicized. Instead of serving borrowers' needs, these programs can stifle the entrepreneurial initiative that community development financial institutions successfully foster. Community development lending requires highly specialized business skills and a commitment to sound business practices. It is often difficult to foster these qualities in the public sector.

As a result, we believe that existing CDFIs should be the foundation for an expanded community development lending initiative, as stated above. Two key responsibilities of conventional lenders as part of this program need to be articulated, however, to ensure that the broader purposes of the Clinton community development banking programs are met:

- **Continue the Community Reinvestment Act (CRA) and expand community reinvestment lending.** The creation of CDFI network under the Clinton Administration must not be a substitute for the CRA. It is our experience that even if the Clinton plan for 100 CDFIs were fully realized in 1993 there would still be an overwhelming demand for affordable credit in America's distressed urban, suburban, and rural communities. New York City alone has a $30 billion affordable housing credit shortfall. The federal government could support community development ingendral by extending the reach of the CRA.

  At the same time, an expanded CDFI industry will provide the conventional lenders with a means to participate in community development lending at substantially reduced risk and lower transaction costs. Many CDFIs have worked successfully with conventional lenders. The Low Income Housing Fund (LIHF) of San Francisco, CA, has pioneered the use of innovative financing mechanisms such as loan packaging to help conventional lenders make community development loans. LIHF currently manges some $16 million in two loan pools in San Francisco and Los Angeles.
- **Link creation of a nationl system of CDFIs to future financial support for and regulation of the conventional financial industry.** The private banking system and capital markets have undergone a profound restructuring over the past 20 years. Banking industry deregulation, growth in the conventional paper markets, insurance industry expansion, and the increasing role of unregulated financial intermediaries such as mortgage banks and finance companies have left many lower and middle-income Americans, small businesses, and poor communities without access to affordable credit. This restructuring has been made possible through myriad government subsidies to conventional financial institutions (e.g., federal deposit insurance, state insurance guarantee funds, federal Reserve Discount Window borrowings, etc.). Government subsidies and new powers should be granted to the financial industry only if it meets quantifiable community lending objectives and provides ongoing financial support to the developing national system of CDFIs.

5. Strategic Federal Support

Federal support should be provided to foster the development of a national system of community development financial institutions:

A) Equity Capital or Net Worth Grants: Sufficient levels of equity (for for-profit lenders) or net worth (for non-profit lenders) is critical to the long-term viability of any financial institution. Access to adequate amounts of equity or net worth is the pricipal impediment to the creation and/or growth of most CDFIs. Only four development banks have been created in the past 20 years, primarily because the the difficulty in raising equity or net worth capital. Distribution of equity funding under a federal program should use a performance-based process (see Section 7).

Equity or net worth capital is critical to all financial institutions:

- It permits greater risk inlending to borrowers with limited credit histories by providing investors adequate protection;
- It enables flexible loan pricing and longer terms, as needed;
- It permits lenders to refinance balloon loans made to borrowers whne designated take-out financing is delayed;
- It protects investors from borrower defaults if allocated loss recerves are exausted;
- It gives CDFIs the financial clout to attract new investments from sources that traditionally have not supported them--such as insurance companies, banks, mutual funds, and universities--and that require minimum net worth levels; and
- It generates 100% earnings as "spread," giving CDFIs the financial independence to forge creative partnerships with borrowers. The spread subsidizes borrower technical assistance, which makes development lending viable.

B) Below-Market & Long-Term Deposits or Loans: The costs of doing community development lending are higher than the costs of traditional conventional lending, in large part because each loan requires the lender to provide technical assistance to the borrower. In addition, the underwriting process is unique for each loan. To insure borrower success, ongoing technical assistance often is required long after loans are closed. The interest earned on below-market deposits or capital helps to pay for this assistance.

Many CDFIs also face the challenge of using short-term capital (for non-depository institutions) or deposits to fund long-term projects. Housing lenders by necessity aften make balloon loans without take-out financing in place. Conventional bankers are hesitant to participate in or to refinance these loans for various reasons, including (1) lack of familiarity with the nonconforming, original underwriting of most CDFI loans, (2) terms and pricing that may be unattractive, (3) the lack of credit enhancements such as loan guarantees and interest rate subsidies, (4) the lack of a specialized secondary market for community development loans, (5) lack of experience with development lending markets, (6) high transaction costs, and (7) a misperception of substantially higher risk in development lending. Longer-term deposits make longer-term lending feasible for CDFIs.

C) Human Capital Development: Efforts to create a national system of community development financial institutionss will only be successful if a generation of directors, managers, and loan officers can be recruited and trained to operate these intermediaries. Development lending and public purpose bank management require specialized knowledge and technical skills, strong social commitments, and extensive community experience, all of which differ in important ways from the skills needed to run a conventional financial institution. Community development lenders should undertake, with Federal support, several initiatives to develop the next generation of community bankers and trustees needed to operate and to govern an expanded network of community development financial institutions. These initiatives could include:

- Creation of a three-year intership/apprentice-ship program at community development financial institutions. This internship would be similar to in-house conventional/investment bank training programs but would also attend to the economic, social, and intellectual formation of participants.

This program could dovetail with President Clinton's plans for a National Service Corps by placing talented young adults in training for productive careers in community development and community development finance.

- Forging cooperative training agreements with select university business schools and conventional financial institutions to complement the apprentice program outlined above.
- Sponsoring regular seminars on capital access, community leadership, public investment, and economic democracy issues for CDFI board and staff members.

The federal program also should include a research program to assess the long-term economic and social issues affecting the CDFI industry and the communities its members serve.

D) Borrower Technical Assistance and New Credit Products Development Funding: CDFIs serve a market of institutions and individuals who have been unable to gain access to credit. Typically, CDFI customers are first-time borrowers with little credit history or development experience. Ongoing technical assistance is critical to successful CDFI lending to housing developers, first-time home-owners, small businesses, and non-profit service providers. The business planning, financial management, and marketing assistance CDFIs provide to their borrowers to build skills in labor intensive and raises transaction costs, ultimately lowering profit margins. It is necessary because it helps to ensure loan repayment and long-term borrower success. To serve this market effectively, CDFIs have created specialized technical assistance programs. CDFIs also continually develop and market new loan products to serve emerging credit needs. The market analysis, product research, and product development costs incurred by CDFIs are substantial. Support for these capacity building programs is essential in three areas:

- Technical assistance to first-time borrowers or organizations undertaking new housing/ business development ventures;
- Technical assistance to help secure conventional lender financing for current CDFI borrowers; and
- New credit product development by CDFIs to meet emerging credit needs of new borrowers.

6. Potential Funding Sources

CDFIs offer the Clinton's Administration a unique opportunity to demonstrate its commitment to economic programs that eschew the "hand out" model, that encourage and abet entrepreneurship, that foster economic self-sufficiency, that support economic growth at the community level where its impact is greatest, and that reward economic and social accountability.

CDFI funding should not come exclusively from a direct federal appropriation but should draw also on the public responsibilities of the federally insured and subsidized conventional financial markets. Those institutions which benefit from public subsidy of their lending or other financial services (e.g., deposit insurance, insurance, and pension fund guarantees) could reasonably be expected to contribute in various ways to meeting credit needs they are unable to address directly.

Several possible financing mechanisms could complement direct Congressional appropriations for the Clinton CDFI program. These include: commercial bank commitments of equity capital and other support to CDFIs as an outcome of CRA negotiations or mega-bank mergers; a share of profits from appreciation of federally sold assets (e.g., a percentage recapture levy on Resolution Trust Corporation properties); a share of profits from government-sponsored enterprises such as Fannie Mae and Freddie Mac; and CDFI set-asides within major legislation to bail out the S&L industry or inject capital into other parts of the financial services industry. A combination of such modest measures could yield hundreds of millions of dollars of capital needed to buil a vibrat, large-scale CDFI sector.

In addition, the Clinton Administration should consider carrots and sticks for commercial financial institutions to provide long-term, low-cost capital to the CDFI sector. Measures such as requiring conventional lenders, pension funds, investment banks, insurance companies, mortgage companies, and finance companies to place a very smal proportion of their overall assets with CDFIs would yield enormous public benefits in the form of jobs, affordable housing, and increased ownership opportunities. It would also underscore the expectation that such institutions that receive public subsidies have special responsibilities to see that community credit needs are met.

Finally, the Clinton Administration should consider incentives to increase investment in CDFIs by America's major wealth-builders--individuals. CDFIs have proven their ability to raise private capital for community investment from individuals. This could be significantly enhanced if federal tax laws were amended to provide tax-free interest to individuals who make below-market community development investments or deposits in loan funds, credit unions, micro-loan funds, and development banks. This incentive would be available to individuals at all income levels, would give investors (or depositors) the equivalent of market-rate returns, and would--via CDFIs--strengthen communities socially and economically.

7. Corresponding Federal Policy Changes

A federal policy of supporting community development finance must be extend beyond the proposed network of 100 CDFIs. The Clinton Administration can back up its investment in CDFIs by a series of administrative and legislative initiatives:

- **Simplify public sector credit enhancement programs to non-profit CDFIs.** Partial and full loan guarantees, for example, could significantly increase the ability of CDFIs to leverage both public and private investment dollars. The Community Preservation Corporation in New York City has successfully used municipal and state guarantee programs to direct more than $1 billion in bank, insurance industry, and municipal pension fund moneys to affordable housing lending. Farmers Home Administration, Federal Housing Administration, and Veterans Administration programs could be used to replicate this model with CDFIs across the nation. Similarly, South Shore bank is the largest Small Business Administration (SBA) lender in Chicago. Beneficiaries are primarily minority-owned businesses. Non-depository CDFIs could increase their business lending if SBA rules were modified to simplify the requirements on non-bank lenders. This adaptation would also increase the number of minorities, women, and rural businesses receiving SBA support.

- **Require government-sponsored enterprises (GSEs)--Fannie Mae, Freddie Mac, Ginnie Mae--to develop customized secondary market programs for housing and business loans originated by CDFIs.** To date, GSEs have been almost completely unresponsive to CDFIs. CDFIs' performing loans are judged by standardized underwriting criteria that are largely irrelevant to CDFIs' lending markets. CDFIs cannot grow and proper unless an active secondary market is fostered for their loans. Existing GSEs have an obligation to serve this market aggressively and can do it profitably. CDFIs' lending track record has spurred great interest among social investors-- such as religous and municipal pension funds-- to purchase performing community development loans through private placement mechanisms.

- **Ensure public accountability of all CDFIs.** Limited federal oversight will be necessary to administer the CDFI initiative and to ensure public accountability. Regulatory and program evaluation standards, however, must be founded in the current policies and practices of the diverse range of CDFIs. We recommed that the Clinton community development initiative rely primarily on performance-based funding to encourage the use of "best available" practices and to enable the industry to grow into a highly effective national system. This approach ensures that recipients of federal support build capacity as they grow. We recommend that two principles should guide this approach:

(1) **Oversight and evaluation should be performance-based.** A new federal community development program would be remiss if it used a strict selection process for participants that excluded a significant sector of the CDFI industry. The only way to build a national network of 100 or more depository CDFIs is to seed the existing industry broadly and then to allocate resources to those organizations that meet negotiated performance targets. This process will allow a range of approaches while ensuring a fair level of return. In addition, it will allow the most innovative and determined lenders to grow while the others drop out of the national system.

(2) **Performance evaluation should be outcome-based.** No two CDFIs will operate alike. Each will have unique target groups, activities, methods, procedures, and priorities, depending on the characteristics of the communities in which they lend. A federal attempt to micro-manage all CDFI lending by requiring, for example, federal sign-offs on individual loans or uniform underwriting or loan servicing guidelines will be counter-productive. Ultimately, it will fail. Instead, federal oversight officials should negotiate expected institutional outcomes with each recipient within a range of statutorily acceptable outcomes that are related to the institution's primary mission of providing credit for community and economic development. Performance evaluation should focus on the CDFI's success at achieving these outcomes. Outcome criteria should be established for, among other things, lending volume, portfolio performance, capacity building, and program results (e.g., service to targeted constituencies), and should be measured over an extended time period that allows for accurate assessment of success.