Looking for a low-risk way to invest in do-good projects like solar power for affordable housing, micro-loans for Native Americans or financial services for immigrants?

Welcome to the world of community development finance institutions (CDFIs)—a virtually invisible $30 billion-plus industry of more than 1,000 mostly nonprofit, revolving-loan funds that includes credit unions, banks and venture capital funds that serve minorities and low- and moderate-income communities.

The impact investments touch on a wide variety of areas, supporting endeavors such as organic farms and the conservation of fisheries and forests. They’re also ideal instruments for high-net-worth investors who would rather devote assets to a cherished cause rather than a traditional venture capital investment.

For example, Coastal Enterprises Inc., a CDFI that serves communities in Maine, puts a focus on funding start-ups and small businesses, particularly those that are related the region’s fisheries, farms and forests. Hodgdon Shipbuilding LLC, a business in East Boothbay, Maine, that was founded in 1816, is one example of CEI’s loan recipients. The CDFI’s funds helped the company complete the construction of a prototype vessel that serves as a tender to superyachts.

Craft 3, a CDFI that focuses on community development in Oregon and Washington states, has provided financing to a community-owned wind farm in Grayland, Wash. The 6-megawatt, four-turbine wind farm sits on 29 acres a mile from the ocean. It powers 1,000 homes and produces $450,000 in annual cash flow, which assists 2,000 working families, according to Craft 3.

“They are mining that renewable energy in ways that stick to the community that the energy is emanating from,” says Craft 3 President and CEO John Berdes.

As responsible lenders—they usually offer technical assistance such as financial literacy or business training with their loans—CDFIs can be considered a success story. Their ranks include some of the most seasoned and sophisticated impact investors in the country—investors who know how to catalyze and compound social impact.

“CDFIs are the unsung heroes of the financial crisis,” says Debra Schwartz, director of program-related investments at the MacArthur Foundation. “They were on the front lines when banks would not lend at all. And it has been their mission and ability to work with the public and private sectors that has allowed them to lead the rebuilding.”

CDFIs lend where mainstream financial institutions do not—to borrowers who are deemed to be higher risk, perhaps more fragile or smaller or earlier stage. During the recession, the delinquencies of borrowers in this credit category shot up, contributing to the domino effect that led to banks writing off loans, the collapse of the credit derivatives market and, ultimately, the Great Recession. Because CDFIs are unregulated, they had more flexibility in working
with troubled borrowers and survived the crisis of 2008 far better than traditional banks. As high-touch lenders whose
mission is to keep their borrowers alive as well as to get their money back, they provided extensions and
restructured loans, and as a result their write-offs were lower.

"We did not have a loan-loss from any CDFI during the Great Recession," says Dan Letendre, managing director at
Bank of America, which oversees the largest CDFI portfolio in the country—about $1.2 billion of mostly loans to 240
CDFIs in 50 states and Puerto Rico. "CDFIs are very good at protecting their investors." Letendre says CDFIs
benefited from their conservative management, high capitalization ratios (an average of 38% in 2010) and first-loss
equity.
**Historic Origins**

CDFIs have their roots in the civil rights movement of more than half a century ago. In 1966, to address discrimination against minorities and women in the home and business loan industries, Senators Robert Kennedy and Jacob Javits created a demonstration project for community development corporations, or CDCs, which were charged with revitalizing their communities with small business loans, mortgages for the underserved and the like. The following year, the first CDC in the country, supported by the Office of Economic Opportunity, was established in Brooklyn, N.Y.

In the wake of the civil rights riots, meanwhile, several religious congregations and Catholic women's orders reassessed their giving strategies and launched community investment initiatives. The aim was to do something positive by both investing in and doing charity work for communities all at once—essentially what is known today as impact investing.

They began their experiments by investing in credit unions, food banks and day-care centers and later, during the Reagan era, in CDCs.

Traditional government investment in housing through HUD was scaled back, and as thousands of homeless appeared on the streets, it was clear shelters were not enough. Rather than relying on grants, the CDCs began to ask for loans so they could develop affordable housing. Several CDCs evolved into some of the loan funds that are CDFIs today. Among the earliest investments—the New Hampshire Community Loan Fund and the Vermont Community Loan Fund—were made by the Sisters of Mercy.

“These were piddling little organizations run by people who theoretically couldn't do what they did because they weren't really lenders and were thinly capitalized with little or no equity,” says Mark Pinsky, CEO of the Opportunity Finance Network (OFN), a CDFI trade group. “The nuns were doing it at 0% to 2% when interest rates were over 20%,” he says. “It was a scary thing, but it was an act of faith that made it possible.

“There are two things you learn when you borrow the nuns' money,” he continues. “You do something important with it, with real [social] impact. And under no circumstances do you lose the nuns' community money.”

The growth in CDFIs took off in the mid-1980s. Between them, the Ford Foundation and the MacArthur Foundation invested hundreds of millions of dollars in dozens of CDFIs across the country. In 1994, the establishment of the Treasury Department's CDFI Fund catapulted the field further by providing grant money that could be leveraged.

**Catalytic Impact**

Although measuring social impact is a hot investment topic, numbers don't tell the whole story and can be misleading. That's because CDFIs, like other impact investments, often act as catalytic agents. For example, they may provide high-risk “gap financing” to a business or development project, which can then attract funding from conventional lenders. Or a CDFI may finance a critical development of a major corner of a neighborhood that leverages other development.

“To say that a CDFI financed 3,000 affordable homes versus another that financed 40,000 does not tell you anything because it's out of context,” says Paige Chapel, president and CEO of the CDFI Assessment and Ratings System (CARS), which does financial analysis of these nonprofit loan funds and assesses their impact.

One example of the leveraging effect is Boston Community Capital's Stabilizing Urban Neighborhoods (SUN) Initiative. Since 2009, it has invested nearly $70 million in foreclosed houses, buying them at market prices before evictions occur and reselling them to their current occupants at an average reduction in mortgage principal and monthly payments of nearly 40%. Besides allowing over 450 families to avoid displacement by providing them with
affordable mortgages, the investment propped up property values and tax revenues and avoided situations that would create the need for more social services.

Historically, CDFIs have focused on affordable housing, child care, community health facilities and small business lending. Lately, however, there has been an increased focus on broad health issues. CDFIs, for instance, are in the midst of building an industrywide capacity to support sustainable agriculture and access to healthy and affordable food.

“If you can get a grocery store into a community that doesn't have one, or if you can expand a corner store [to include fruits and vegetables], or if you can finance a food hub that connects farmers to institutional buyers of agricultural products like hospitals and schools, you can have a big impact on the economic well-being of people,” says Pam Porter, executive vice president of strategic consulting at OFN. “It provides jobs and income, and it stabilizes property values. And it addresses a major public health issue.”

The health issue she is referring to is obesity, which studies have indicated is a problem tied to income level.

At a conference in Seattle two years ago, David Erickson, director of the Center for Community Development at the Federal Reserve of San Francisco, showed two maps of Los Angeles—one that displayed obesity rates by neighborhood and another by income level.

“They are the same map,” he said at the time. “Access to health care will not improve a person’s health. The ZIP code is more important than the genetic code.”

In fact, Letendre points out, public health officials are focusing on the same environmental and behavioral stress factors that have a negative impact on health—lack of a job, poor housing, bad food, etc.—as community development professionals. That’s one of the reasons the Federal Reserve brought the two groups together at a conference in Washington, D.C., in March.

“In the community development space, we have all these different silos—housing, health, food,” says Kimberlee Cornett, managing director of the Kresge Foundation's social investment practice. “But the thread that really runs through all of that is that almost anything we do has health implications even if it’s non-medical. Think about the weight—the mental stress level—that is lifted off a family when they know they are not going to be evicted and wind up in a shelter.”

Holistic impacts aside, CDFIs have long recognized that policy change is the way to affect millions of people. CARS awards CDFIs a “policy plus” if they can demonstrate that changing public policy is a critical part of their agenda, staffing and funding. CARS has rated 80 CDFIs representing more than half of the $11 billion in on-balance-sheet assets for the industry's loan funds. According to Chapel, about 45% of them have won the “policy plus” designation.
Investing In The Common Good

Most loan funds have assets under management ranging from under $200,000 to nearly $1 billion. Since most are nonprofits, investors cannot make equity investments; equity is derived from either grants or long-term (10 years or more), subordinated, low- or zero-interest-rate debt. As investments, loans are not tax-deductible. CDFIs generally make interest payments quarterly or semi-annually, with principal due at expiration. Individuals usually invest directly or make program-related investments through their foundations.

CDFI loan funds, most of which are nonprofit, generally offer returns ranging from 1% to 5%, with 3% being common, Letendre says, adding that they also tend to be run by seasoned fund managers and organizations with experience. Interest usually rises as the term of the debt increases.

“Our expertise is not small business in the Pacific Northwest,” says Randy Rice, who works with Trillium Asset Management’s community impact investing portfolio. “We like that CDFIs have the expertise to make these decisions. We do not have to do transaction-based due diligence, and we are not looking over every transaction that each CDFI does.”

While Trillium does due diligence on the CDFIs, it supplements its research with site visits. “We want to meet the folks,” Rice says. “We’re interested in seeing what our clients’ money is helping to create.”

Whether clients are attracted to geography or issues, Trillium can find a CDFI in which to place its clients’ money. Sustainable agriculture is popular right now, though it can mean anything to clients from sustainable fisheries or organic farms to grocery stores or food co-ops. In this area, Rice likes the Vermont Community Loan Fund, Coastal Enterprises Inc., the Reinvestment Fund (TRF) and the Cooperative Fund of New England.

Andrew McIntosh, trust advisor for high-impact investments at Loring Wolcott & Coolidge, also considers how useful a client’s investment is to a particular CDFI. “If we have a client who only has $10,000 to $25,000 available for an investment in a CDFI, do we want to use a CDFI that has a $125 million loan fund? Or a smaller one, where the funds are a bit more meaningful?” he says. “It’s been an odd couple of years, when institutional funds have come into some CDFIs, so that our smaller investments are not quite so important to them. ... Not all, but a few, have reported this to us.”

The MacArthur Foundation’s Schwartz says the most valuable money for a CDFI is not a short-term, market-rate investment.

“The most important kind of money for CDFIs to do their work is longer-term, patient, higher risk and frankly lower-return capital because that’s the capital that catalyzes everything else,” she says. “They are doing the innovation. Because it’s so innovative, so high-touch, because it’s mission-driven, it means that they are not just cranking out cookie-cutter deals.”