Strength in Adversity:
Community Capital Faces Up to the Economic Crisis

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First Responders—America's Community Development Organizations

This paper reviews the impact of the economic crisis on the community development industry. Specifically, it asks, how are Community Development Financial Institutions (CDFIs) faring? What trends are emerging? What steps are CDFIs taking to respond to the crisis? In addition, the paper offers "best practices" to help all CDFIs manage this difficult climate. To answer these questions and to learn from our CDFI peers, we conducted a series of eleven interviews with leading CDFIs across the country.[2] A number of common themes emerged, from heightened portfolio risk and decreased liquidity, to the need to develop new skills such as how to implement an effective loan workout.

CDFIs can survive this economic crisis and deepen their mission, despite the extraordinary difficulty of the current period. CDFIs are the first responders in neighborhoods across the country and for families hardest hit by the downturn. CDFIs have created an industry joined together by a common mission of providing opportunities for people and places left out of the economic mainstream. The CDFI network can create the strength for CFDIs to help one another through these times, and to ensure not only that the field survives, but that it thrives.

Avoiding Denial—What Is the Impact of the Economic Crisis on Community Finance?

Heightened Risk

In general, all CDFIs reported heightened risk in their portfolios and particularly in housing loans, whether they were national, regional, local, large, small, rural or urban. The severity of risk varied considerably by portfolio concentration and by size. Those with high concentrations of housing, particularly homeownership projects, reported far greater risk. Eight of the ten CDFIs with sizable housing portfolios saw homeownership projects as a primary source of increased risk. In particular, respondents reported that unsubsidized homeownership loans were experiencing the greatest weakness.

Heightened risk was evident in increased delinquency rates, or an increase in loan extensions, or increases in loan loss reserves, and occasionally in all three. Two respondents reported no loss reserve increases. The others reported some increase in reserves, generally by 25 percent to 50 percent. One CDFI with a large exposure to homeownership reported a tenfold increase in its annual provision for loan loss reserves.

The second most frequent cause of growing risk was dependency on fundraising or public subsidy (reported by five of eleven CDFIs). One CDFI reported a full stop on new loans that depended on fundraising.

Smaller CDFIs reported less portfolio deterioration than larger CDFIs. Respondents saw short-term acquisition and predevelopment loans as more risky than long-term loans for projects already in service and seasoned, especially community facilities. Portfolios with greater concentrations in Low Income Housing Tax Credit (LIHTC) projects experienced greater risk. One CDFI avoided portfolio deterioration

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because of the absence of LIHTC-dependent projects in its portfolio. Projects in weaker markets, such as those in rural or exurban areas, were affected more than in strong markets.

Geographically, western CDFIs saw more trouble than others. Several national and regional CDFIs reported a concentration of problems in California. They reported enduring slow payment on loans and deep financial stresses on community developers. The strains in California CDFI portfolios extended beyond housing and homeownership to health care facilities, charter schools, and other community facilities. One CEO feared that the affordable housing delivery system would be permanently weakened because many community developers would not survive the current economy. One national CDFI reported the weakness in its portfolio was concentrated in Los Angeles, Florida, and in rural locations.

Although community facility portfolios seem to be holding steady at present, many leaders said they were waiting for "the other shoe to drop," and foresaw trouble in this sector in the near future, as well as in their commercial portfolios. One respondent predicted the commercial and facility loans "will be the second wave."

Need for Patience

Most CDFIs (nine of eleven respondents) called for greater patience as borrowers scrambled to put resources together to make deals work. "Everything is taking longer," one respondent said. "Borrowers are going multiple rounds to get financing and subsidy, at the state and city level." Some leaders reported that their delinquencies were stable because they simply extended loans, believing that the borrower would eventually work out the problems. One CDFI reported extending 80 percent of its housing loans (up from 50 percent in more normal times). Another reported that they had always experienced many extensions, but "now it is for bad reasons." In part because of this growing need for patience as projects came together, all but a few CDFIs were anxious about investor renewals and serious liquidity issues that affected their ability to finance new requests.

Serious Liquidity Problems

Liquidity shortages were felt broadly, but large CDFIs were particularly affected. Six of eight large or rural CDFIs reported current and often severe liquidity problems, or concern about future liquidity problems. Smaller CDFIs fared better as well as those located in the Midwest. All but one CDFI expressed concern about a contracting capital environment, even if they were managing well at present. Respondents also noted the need for extensions, the lack of new capital coming into the field, and concern about capital renewals. Indeed, one CDFI leader said, "If banks don't start lending again at reasonable rates, a lot of us will go out of business." Another said that their capital partners were "really hunkered down. They've begun to understand that this is a structural adjustment and they need to figure out the new normal."

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Many of the CDFIs that experienced strong growth in deployment during the past two to three years were more likely tapped out of capital than those with growth in the past year. On the other hand, CDFIs that had not expanded their lending volumes appeared to be faring better than others with respect to liquidity. In the case of faster-growing CDFIs, recent high-volume levels had consumed much of their available capital and the need to extend loans was causing a capital crunch. Nearly all CDFIs reported difficulty in getting new capital and sometimes renewed capital. Most reported "just making it," by saying no to borrower requests. Some indicated that the liquidity problems were being offset by reduced demand. Others reported that demand had increased in recent months, largely from the contraction of lending by banks.

CDFIs reported mixed experiences with investor renewal of capital. In general, they were "holding steady" with capital levels, but new capital was virtually impossible to find. One CDFI reported negotiating with a bank for more than two years and being on the cusp of a capital commitment, only to find the bank taken over by another, and the verbal commitment nullified.

Housing Loans Are Hardest Hit

As noted above, most CDFI leaders reported that increased risk came mainly from the housing portion of their portfolios, particularly from for-sale housing. "Homeownership," said one respondent, "is clearly most severely impacted. It is head and shoulders above the others in weakness. If ten deals are in trouble, seven will be in for sale/homeownership. However, our community facilities are fine."

Community facilities (charter schools, child care centers, health care centers, water and sewer systems, and other community centers) seemed to be performing well, particularly if the financing was long-term and for a facility already in service. That said, a few saw future trouble in their community facilities portfolios, assuming hard times spill over into the next year. CDFIs with loans in California reported more concern about community facilities projects than others.

Three CDFIs continued to experience strong customer demand, particularly when the CDFI was involved in financing community facilities or commercial lending. As one respondent said, "There is a ton of demand right now. Our phones are ringing off the hooks." Her organization, she said, was "moving upstream" and taking on deals previously done by banks. Most leaders, however, and particularly those concentrated in housing, had seen demand slow dramatically during the past few months largely because of the uncertainty of public support, the collapse of the LIHTC market, and state or local budget issues that made new projects too dicey to undertake. The reasons given for slower volume included: housing developers remaining on the sidelines, waiting for property values to bottom out; housing developers are financially weaker, because they are paying the carrying costs of unfinished projects over longer periods of time as total project financing is assembled; lack of capital supply is forcing demand to contract; lack of public subsidy to fund new projects; homeowners remaining on the sidelines because of uncertainty over their employment future, despite the low cost of housing.

How Are CDFIs Responding?

In general, CDFIs are responding to the need for patience by extending loans (nine of eleven respondents) where an extension did not cover up a credit problem. All CDFIs but one reported notable increases in extended loans. The result is a liquidity crunch that often forces CDFIs to dial down positive responses to new requests.

CDFIs are managing heightened risk through a combination of extra vigilance toward late payments, bulking up loss reserves (nine of eleven respondents) and, in a few cases, performing stress tests on portfolios and corporate budgets. Many CDFIs are scrutinizing deals more closely, along with asset valuations, and occasionally, reappraisals of portfolio collateral. Most reported higher scrutiny of transactions at the front end, in light of the risk environment.

The most common risk management strategy is paying greater attention to late payments. CDFIs are making calls to customers within a few days of the due date, and are escalating if payments are not received. The second and third most widely used approach to mitigating risk is paying extra attention to borrowers' financial condition and scrubbing of asset valuation. CDFIs are also performing stress tests on borrower projections, looking at levels of borrower liquidity to determine size of loans, as well as imposing tighter terms and conditions.

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Yes We Can! (Manage Through This)

The community development financial sector's biggest asset is its commitment to a shared vision and an industry structure that does not require competition for vitality. The economic crisis calls on this asset more than ever. The field will need the strength and insights of everyone to pull through this extraordinary time. Several leaders noted that if the crisis goes on for more than a year, it would create serious hardship for the industry. One CDFI leader said, "Philanthropy needs to hear that 2010 is a watershed year for CDFIs and other nonprofits dependent on multi-year grants. 2011 is not survivable without continuing support. We may watch the silent demise of nonprofits."

Many CDFI leaders called for new ways of communicating and sharing, for creating united fronts endorsing common positions on critical issues, especially capital requirements. To get through this crisis, the field will need to pull together more closely than in the past. The watchwords for the next several years will be: learn, share, and help.

Steps to Weather the Storm

Navigating the worst economy in a century will require that members focus on ensuring that the field is as secure as possible and able to continue to attain its goals and sustain its mission. This requires a number of proactive steps:

Batten Down the Hatches

During any crisis, it is important to identify one's soft underbelly and protect it, rather than waiting for problems to arise. Although some CDFIs are reporting no dramatic increases in delinquency rates, they are anticipating problems and are rescoring their portfolios, increasing their risk reserves, and scrutinizing new requests. These are perfect initial steps.

Now is the time, as well, to begin stress-testing at the organizational level. How much of a revenue decrease can the organization withstand? What would happen if grant support declined by half? What happens if ten percent of the organization's portfolio is nonperforming? The goal is to identify in broad strokes the magnitude of potential problems and to develop responses for the back pocket if bad news is forthcoming. In the end, the actual steps an organization takes may be quite different. But there is nothing quite as reassuring to a leader as thinking through how bad it might get, identifying the soft spots, and developing contingency plans.

Workouts and Foreclosures

For many CDFIs, loan workouts are a rare event. Although projects often hit bumps in the road, the ability to be patient and responsive to borrower requests has often been the main ingredient for a successful workout. However, conditions have changed markedly in the past twelve months. Good workout and restructuring are specialized skills. In the best circumstances, they can be a tool to enhance borrower strength and capacity. Few CDFIs, however, can afford to bring on special asset managers. Yet all CDFI lending staff can learn the special skills of a workout situation. One of the hardest things to balance is when to exercise speedy and decisive action over simple patience. A second difficulty is how to communicate in a manner that helps the customer understand why the workout is the best course, particularly if wishful thinking is at play about the project's future chances.

In any event, it is worth considering whether an industry wide response is warranted. This could take the form of a shared approach to workouts and restructurings, or training for lending staff. At the highest level, an industry response might also include a "bad bank" where CDFIs could create liquidity from their underperforming assets while transferring them to specialized expertise to help customers get through these difficult economic times.

Our Borrowers, Ourselves

Policy matters. CDFIs are frequently lagging indicators of the overall economic environment. Although borrowers are on the frontlines, the field can be shielded from immediate impact by borrowers' coping strategies: they use their own cash to feed projects or fundraising shortfalls, they lower operating expenses to cover debt service payments, and so forth. However, if the economic downturn is both deep and protracted, these coping strategies will be temporary. Ultimately, the health of CDFIs depends on the financial health of its customers.

Many CDFIs are witnessing the deteriorating conditions of community developers and human service organizations. The withdrawal of public safety net services and the contraction of philanthropic support pose a special challenge to the CDFI agenda. Raising a strong voice to advocate for the community development agenda is more important now than ever before, and the message must be about the resources that not only benefit CDFIs, but also their customers. LIHTC, Section 8, and Community Development Block Grants are examples of programs central to the community development agenda, but less central to the CDFI advocacy agenda. More than anything else, supporting the advocacy agenda of community development will protect borrowers and the CDFI field in the coming years.

Never Waste a Crisis

Use the basics to grow stronger. It is worth repeating the basics of sound fiscal and organizational management. There is nothing complicated or fancy about these principles. They are rooted in everyday common sense. Ironically, several of the high-flying financial institutions that crashed in the current bust violated these fundamentals.

To keep it simple, there are three financial management principles that matter most: net worth, liquidity, and net operating income margins. Of the three, net worth or equity is most important. There are only two ways to create net worth: through annual surpluses or attracting equity and capital grants, for example from the Financial Assistance program from the CDFI Fund or the Capital Magnet Fund. Sufficient liquidity requires CDFIs to manage cash to cover at least one year of upcoming liabilities (although management textbooks say the ratio should be 2:1, for CDFIs, 1:1 is a must). Keep 90 days of operating expenses in cash as well. In terms of net operating income, always budget a surplus. A four to eight percent net operating margin has proven to be a good range. This is the cushion that allows budget estimation mistakes and revenue reversals to be absorbed without eroding net worth.

Other Best Practices

Other best practices include full-cost accounting, ongoing forecasts of annual and multiyear performance, and scenario planning. These are techniques that support financial security.

Full-cost accounting: Full-cost accounting aligns the expenses attributable to an activity or program with the revenue the program generates. It requires properly allocating management and general costs (overhead). Full-cost accounting is the basis for understanding which activities cover their costs, which create surpluses, and which require discretionary resources. This allows management to make rational and deliberate decisions about which activities to expand and which to shrink.

Scenario planning: Create high-, medium-, and low-risk scenarios for each annual planning cycle. This can seem like make-work, but it is crucial. If nothing else, scenario planning forces thought about the assumptions beneath annual plans, and programs are stronger for it. Moreover, the financial aspect of scenario planning can reveal weaknesses and assumptions that alert management to issues they must tackle. Using worst-case scenarios in the present climate forces us past our natural denial and disbelief. In the end, worst-case planning can spark new ways of looking at an organization and point to creative solutions to existing problems.

Ongoing projections of fiscal performance: A discipline often overlooked is preparing year-end projections with each financial statement. Similarly, multiyear scenarios (three to five years) should be refreshed annually as part of the planning cycle.

The Network Solution: Sharing Our Way through This

CDFIs form a national network dedicated to a common vision of community development and poverty alleviation. On a daily basis, however, the field operates separately, with little sharing of services, operations, or expertise across organizations. This isolation causes a "hall

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of mirrors," where each CDFI creates independently the systems and expertise needed to run its business. Each enterprise is largely on its own in addressing problems and challenges. The result is increased overhead and inefficiency. The field's survival and future health depends on greater efficiency and cost savings. In these most difficult of times, the field needs everyone's ideas and cooperation.

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CDFI leaders identified five pressing needs for the future:

(1) Equity support. The top priority for CDFI leaders was the need for additional equity and protective capital during the down cycle. This could take the form of equity grants, loan loss reserve grants, possibly even equity equivalent loans. Many equity bases are stretched by credit deterioration at precisely the moment CDFIs need to be patient with customers. Additional equity would mitigate this and permit more mission-driven behavior rather than "hunkering down." As one organization said, "there's no sense of being a CDFI if we can't push mission in a down time."

(2) Liquidity relief. A near tie for first place was the need for additional liquidity. Although the need is for additional liquidity, many also made the point that the price must be reasonable so that CDFIs could earn spread income. The strategy for this may well be joint advocacy for additional resources for the CDFI Fund, for renewed capital commitments from banking partners and foundations, or increased capital commitments through the current regulatory reform discussions. There was interest in innovative new legislation, such as the Opportunity Finance Network sponsored "CDFI bond" program. Likewise, several leaders reflected the concern that foundations with program related investments (PRIs) and banks with loans to CDFIs were not responding flexibly with capital renewals or extension in the face of extraordinary financial circumstances. They pointed to a need to join together to influence investors.

(3) Workout/troubled asset relief. Several organizations asked for a centralized workout service that they could call upon in dealing with the troubled loans in their portfolios. This could take the form of a "bad bank" to purchase troubled loans and recapitalize CDFIs. A second approach would be to provide expertise that CDFIs could call upon for help with their most troubled loans.

(4) A forum for self-help. Every organization interviewed called for additional opportunities to learn from one another. Some were hopeful things will improve soon; others felt there was more darkness to come. Nevertheless, all organizations called for increased communication and sharing of best practices, resources, and information. A few called for new models of shared services to improve operating efficiency. One leader asked for "volunteers from banks who are workout/trouble asset specialists." Another asked for help in developing sophisticated liquidity models and processes. Most called for stronger advocacy within policy circles.

(5) Policies for new resources. Central to CDFI-specific policy work are the CDFI Fund appropriations debate, funding the Capital Magnet Fund – included with an $80 million allocation in President Obama's budget—and funding of the New Markets Tax Credit program.

In addition, the importance of the upcoming Community Reinvestment Act debate cannot be overstated. CDFIs need to be a strong voice in this debate, advocating for increased resources for communities. In fact, the Opportunity Finance Network is developing ideas for building CDFIs directly into the fabric of regulatory reform as a "must do" for financial institutions in meeting their community reinvestment obligations.

Because the future of development finance is intimately linked to its customers, many of the policy issues affecting those customers will provide ultimate support to CDFIs. These include the Low Income Housing Tax Credit market, Section 8 subsidies, National Affordable Housing Trust Fund subsidies, Community Development Block Grant programs, and a range of education, child care, and health care operating subsidies. Providing support to CDFIs without shoring up these underlying programs will be only a temporary solution. CDFIs could lend critical support to their customers when they advocate for increased federal and local support for these safety-net programs. CI

Endnotes

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1. This article is a condensed excerpt of a Community Development Investment Center Working Paper, entitled "The Economic Crisis and Community Development Finance: An Industry Assessment." For the full article by Nancy Andrews, see http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf
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Peer-to-Peer Lending and Community Development Finance

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5. To date, only one platform, MicroPlace, has been granted approval from the Securities and Exchange Commission (SEC) to sell third-party-issued securities to multiple individual investors on its site without triggering a suitability requirement. While this is a key regulatory achievement, it is important to note that securities sold on MicroPlace are backed by their issuer—not the lender or the end borrower. The SEC has yet to allow any P2P finance platforms to sell third-party issued securities backed by assets (loans) online.
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7. Interview with Chris Larsen on July 17, 2009.
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