BACKGROUNDER ON FINANCING SUSTAINABLE DEVELOPMENT

Prepared by Environmental Defense

Summary

This backgrounder provides an overview of the community development finance industry to illustrate how revolving loan funds and community development financial organizations are structured and operated. These models will be reviewed and assessed as part of the Environmental Defense/Shorebank Enterprise Pacific project to develop the innovative California Sustainable Fisheries Revolving Loan Fund.

Background

The community development finance industry embraces a broad cross section of development institutions, both for-profit and not-for-profit. Community Development Financial Institutions (CDFIs) generally focus their activities and resources on one or more areas of social need including affordable housing (owned and rented), small business support, community reinvestment, community facilities (e.g. child care, health care), consumer credit, and financial services. Activities include expert consulting services (in the areas of need from above), building the capacity of beneficiaries, and investment of dollars to support specific tangible projects that have positive environmental, social, and economic outcomes.

Most mature CDFI's are certified by the US Treasury under the Community Development Financial Institutions program (www.cdfifund.gov/overview). This certification is available to those non-profits with formal business plans, assured levels of community accountability, and professional management systems. Many of these same organizations have received financial support from Treasury's CDFI Fund as well.

The total capitalization of CDFIs in the US today is about $4.6 billion. About 65% of this amount is held by for-profit institutions (banks, mostly). The balance, or about $1.6 billion, is held by non-profit organizations. Those focused on economic development represent about 20% of the non-profit CDFI contingent (with the balance focused primarily on affordable housing activities). The group of non-profit organizations focused on economic development, share a concern for delivering capital and services to people and communities that cannot access traditional bank capital. The results they seek are wealth creation, economic opportunity, stable economic sectors, and locally vital economies that deliver leveraged positive impact for many people. The California Sustainable Fisheries Revolving Loan Fund would focus on investments aimed at revitalizing California's fisheries by improving both financial and environmental performance.

Need for Economic Development CDFIs

The CDFI movement emerged from the civil rights and economic opportunity movements. Significant impetus was derived from the well documented history of many financial institutions actively avoiding certain communities (redlining). CDFIs recognize that chronic poverty—of income and of assets—deprives many of the opportunity to access capital. As many have observed, it takes money to make money. CDFIs deliver that money, affirmatively and prudently, when banks and private investors cannot or will not. Fisheries and communities, like people, need capital to reverse economic and physical decline (i.e. fisheries sector). Many CDFIs focus their resources on discrete places knowing that concentrated capital investing will lead to economic revitalization and the jobs and opportunity that come with it.

CDFIs are needed to provide capital for projects that traditional sources of capital such as banks are unlikely to invest in. Fisheries are one such sector; banks generally do not have sufficient fisheries expertise to make good investments in fisheries, nor are they typically willing to provide extensive financial advice to fishermen. As a sector in transition, due to regulatory, management, and environmental issues, the fishing and seafood industry also becomes perceived as a higher risk investment by traditional banking standards. Targeted and well-managed non-bank capital can be used to stabilize the transition underway and result in re-establishing a sector that is attractive to traditional bank standards.

CDFI Financial Structure

Because CDFIs provide loans and other investments to third parties they must access significant amounts of capital. Typically this capital is accumulated in three ways:

1. <u>Grants:</u> Outright grants from public and private sources provide permanent capital. This permanent capital ("fund balance") is roughly equivalent to the "equity" or "net worth" of a for-profit organization. These funds are loaned to borrowers and recovered over time. There are numerous national and regional private sector supporters of economic development CDFIs. Securing a sufficient level of start-up permanent capital is essential for CDFIs to ensure future growth.

2. <u>Institutional Loans:</u> Many foundations and corporations make loans to CDFIs instead of grants. These "program related investments" (PRI) increase total capital available for lending and are only possible if a CDFI has adequate "net worth" to justify a loan. The Ford, MacArthur, and Heron Foundations have been leaders in the PRI field. Many banks also make loans to non-profit CDFIs to increase their lending capacity (Key Bank, Washington Mutual, Bank of America). Many foundations like the PRI vehicle because these very low interest loans apply to the minimum distribution requirements of the IRS and because they can be recovered and reapplied in the future. (www.fdncenter.org/learn/faqs/pri.html)

3. Individual Loans: A few CDFIs have been able to attract socially responsible investors making personal loans. A growing number of individuals with high net worth are opting to make personal investments rather than just outright contributions and find mature CDFIs to be attractive in this regard.

Because economic development CDFIs are focused on investments, and the recovery of those investments, they also tend to be strong managers of their own financial position. Many earn 50% and more of their operating costs from their lending activities, relying on annual grant support for basic survival in diminishing amounts as they grow.

A significant component of a well-run CDFI is risk management. Because they make high-risk investments they sometimes lose their investment. If they never lost any they would not be doing their jobs. That said, they work hard to minimize these losses. They also seek grant support that allows them to create reserves to absorb modest losses. Most CDFIs manage their losses to less than 5% of their total lending activities.

CDFI Impact

Economic development CDFIs generally measure results in terms of (1) successful outreach to targeted beneficiaries; (2) the employment impacts of their investments; (3) the leverage of additional investment resources made possible with their investments; and (4) increases in assets among low income people. Depending on their discrete missions, the needs of their communities, and/or the special opportunities for impact, there are additional metrics that could apply, such as improvements in environmental performance or increases in value-added products (in the case of the fisheries revolving loan fund).

Additional Information

Additional information on the non-profit component of the CDFI movement can be obtained from National Community Capital Association (www.communitycapital.org) and the Community Development Venture Capital Alliance (www.cdvca.org).