

For years, the Sisters of Mercy of Omaha in Nebraska saw the housing problems that plagued the disadvantaged members of the community with whom they worked. Many had difficulties with landlords, were denied loans as high-risk borrowers or lived in deteriorated housing.

The sisters decided to become part of the solution. They became landlords.

To accomplish their objective, they purchased property and they also developed a source of loan capital, establishing an organization aptly named Mercy Loan Fund. The Denver-based organization, which is a subsidiary of Mercy Housing, makes loans to developers who plan to build housing for low-income, high-risk individuals. Borrowers need not be faith-based, but they do need to be committed to providing affordable housing. Many of the investors are Catholic sisters, entrusting their retirement funds to the organization.

Mercy Loan Fund is just one type of a community development financial institution, or CDFI. This type of organization fills a void left by traditional banks, said Diane Leavesley, president of the Mercy Loan Fund.

CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and nonprofit developers; flexible underwriting and risk capital for needed community facilities; and technical assistance, commercial loans and investments to small startups or expanding businesses in low-income areas. CDFIs include regulated institutions such as community development banks and credit unions, and nonregulated institutions such as loan and venture capital funds.

Leavesley, a director at the Denver Branch of the Federal Reserve Bank of



SIMONE BENNETT, operator of Almost Home Child Care, is one of many recipients of the First Step Fund, a microenterprise loan fund in Kansas City, Mo., that provides technical training to participants.

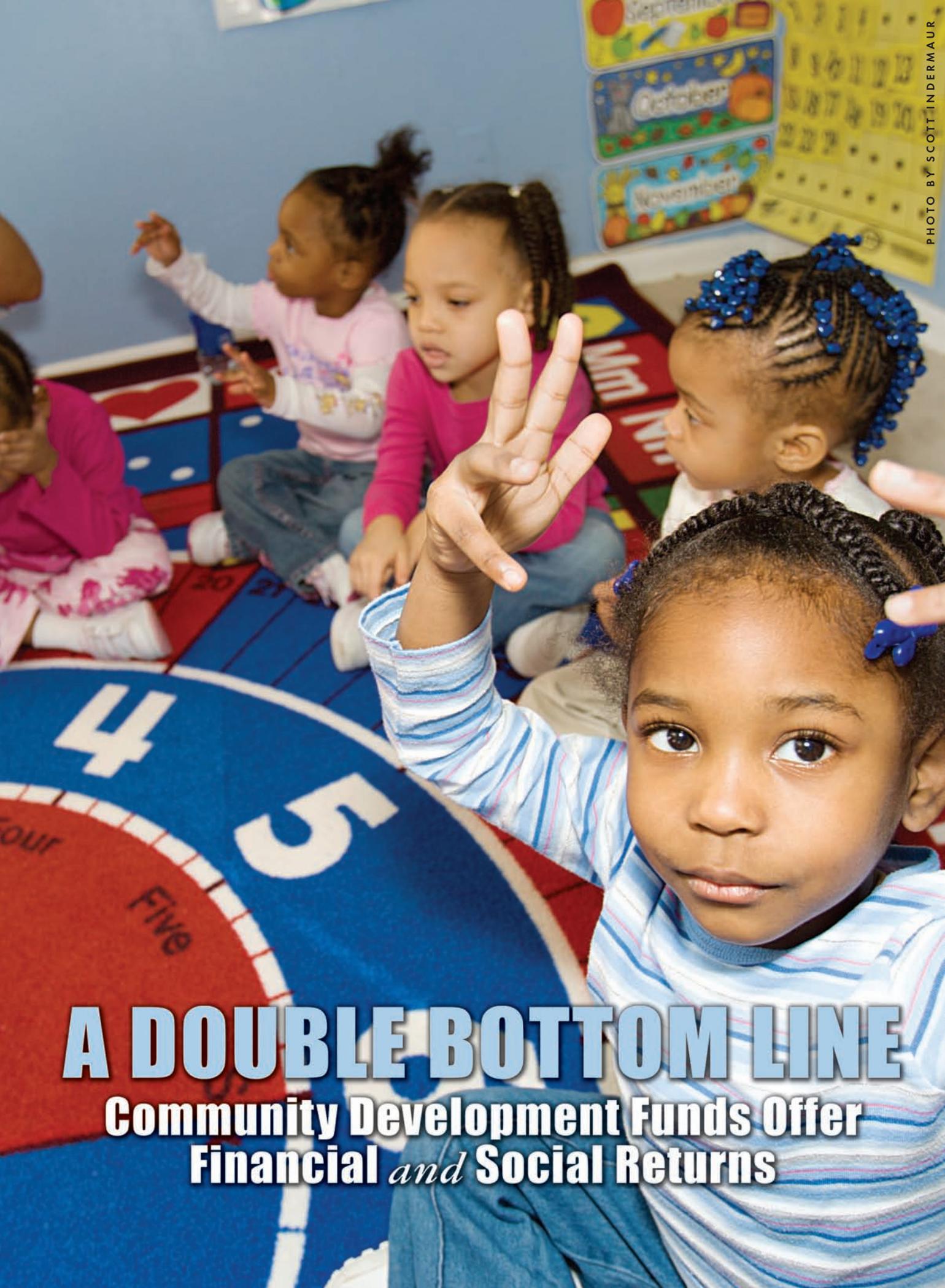


PHOTO BY SCOTT INDERMAUR

A DOUBLE BOTTOM LINE

Community Development Funds Offer
Financial *and* Social Returns

Kansas City, is careful to note that her CDFI does not compete with banks, but complements them instead.

“There are needs for gap financing that traditional banks are unable to meet,” Leavesley said. “We can provide loans with higher loan-to-value ratios and work with less-creditworthy borrowers than a banker would.”

In some cases, Mercy works with startup organizations that graduate to working with banks.

“We consider that a success,” Leavesley said.

In other cases, Mercy will be in a second position, financing a second mortgage on a property whose first mortgage is with a traditional bank, enabling the bank to remain adequately secured on the investment.

Linda Tinney, vice president and community development manager for U.S. Bank, counts Mercy Loan Fund as an important partner in their affordable-housing lending programs.

“They get projects started with their early-stage, higher-risk financing that allows us to come in behind and support,” Tinney said. In addition to their skilled management and mission-driven staff, Tinney said, CDFIs help develop the local capacity and infrastructure needed to support broader economic development.

Filling a niche

Because of the potential that CDFIs represent in reaching nontraditional borrowers, the Community Affairs Department of the Federal Reserve Bank of Kansas City has taken an interest.

“CDFIs set an example that financing can work in low-income and distressed communities,” said Steve Shepelwich, a senior advisor of the Community Affairs Department in the Bank’s Oklahoma City Branch. Shepelwich has been studying CDFIs in the Tenth District.

The department has taken an active role in supporting training events for CDFIs and raising awareness of the roles they can play in economic development. In Oklahoma, for example, the department co-hosted a regional training event with the Association for Enterprise Opportunity for organizations that provide support to microenterprises, as well as



partnered with local CDFIs in strengthening the delivery of financial education services.

CDFIs have been around since the early 20th century, but contemporary developments helped boost their numbers. The Community Reinvestment Act of 1977 (CRA) placed the responsibility on depository institutions to lend to, invest in and serve all of the communities in which they receive deposits from customers. The mission and innovative business strategies of CDFIs have made them important partners for banks in their efforts to meet this obligation. In 1994, the federal government established the CDFI Fund within the Treasury Department with the goal of supporting CDFIs in their efforts to provide capital and financial services to underserved people and communities. CDFIs that obtain certification from the Treasury Department are eligible for various grants, loans and awards. In addition, certification indicates the CDFI has undergone a measure of due diligence into its background and operations, thereby making it



PHOTO BY SCOTT INDERMAUR

THE “FIRST STEP FASTTRAC” TRAINING Jacqueline Buycks (left) received was instrumental in helping her identify solid business opportunities. After graduating from the program, she opened Big Mama’s Rolls Bakery in Raytown, Mo., along with her sisters Joyce Brown and Jill Kemp.

a more favorable potential partner for a bank.

CDFIs come in many shapes and sizes, each variant seeking to fill a niche. For instance, Mercy Loan Fund is a community development loan fund; other types of CDFIs are microenterprise development loan funds, community development banks and credit unions, and community development venture capital funds. The common theme is the desire to revitalize communities and to improve the quality of life of those who live and work in these communities.

A ‘double bottom line’

Shepelwich said that CDFIs present an op-

tion for “social investors” who want their investments to fit their values. In industry parlance, investments that provide social as well as financial returns have a “double bottom line.” CDFIs offer individuals an opportunity to receive both a return, though often at a below-market rate (Mercy Loan Fund investors receive about 3 percent), and the assurance that their investment will be used to expand opportunities for local small businesses and community members. CDFIs offer banks and other corporations the ability to engage in new market opportunities, with reduced risk, and to contribute to corporate social responsibility goals.

CDFIs and banks frequently work as partners, with the CDFI underwriting loans while the banks provide capital. But a CDFI does much more than service the loan, depending on the niche it fills. All CDFIs offer additional services to help their clients make successful use of the financing provided. Some CDFIs offer business training and consulting services for borrowers. For people who are “unbanked,” CDFIs provide an alternative to higher-cost lenders by offering microloans and financial literacy courses.

Nationwide, CDFIs control more than \$17 billion in assets, according to the CDFI Data Project, an industry database on CDFIs. The 28 certified CDFIs in the Tenth District that participated in the survey reported a total of \$512 million in assets. Of this, \$345 million financed housing, small business development and other development goals throughout the District. In 2004, these CDFIs financed over 900 businesses, resulting in the creation of over 750 new jobs and the creation or renovation of nearly 1,500 housing units.

While consumer loans accounted for the greatest share of the loan volume (38 percent), the survey found that 54 percent of financing dollars went to housing. Another 28 percent went to business lending with the remainder financing consumer lending and community facilities projects.

According to Shepelwich, given that only 53 of the 752 certified CDFIs in the country are located in the Tenth District, there is ample room for expansion, both in terms of the



PHOTO BY SCOTT INDERMAUR

ROBERT AND MARTHA MACFARLAND established Cupini's Fresh Pasta & Panini in downtown Kansas City, Mo., using favorable CDFI financing rates to purchase freezers, ovens and fixtures.

financing offered by existing institutions as well as the number of CDFIs operating Districtwide.

A business model

The EDC Loan Corp., a subsidiary of the city-run Economic Development Corp. in Kansas City, counts a number of business-

es in low-income and distressed areas as clients.

"We've had great success using our CDFI designation," said Brian Standage, the director of finance for EDC Loan Corp. His organization has long used a number of products to underwrite loans to small businesses in the urban core and became CDFI-certified in late 2001. In order to receive that certification, EDC Loan Corp.'s portfolio must maintain a certain level of its investments in distressed communities.

Standage said his organization works with a handful of local and regional community banks, which receive an incentive from the Treasury Department for the loans they provide. Because banks receive that incentive, they can accept a lower rate of return from the loan, Standage said. Banks are motivated further by the potential of receiving credit toward meeting their obligations under CRA to serve the whole community.

Since becoming certified, EDC Loan Corp. has provided 29 loans totaling \$1.6 million, which, in turn, have led to the creation or retention of 149 jobs and the renovation of buildings in Kansas City. Entrepreneurs need only 10 percent down for a

business loan, compared with 20 percent or more required by traditional lenders.

Because of the higher risk EDC Loan Corp. takes on, underwriting is important, Standage said. A person's creditworthiness and business plan are reviewed carefully, just as they would be at a bank.

"We want to make sure we do due diligence," he said. "We are stringent on how we underwrite. Some lenders look at social return. We look strictly at economic return."

One CDFI that does look mainly at social return is the First Step Fund, a microenterprise

development loan fund in Kansas City, Mo. Though a CDFI, First Step is not certified by the Treasury Department because the program's primary focus is not lending.

First Step provides technical training to its participants during 10- and 16-week sessions. Participants all take part in reviewing loans, and graduates of the sessions can qualify for microloans of \$500 to \$2,500. Graduates, whose endeavors run the gamut of enterprises—janitorial services, etiquette classes, administrative support services and bakeries—receive ongoing counseling.

"Our focus as an organization is the individual and fostering economic self-sufficiency," said Executive Director Vanessa Finley. "The tool we use is entrepreneurship."

Finley's organization has created its own curriculum that teaches business planning called "First Step FastTrac," and another program for child care providers, "Developing a Family Child Care Business." First Step has licensed both, which are sold to sites around the country, providing the main source of revenue for First Step.

Jacqueline Buycks, a program graduate who now is vice president of First Step's Board of Directors, said that by requiring borrowers to complete a training program first, the CDFI lowers the risk associated with the loans. Buycks operates two microenterprises, a staffing service and a bakery that she co-owns with her two sisters.

"I really believe that the training I've had has been instrumental in helping me make intelligent business decisions," she said. "That is key because not every business plan is feasible."

Another recipient of First Step's training was Simone Bennett, operator of Almost Home Child Care. She said the training helped her run a more efficient business, a child care center that takes in 12 children full-time. This, indeed, is an example of the type of social returns that CDFIs offer.

On the other end of the CDFI spectrum are venture capital funds, which take an ownership position in their investments. MetaFund, in Oklahoma City, is one such CDFI.

MetaFund Director Tom Loy ticks off the

businesses his firm has invested in—everything from a sod farm to a Native American newspaper.

"Almost everything we invest in is too early-stage or too undercapitalized for a bank to consider," he said.

Furthermore, all his investments have the potential to yield social returns.

"Everything we do we hope is either creating jobs or housing or otherwise directly benefiting low- or moderate-income people, or residents of distressed geographic areas, which is a broad definition of the Community Reinvestment Act," Loy said. "But we are not doing this as a loss leader, as most banks would. For us, it is designed to be a self-sustaining business model."

'Spirit and drive'

CDFI financiers agree that finding funding for entrepreneurs is rewarding.

"We're providing capital that's otherwise unavailable to small business," Standage said.

One of those businesses is Cupini's Fresh Pasta & Panini in downtown Kansas City, Mo. Owner Robert MacFarland said the terms of the loan he received were "stellar."

He used the funds to purchase freezers, ovens, deli counters and tables for the business that he opened in March 2005 in an area that, until then, had no delicatessens.

He credits a CDFI with making his endeavor possible and, in turn, contributing to the development of the community.

"Not only does it take an entrepreneur with a big spirit and a great drive, but it takes someone willing to finance them."

T

BY TONI LAPP, SENIOR WRITER

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.