
# Bridges *to* Dreams

THE STORY OF THE **LOW INCOME INVESTMENT FUND**

CELEBRATING 25 YEARS OF IMPACT: **1984-2009**

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By THOMAS MILLER

The history of community development is a story of committed neighbors, leaders and ordinary citizens trying to make a difference from the ground up – a story that is largely untold. This book is an effort to tell the story of the remarkable American experiment in community development through the eyes of one player, the Low Income Investment Fund (LIIF). LIIF's work illustrates the larger picture of community capital organizations that connect private financial markets with local needs. Through LIIF's example, we see the growth of the community development field as a whole – its expansion in scale, sophistication and impact.

Over the past three decades, the Low Income Investment Fund and other community developers have built a robust infrastructure of support for the people and places facing the deepest economic challenges in our country. With our roots in the social activism of the '60s, we are an entrepreneurial response to America's social needs – built from the grassroots up. Today, community development finance is a $25 billion field that creates a bridge between private capital markets, complicated government programs, and the communities most in need.

This infrastructure has never been more important than now, during the current economic downturn. While the nation faces a recession, the people and places we serve experience a depression. These communities suffer unemployment levels as high as 20 percent, while basic services like health care and child care are stretched to the point of breaking. Community developers – the neighborhood builders, investors and service providers working in poor communities – have been on the frontlines of this crisis. We are America's "first responders" in these vulnerable places. We pick up the phone to hear anxious mothers trying to provide for their children; we provide stop gap financing to service providers facing state and local funding shortfalls that threaten their programs; we struggle to keep community projects alive, even as the resources to support them dry up.

LIIF and the community development field were established to ensure that no community is left behind. Even as the nation faces its greatest economic crisis in a generation, we continue to forge ahead toward the vision of opportunity, where all people and communities can realize their dreams.

NANCY O. ANDREWS
President and CEO

Rose Williams was married in 1944 in her family's living room in Harlem, New York. She and her neighbors in the Garden Court apartments are low income; some grew up on welfare and all struggled to avoid having too much month left at the end of the money. This is the only home they have ever known – their children play in the same familiar stairwells and courtyards, the few trees a bit bigger now and easier to hide behind. They had been lucky so far and knew it. In a place like New York City, with its extraordinary land and housing costs, there's always a risk that the owner will sell out or convert to condos. Rose decided it was time to take charge of that risk. With no experience but with considerable courage, she attended real estate classes, lobbied local community groups, met with attorneys and convinced 150 low income families to join her quest to own the place they called home. The Low Income Investment Fund (LIIF) helped them realize that dream, first with a loan of $600,000 which has been repaid, and then with a loan of $680,000, which is now being repaid.

One way to look at such lending is to describe it as bridging a gap. Simply put, that gap is caused by the fact that the unconventional collateral and repayment sources inherent in many community development projects do not fully meet the standards used by commercial lenders. Further, these projects are often developed by nonprofit organizations with limited experience in real estate development and limited "equity capital" to invest. Banks and other commercial lenders may provide some portion of the financing needed, but are often unable to complete the transaction without a partner that can help the applicants understand the deal while also providing capital on flexible terms.

Community development financial institutions (CDFI), like LIIF, build bridges between unconventional borrowers and commercial lenders, providing capital in ways that allow socially important projects to go forward. Since CDFIs use resources from governments and private foundations, among others, they do not compete with banks and other lenders. Rather their role is to provide only that portion of a financial package that will not come from more traditional sources. CDFIs often find the ground moving on either side of the bridge: market-driven capital changes its risk appetite for unconventional opportunities, and community developers must adapt as government policies ebb and flow.

LIIF's choices about its financial products, the degree of risk it will take and the terms of its loans must be responsive to shifting markets. This is especially clear in the current economic environment of severe disruption to capital markets. The alarming turmoil of the past two years is often attributed to financial institutions making risky loans and leveraging capital unwisely. While lending to public-purpose projects has not been identified as part of these problems, the turmoil starkly illustrates the ever-changing nature of capital markets . But even in "normal" times, the bridges LIIF builds must be able to shift as its borrowers and co-lenders adjust to changing circumstances.

After 25 years of work, LIIF has made or packaged loans and grants totaling over $750 million, leveraging total capital of over $4.7 billion and mobilizing $15 billion in estimated financial benefits for poor households.

LIIF calculates that its community investments have supported:

| Project Type | People Served | Percentage Low income | Estimated Lifetime Economic Benefit |
|---|---|---|---|
| Housing | 151,000 | 97% | $10.2 billion |
| Child Care | 394,000 | 97% | $5.0 billion |
| Schools | 139,000 | 99% | $0.5 billion |
| Community Facilities | 20,000 | 97% | – |
| **TOTAL BENEFITS** | **704,000** | **97%** | **$15.7 billion**[1] |

The value of the community projects LIIF has capitalized is a remarkable story of leverage. For *each dollar* of its net public support, LIIF has:

- Deployed $31 of capital,
- Financed $208 of community development projects, and
- Created $628 in economic benefits to low income people and society at large.

These are not classic "cost/benefit" analyses and have not been independently verified, but are intended to illustrate what LIIF has achieved with the grant support it has received over the years. The multiples are high because LIIF has managed triple leverage.

- First, at the community level for projects.
- Second, at the market level with private capital investments.
- Third, at the family level, with improved livelihoods and economic mobility.

Though many proxies and subjective judgments are involved in these calculations, the point they illustrate is clear:

**IT MULTIPLIES ITS RESOURCES MANY TIMES OVER, ACHIEVING BENEFITS FAR GREATER THAN ITS RESOURCES ALONE WOULD ALLOW.**

At the end of 2009, LIIF had access to capital resources totaling nearly $600 million, with nearly $150 million on its balance sheet and over $430 million in external capital that LIIF manages for others. Since inception, the subsidy needed for LIIF's lending operations (net of income it earns from borrowers) adds up to less than 6 cents for each dollar of capital provided. In recent years, LIIF has generated sufficient earned income (excluding grants) to cover the entire cost of its lending program (not including reserves for bad loans).

In 2002, the organization changed its name from the Low Income Housing Fund to the Low Income Investment Fund. Some worried that the new name was oxymoronic. It is not. It speaks directly to one of the principal lessons learned about poverty alleviation:

**ACTIVITIES THAT SERVE LOW INCOME PEOPLE REQUIRE *AND DESERVE* INVESTMENT.**

This is fundamental to LIIF's mission and mode of operation.

A nonprofit community development financial institution committed to poverty alleviation, LIIF provides capital to community projects developed by community-based organizations working directly in poor neighborhoods. LIIF operates primarily in California and New York, home to 20 percent of the nation's poor and with some of the highest costs of living in the world. Banks, insurance companies, religious institutions and private foundations invest in LIIF, which then supports community-building groups that develop housing, child care, charter schools and other community facilities. LIIF covers its operating costs through fees, interest earnings and charitable contributions.

Before turning to an examination of the way LIIF goes about its work and the lessons it has learned, let us pause to consider exactly how it serves the public interest.

# POLICY CONTEXT

Free-market capitalism is a powerful engine. Even with the current difficulties in capital markets, there is little debate about capitalism's unmatched ability to produce goods and services at the lowest cost. But that is only half the battle. A society must also maximize the extent to which its people participate in its economy. As we learned from economist Joseph Schumpeter, "creative destruction" is central to this economic system; as markets shift, enterprises and entire industrial sectors prosper or fail.[2] Such failure is necessary for fast and efficient economic growth, but those involved can pay a high price. Creative destruction leaves a turbulent wake, one in which livelihoods are disrupted at least and ruined at worst.

Markets also are limited. There is a point at which they can not profitably deliver goods and services to low-income people. In the United States, even our social policy is based on "free market" principles; individuals are responsible for finding their own health care, child care, housing and other fundamentals of life. Federal, state and local governments often provide basic infrastructure – such as roads and school systems – but individuals must figure out how to use them and, in many cases, come up with the money to pay the freight. Freedom of choice in economic and social matters is unquestionably a very good thing. But by definition, it means that government does not take responsibility for seeing that people get jobs or houses or medical care. Rose and her fellow tenants fell outside the borderline of markets – if they wanted to save their homes, they had to develop, finance and manage the project themselves.

Success in life is up to the individual, and is much easier for some than for others. In fact, for those experiencing difficulties, a sort of reverse "trickle-down theory" is at work, in which challenge piles upon challenge and re-entering the mainstream is ever harder. Lack of education, medical problems, family turmoil and many other factors play a part. But, in the end, it adds up to the same thing: markets can be efficient but are largely sink-or-swim propositions. If you are short on swimming skills and life preservers, drowning is a real possibility.

LIIF was explicitly formed to help low income people find and bridge the path to self-sufficiency.

LIIF was explicitly formed to help low income people find and bridge the path to self- sufficiency. It raises capital, supports community projects, recovers the loans it makes and revolves recovered funds into support for more projects. LIIF is concerned with its own finances, and must be strong enough to prevent stumbles from becoming fatal. Yet, it does not seek commercial levels of profit, and this creates a special challenge.

Capital is famously footloose. In fact, these days capital no longer has any feet at all; it mostly just flits around the globe looking for those who will pay the most to use it for a while. The larger economy depends upon liquid and efficient markets that collect capital from those with a surplus and allocate it to those needing it and willing to pay the most for it. The key phrase here is "pay the most." Capital markets are almost entirely devoted to maximizing financial returns – an effective allocation mechanism only as long as profits are an appropriate measure of value.

Yet, community projects focus on other goals. Profit maximization is not appropriate and could even harm their public purpose. Government use of capital (for school buildings, water systems or roads) looks to the degree of public benefit rather than to financial return. Similarly, enterprises or projects sponsored by nonprofit community groups are not interested in profit maximization. They intend to reach the poor – by definition, a group with limited purchasing power – by making investments that improve their economic future.

As a consequence, there is a wide gap between capital markets focused primarily on profits, and social-development projects focused primarily on low income people and communities. This gap requires a bridge. Without one, commercial capital markets will not be friendly to borrowers with a social mission.

It is important to emphasize that this gap is not created by the likelihood of capital loss. LIIF and others have clearly shown that loss rates for loans to social projects are no higher than loans for purely commercial activities. Rather, the difficulty is with transaction costs, the cost of finding and working with borrowers, and the special nature of the collateral and revenue streams they present. Even if loans to affordable housing, child care centers and community schools offered commercial rates of return, their relatively small size and considerable complexity present difficulties for commercial financers.

As a society seeks to build an economic system with the widest possible participation and highest productivity and resilience, it must find a way to address the costs of creative destruction. This is only partly a question of compassion for fellow citizens. It is also a question of enhancing social stability, maximizing productivity and achieving full participation of all citizens in the economic mainstream. High-performing societies build bridges to economic inclusion so that all citizens can participate in prosperity.

## SUMMARY OF INPUTS AND OUTPUTS

LIIF is one among many CDFIs seeking to build these bridges. Opportunity Finance Network, the national association of community development financial institutions, estimates that 1,200 CDFIs operate in low-wealth communities in the United States. Collectively, CDFIs represent a remarkable American success story. As of the end of 2006, 504 held assets exceeding $25 billion, had community investments of $15 billion outstanding and invested $4.5 billion during the year. That financing supported 8,185 businesses, 69,893 affordable homes and 750 community facilities, including child care centers and schools.[3]

LIIF was founded in 1984 with an initial concentration on affordable housing. Over time, LIIF added two other areas of strategic focus: child care and education, key leverage points in addressing the problem of poverty. LIIF's 24 years can be grouped into three phases:

- **Building: 1984 – 1994.** LIIF proved its concept and ability to implement.
- **Growing: 1994 – 2000.** Capital and lending growth accelerated to critical mass.
- **Deepening: 2000 – 2008.** Growth continued to accelerate while LIIF developed dedicated programs for child care and charter schools to complete its array of key strategies.

LIIF first sought to demonstrate that a nonprofit lender could master the underwriting challenges required to finance low income housing and build strong relationships with banks and other commercial lenders. Equally important, LIIF was committed to taking risks and responding flexibly to the needs of affordable-housing developers.

LIIF knew from the beginning that flexibility would be key to raising and deploying capital, and developed a number of ways to assist developers of affordable housing. It made direct loans from a revolving fund and participated in loans with other financers. It created capital pools that induced private financial institutions to join together to assemble large-scale predevelopment loans to acquire sites and complete early-stage work. LIIF also provided lines of credit for acquisitions and working capital, small grants to "write-down" interest rates for borrowers, mortgage guarantees for private lenders, and training and technical assistance for applicants and borrowers. Throughout, LIIF has realized a loan-loss rate of less than two-tenths of one percent (.00195) and low income people comprise well over 95 percent of those benefiting from its work.

## Building: 1984 – 1994

When LIIF began in 1984, the federal government was severely reducing its support for housing programs. Nonprofit community builders struggled to survive and subsidies disappeared. But people in low income communities organized to improve conditions and learned new ways to develop projects. Public agencies at state and local levels replaced some of the federal resources, and a new institutional form emerged: the community development financial institution. CDFIs became an important part of the community development scene, focusing on assembling project financing from an array of sources, including religious orders, foundations and other financial institutions. LIIF was formed to show by example that projects serving low income people are worthy of credit. By the end of its first decade, LIIF had established offices, supporters and deal flow in San Francisco, Los Angeles and New York. Its "proof-of-concept" was clearly successful.

**BY ITS 10TH ANNIVERSARY IN 1994, LIIF HAD:**

- made loans and commitments totaling $31 million, and packaged loans funded by others totaling $55 million;
- accumulated total assets of $21 million, and arranged to manage investor capital pools of $40 million, for total capital resources of $61 million; and
- achieved net worth of over $6 million and loans outstanding of $9 million.

## Growing: 1994 – 2000

The following six years brought remarkable expansion in LIIF's balance sheet and lending volume – it was becoming one of the nation's largest community development financial institutions. It offered larger loans for more complex projects. And in 1998, LIIF managed its first and only leadership transition. A year later, its vision grew beyond housing. Recognizing that poverty is caused by a Gordian knot of problems, LIIF added child care, education and workforce development to its program agenda. LIIF was confident that its expertise in raising and deploying capital would be just as valuable in new arenas as they had been for housing.

**BY THE END OF 2000, LIIF'S ACCOMPLISHMENTS INCLUDED:**

- $227 million in loans made, including $97 million packaged for other lenders;
- $51 million in total assets and $32.2 million in capital managed for other investors, for $83 million in total capital resources; and
- $15 million of total net worth and $18.5 million in outstanding loans.

Seeing success with its broader mission, LIIF sharpened its focus on child care. In 1998, the City of San Francisco asked it to administer the Child Care Facilities Fund (CCFF) with the goal of reducing the city's severe shortage of child care spaces. A short time later, this shift was reflected in a new name. Born as the Low Income Housing Fund, LIIF changed its name in 2002 to the Low Income Investment Fund.

## Deepening: 2000 – 2008

Over these eight years, LIIF's lending volume and balance sheet growth accelerated. Lending commitments in 2001 reached $40 million, a near doubling over the prior year; doubled again to almost $100 million in 2005; and continue at historically high levels. In 2004, LIIF established a goal of providing $1 billion in capital to serve one million people over 10 years.

**BY THE END OF 2008, LIIF HAD:**

- made loans and other financial commitments totaling $690 million, including $264 million packaged for other lenders;
- accumulated total assets of $152 million and arranged to manage $423 million of capital for other lenders, for total capital resources of $575 million; and
- achieved net worth of $37.6 million, and loans outstanding of $93 million on LIIF's balance sheet, and $110 million managed for others.

### > *Child Care Program*

In 1999, the David and Lucile Packard Foundation, which had been providing grants to child care centers for some time, concluded that something more was needed. A major barrier was the difficulty that centers faced in finding or developing suitable facilities. In large part because of LIIF's success with CCFF, the Packard Foundation selected LIIF to manage its new program for the State of California: The Affordable Buildings for Children's Development (ABCD) Initiative. With its goal of supporting the development of 15,000 child care spaces by 2010, ABCD builds the capacity of communities across the state to create the hundreds of thousands of child care spaces needed to bridge the gap facing low income children. LIIF is exceeding this target; by the end of fiscal 2008, it had made child care grants of $21 million and loans of $30 million in support of 100,000 child care spaces serving 322,000 people.

With its skill in capital development and deployment, LIIF had proven its ability to enlarge its focus to other sectors, and in 1999 added another arena in which facilities development was constraining progress: education, largely through community-based charter schools.

## > *Education Program*

A fast-growing alternative to traditional public school systems, charter schools are often developed by private individuals and groups in low income communities. In some places, such as Los Angeles and New York City, charter schools help keep construction of school facilities on pace with demand. But while charter schools are public schools and receive funding from the same sources as other public schools, they do not receive capital funding for facilities.

When LIIF first designed a charter school lending program, most schools were not able to access tax-exempt bond financing. But within just a few years, bond markets opened up to charter schools, attracted by their relatively large capital requirements and predictable revenue streams. However, even with this source of long-term financing, charter schools still had to contend with the gap created by their inability to arrange acquisition and construction financing. The fast changes in the availability of capital for charter schools are an apt illustration of how quickly markets change and LIIF's bridges must move.

Building on its strong history with first-time borrowers and unconventional revenue streams, in 2002, LIIF began to assemble a special capital pool to finance charter school facilities in California. Working with a number of charter school developers, funders and advocacy groups, LIIF secured a $3 million grant from the US Department of Education to mitigate the risk to private investors in the new loan pool. With Excellent Education through Charter Schools (ExED), LIIF created two funds totaling $71 million. In 2007, LIIF received a $5 million grant from the Department of Education to expand its charter school lending both within California and in other markets, including New York. As of the end of 2008, LIIF had made loans of $123 million for charter schools, using its own capital and assembling capital resources from other institutions to create 41,000 new school spaces serving 131,000 students.

### > *Workforce Development Program*

LIIF also looked for ways to expand its focus in the field of workforce development. To increase their chances of finding and keeping better paying jobs, low income people need access to employment training and placement programs. LIIF had in the past made several loans to workforce development groups, and sought to create a new dedicated program. But while housing, child care and education provided good opportunities for a capital-led development strategy, LIIF could not find a similar handle for workforce development. To some extent, this is because nonprofit groups working in this area have access to other sources of capital, and to some extent it is because workforce development revenue sources are more uncertain. In general, special facilities are not as central to workforce development programs as they are in housing, child care and education. LIIF was not able to establish a dedicated workforce development capital program.

## HOW DOES LIIF DO THIS?

LIIF borrows money from banks, private foundations, religious institutions, insurance companies and others seeking to use their capital to help meet social goals. LIIF then lends those funds to community developers that need capital to implement their social-action strategies. This is called "intermediation" and is a common business in capital markets. LIIF must do this while achieving repayment rates sufficient to return capital to its own investors, and at a cost that can be covered by the interest, fees and contributions it receives.

But if LIIF provides loans for projects with social goals, how is it repaid? In most cases, loan payments to LIIF come from a combination of government subsidies and fees paid by those served by the projects. Most public programs do not provide capital for construction of facilities, whether they are intended for housing, schools, child care centers or other community uses. But annual revenues are usually sufficient to allow program operators to service debt. Essentially, LIIF capitalizes subsidy streams by allowing program managers to build facilities and then use a portion of the facility's future revenue to service the loan from LIIF. It knows its borrowers and is familiar with their diverse revenue streams.

LIIF makes loans to nonprofits for the full spectrum of their needs: predevelopment, acquisition, lines of credit, construction, mini-permanent and loans that bridge future public contracts. Terms vary depending on the situation, ranging from a few months to 15 years or more. Interest rates tend to be a bit higher than those of commercial lenders, but repayment terms are quite flexible. Further, LIIF's willingness to commit early and to provide terms suited to a particular project can move a stalled project to green-light mode. Flexibility is its hallmark.

For example, a number of loans are structured to allow payments over a long amortization schedule – say, 20 years – but carry a balloon payment due within a shorter term – say, five years. LIIF's repayment then depends on an organization's ability to refinance, which can be a risky proposition when cash flow is thin and collateral is rarely up to commercial requirements. At times, LIIF lends more than 100 percent of collateral value and invests in projects where cash flow is projected at only a whisper above that needed to service its loan, considerably less than most commercial deals require. While this presents a thin sheet of ice upon which to skate, LIIF's historic repayment experience remains sound.

LIIF often works with inexperienced borrowers (such as Rose and her neighbors), uses flexible underwriting and loan terms, and looks to unusual and uncertain cash flow for repayment. Yet, in its 24 years, LIIF has loaned $620 million (not including grants made to others) and written off only $1.2 million, a write-off percentage of less than 0.2 percent, or 20 cents for every $100 loaned. This compares favorably with the experience of commercial banks as well as with LIIF's peer group of community development financial intermediaries.

Commercial lenders are not attracted to this work because of small deal sizes, unusual revenue streams, poor profit potential and tricky collateral. But the founders of LIIF were convinced those hurdles could be overcome, and they have been proven correct. To play this role, LIIF requires capital, borrowers and the skill to underwrite and collect loans made to community developers for unique projects that do not meet the profit-maximizing yields required by commercial lenders.

## > *Sources of Capital*

Those providing capital to LIIF ask two questions: What social progress will be achieved, and will they get their money back? Foundations, public-sector entities and religious institutions are just as concerned as banks and insurance companies as to whether LIIF will be able to repay them. Therefore, like any other borrower, LIIF must present a solid balance sheet to its lenders.

LIIF has raised capital from hundreds of diverse sources. During its first few years, financing was provided by two banks, two foundations, a religious institution, a non-profit development finance group and private individuals. By the end of 2008, LIIF had received a total of $26 million in capital grants over its 24-year history, most from private foundations and the Community Development Financial Institutions Fund of the federal Department of the Treasury, and had added nearly $12 million to its net worth through annual surpluses. LIIF's total net worth of $38 million supports borrowing from capital sources of $101 million at the end of FY 2008.

These loans tend to come from institutions with an interest in LIIF's social goals, either because regulators encourage it – primarily through Community Reinvestment Act (CRA) requirements for banks – or because their nature leads them there (e.g., religious institutions' pension funds or charitable foundations' social lending programs).

In addition to these "on balance sheet" funds, LIIF also manages funds held by other institutions. LIIF underwrites and packages loans on behalf of others and also sells participations in community loans to private investors. Those lenders rely on LIIF's expertise and its deep understanding of the requirements of both borrowers and lenders. Along with the technical assistance offered to borrowers on project structuring and loan packaging, LIIF's community lending competence lowers transaction costs and perceptions of risk. This tactic was present at LIIF's beginning and has grown considerably. By the end of 2008, LIIF had access to $423 million in capital resources allocated solely to it by other institutions.

LIIF believes that leveraging the capital of others will likely be its largest source of growth in coming years. To achieve its social goals, there is no reason why these loans must be held on LIIF's balance sheet. In fact, there is even more social power in transferring these loans to commercial sources: private capital investors will learn more about community investing and be more comfortable making such loans themselves once LIIF has led them through a good experience.

LIIF has learned that it needs both types of funds: its own revolving loan fund (RLF) and funds held by others and managed by LIIF. The RLF provides higher earnings and the flexibility to tailor loan terms to the needs of borrowers. The capital LIIF manages for others allows it to leverage larger capital investments in low income communities than otherwise possible.

While banks have always been a key source of capital for LIIF, this is due in part to legislation enacted before it was formed. In the 1970s, community reactions to "redlining" caused heated confrontations. Banks were literally drawing a red line on a map around entire low income communities and refusing to lend to individuals and groups within that boundary. The Community Reinvestment Act (CRA) was enacted in 1977 to address this. CRA requires banks to achieve good "scores" on loans an investments in communities from which they take deposits. The federal government acknowledges the importance of the private banking system and helps banks gather funds by guaranteeing depositors against loss.[4] In return, banks are asked to provide capital to places from which they gather deposits, including low income communities. It is not possible to determine how much of LIIF's capital is motivated by the CRA, but it is very likely a large part.

## > *Borrowers*

The best evidence of the need for what LIIF offers is its lending volume, which by the end of 2008 had reached $356 million in direct loans and $264 million in packaged loans since its inception (not including $74 million in grants LIIF has made to other groups). This capital has supported thousands of community projects serving over 600,000 people. Proof that LIIF's community investments are sound can be found in the fact that it recovers more than 99 percent of its loans. But has LIIF merely been displacing the lending that banks might otherwise handle?

LIIF's loan capital has supported thousands of community projects serving over 600,000 people.

To prevent "rate shopping" and avoid displacing private capital, LIIF charges a higher interest rate than banks and other commercial lenders. This does not mean its rates are "above market." Rather, this is a strong indication that the flexibility offered by LIIF allows community projects to go forward that otherwise might not. So, to a considerable extent, LIIF's loan terms have built-in checkpoints. If its collateral or repayment standards are too high, borrowers will seek financing elsewhere. If its standards are too low, its loss rate will increase and LIIF will have difficulty raising capital.

These internal checkpoints define the margin in which LIIF works. On one side are loans that will go bad no matter how flexible and patient LIIF is, and on the other are loans so good that they are acceptable to commercial lenders. LIIF works in the middle.

### > *Skills*

LIIF's community investments are managed by three field offices: Los Angeles, San Francisco and New York. A local presence is crucial to sourcing deals, but even more to understanding social and fiscal contexts. Cities and states provide significant help – and at times, hindrance – to the sorts of projects that LIIF finances. Foundations have differing interests and their own rules. Some pension funds or religious institutions work only with local projects. Banks often have different policies in different places. But even more importantly, LIIF must work closely with borrowers before and after a loan is made. Almost never does an application arrive at LIIF's door ready to go, and it often takes years to go from initial contact to loan closing. Geographic proximity is important.

LIIF's only two CEOs both have strong backgrounds in lending and social action. The person leading LIIF must be credible with bankers as well as foundations and religious institutions, and must have a deep understanding of the social issues at hand. The CEO must understand the need to welcome and assist inexperienced borrowers while at the same time demanding high standards. LIIF's Board of Directors is drawn from leaders in capital markets and social policy.

In many situations, especially when relatively young, nonprofit programs are small and financially fragile. Their leadership typically has little experience with real estate development or financing. This was the case several decades ago when nonprofits first took on the task of increasing the nation's supply of affordable housing, and it is the case today for child care facilities and charter schools. The staff members of these local organizations have experience with serving people, not with construction, real estate development or negotiation of large loans. Even if they build the skills necessary to handle a facilities development project, it would likely be inefficient. As soon as the facility is completed, the child care or charter school operator will not need those skills again for some years. LIIF builds these skills within its staff.

## SOCIAL ACHIEVEMENTS

LIIF's strategies aim at fostering economic independence for those who are hardest to reach. The vast majority of households assisted by LIIF financing are very low income (usually defined as less than 50 percent of median income in their area), and a high percentage have special needs, such as homelessness or HIV/AIDS. What more can LIIF say about the impact of its work?

LIIF began with a focus on affordable housing and expanded into child care and schools in low income communities. LIIF has also financed workforce development groups and community facilities, such as shelters for the homeless, as well as occasional loans for commercial development and even working capital loans for nonprofits operating in these fields. These strategies comprise LIIF's view of the key ingredients to helping low income people get back into the economic mainstream and build the resilience needed to stay there.

- With affordable and stable housing, families are better able to find and keep jobs, and children do better in school and are healthier. Yet in 2005, very low and extremely low income families struggled with high housing costs that absorbed 41 percent and 83 percent of their income, respectively.[5]
- Children from poor families who attend well-run child care programs have better achievement scores, educational attainment and employment, and lower rates of crime, delinquency and welfare dependence.[6]

- Education is one of the most effective tools to lift people out of poverty. Nationally, over half the students enrolled in charter schools are from low income families, and current research indicates that charter schools often outperform their public school counterparts.[7]

LIIF's social achievements can be credited to triple leverage, all turning on an equity base fulcrum: its net worth. This net worth comes from capital grants and retention of annual operating surpluses, and now totals $38 million.

One way of computing the public cost of building LIIF would be to merely total all the grants it has received. But many of those grants were for relending and remain on LIIF's balance sheet to this day. As a proxy for the cost of its public support, it is more accurate to begin with total grant support for LIIF of $60 million (not including grants it received for the purpose of re-granting to other groups), reduced by its net worth as of June 30, 2008, of $38 million, to arrive at "net charitable support" of $22 million.[8]

To build its first tier of leverage, LIIF uses its net worth to borrow funds from banks and other sources, or arranges with such sources to make and manage loans that remain on those lenders' books. At the end of fiscal year 2008, LIIF had borrowed capital of $101 million and was managing another $423 million in capital for other institutions. In its 24 years, LIIF has made loans totaling $356 million, packaged loans for other lenders totaling $264 million and made grants of $74 million. Looking at just this first layer of leverage, LIIF has deployed $31 of capital for each dollar of its net public support.

For the second tier of leverage, LIIF's capital joins at the project level with funding from others for the project – a housing development, a child care center, a school. LIIF estimates that its total transactions of $690 million have financed projects with total development costs of $4.7 billion. Combining these two tiers of leverage, LIIF's loans have generated approximately $208 in development for each dollar of its net public support.

The third and final tier of leverage looks not to LIIF's finances, but to the economic benefits to low income people or society at large. Those benefits, summarized earlier in this paper, total $14.2 billion. Dividing that number by LIIF's net public support yields $628 in financial benefit for each dollar of public support. This number should not be seen as some sort of earnings-per-share equivalent or as an actual cost/benefit ratio. Rather, it illustrates the remarkable extent to which LIIF has created large benefits at a relatively small public cost.

## > *What Have We Learned?*

The fundamental purpose of LIIF's work is building flexible bridges between communities and capital markets. Building these bridges requires financial credibility, cost efficiency and a trait central to entrepreneurship. How are those attributes acquired in the face of the uncertainty surrounding small projects developed by nonprofits that must manage tricky revenue flows?

The necessary first ingredient is LIIF's net worth, which is the result of a combination of capital grants and retained annual operating surpluses. Further, LIIF has benefited from the Community Reinvestment Act, which encourages banks to lend in low income communities. The largest share of its capital has come from banks, and the largest portion of banks' motivation to provide such capital resides in the CRA. While some banks and other institutions would participate without the CRA, it is clear that the scope and scale of LIIF's work and its broader social impact would be severely reduced if the CRA did not exist.

But while the CRA is crucial to LIIF's ability to raise capital, LIIF has also learned that it is possible to create leverage far beyond its balance sheet by organizing and packaging funds for investors. Pension funds, insurance companies and other institutions not subject to CRA requirements have invested significant resources with LIIF. And even banks, which must attend to the CRA, would still not place their funds with LIIF unless they were comfortable with its abilities.

Comfort comes from two sources. First, LIIF's track record and the strength of its balance sheet show it is able to manage complex lending programs. Second, LIIF's deep understanding of its borrowers, and the various public programs used by its borrowers, allows it to efficiently find and manage transactions in the face of considerable market uncertainty.

## > *Financial Credibility*

LIIF focuses explicitly on building its financial strength and has never seen its equity cushion fall below 20 percent of total assets, approximately double the ratio maintained by commercial banks. Alongside that equity is another sort of cushion. LIIF keeps a reserve for loan losses that is much larger than its historic loss rate. As of June 30, 2008, $6.5 million was held as reserves for possible loan losses, approximately 7.2 percent of the balance of outstanding loans, even though its actual historic loss rate is less than two-tenths of 1 percent. LIIF knows that it largely works in “special markets” uncharted by commercial lenders and must be able to take significant risks without risking the entire institution. LIIF’s capital providers also want to see a sufficient reserve for bad times. In the current economic crisis facing commercial capital markets, the wisdom of carrying sufficient loss reserves is especially apparent.

Achieving economic strength is partially a function of a strong equity base, but it is also function of a relentless focus on costs and efficiency. LIIF concentrates on “bottom line” targets, and delegates clear responsibility for achieving them through each operation of the organization. More than 30 percent of LIIF’s retained equity, the fulcrum for all its leverage, comes from operating surpluses built up over the years. And LIIF has always sought to maintain a diverse revenue base so that it can tolerate the loss of even its largest funders.

These are the three ingredients of LIIF’s financial credibility: a strong equity base, ample reserve for loan losses and annual operating surpluses.

But wait. LIIF rarely turns down a loan applicant, makes loans on flexible terms to inexperienced borrowers, only provides financing not available from commercial sources and often relies on refinancing to recover its loans. With the relative inexperience of many of its borrowers and their dependence on unusual and often undependable revenue streams, why is LIIF’s loan loss rate so low?

LIIF's superior loan loss experience springs from the same flexibility that has generated its large loan volumes. Since its goals are primarily social in nature, LIIF goes out of its way to structure its loans to meet the needs of borrowers. If a local project gets into difficulty, LIIF works with the borrower to restructure as needed, and can be very patient while operating or funding challenges are worked out. Finally, the nature of the projects leads all parties to the same attitude. The nonprofit program operator, relevant government agencies, and foundations or other funders involved all share the overriding goal of project success. Their support for a project is stimulated not by financial considerations, but by social goals which can only be achieved through project success.

## > *Transaction Cost Efficiency*

LIIF has learned that this work can be done at acceptable costs, and now covers 100 percent of its lending costs through fees and interest earned on loans.[9] While it took years for LIIF to reach this point, its historic cost of deploying capital (net of lending revenues) is only 5.6 cents per dollar of capital provided. Since inception, LIIF:

| | |
|---|---|
| Earned from its lending work | $52 million |
| Earned from investment of cash balances | $27 million |
| Paid in interest to suppliers of its capital | -$26 million |
| **Equals net interest and fee earnings** | **$53 million** |
| Incurred staff and other operating costs of | -$91 million |
| **Equals lending costs net of earnings** | **$38 million** |
| To provide capital funding of | $694 million |
| **YIELDS NET COST-PER-DOLLAR OF CAPITAL PROVIDED** | **5.6 cents** |

LIIF borrows money from banks at an interest rate much lower than commercial levels – an average of less than 3 percent – and lends at a little over 7 percent. Below-market cost of capital is central to LIIF's ability to cover its transaction costs, and lenders are only willing to extend such low rates to LIIF because public policy (in the form of the CRA) requires that regulated banks offer investments in low income communities. A bank can do this directly and cover its own high transaction costs, or it can make a low-interest loan to LIIF. Many banks have concluded that the interest given up is less than the extra transaction costs that would be incurred by direct lending. In any case, such lending would never be profitable on a commercial basis.

## > *Embracing Ambiguity*

A particular behavior is crucial to managing shifting market niches and entering new territories from scratch, and it has to do with an individual's or organization's attitude toward ambiguity. For private-sector entrepreneurs, high value is placed on one's "tolerance for ambiguity" – the ability to act in the face of incomplete information is the essence of entrepreneurial behavior.

Financial institutions and the capital markets that fuel them are just like the rest of us; they prefer to do business within their comfort zone. While these entities may diligently check collateral, income and cash flow, if they are not familiar with a particular type of borrower and their business, they are not sure they even know the right questions to ask. Many CDFIs, including LIIF, explicitly seek to assist banks and other financial institutions in learning how to do community lending. Some go so far as to posit that their biggest success would be working themselves out of business: after demonstrating how to lend to community projects, the banks and capital markets would take over the work.

Free markets fail neither often nor for long. After all, surrounded by competitors, it is in each player's best interests to quickly spot and respond to new opportunities. If there is a segment in which commercial capital markets are not active – for example, capitalizing development of housing devoted to low income individuals – it is usually because the risk/reward or transaction-cost profile does not meet the standards of the owners of the capital. A capital manager's job is to meet the capital owners' standards, and that most often means profits within acceptable risk and liquidity parameters. When a capital manager, or the entire capital market, declines to finance a project that does not meet those standards, it is guarding against failure.

However, when commercial financers learn this work, they will to some extent do it themselves. From a social policy standpoint, this is a huge success; there is no need to use public resources to finance an activity if it can attract purely private capital. But this is a strange sort of business model for LIIF. Is their business plan to go out of business?

In a sense, yes. LIIF's essential business is not lending, but spotting niches. Its most important skill, its comparative advantage, is to find gaps between the need in communities for capital and the private market's willingness to respond. LIIF figures out a way to bridge that gap, spends a decade or two making and recovering loans and bringing banks and other commercial sources into deals on an ad hoc or pooled basis, and then watches as those private sources do more and more of the community lending at *lower* interest rates to community borrowers than LIIF can provide.

It is important to note that this shift to increasing receptivity to community borrowers is fairly recent and at least coincident with, if not caused by, the tidal wave of global liquidity and now infamous exuberance seen in the first five or six years of this century. That liquidity caused capital markets to look ever more flexibly for investment opportunities. Now there may well be a retreat by capital markets away from community projects.

The point remains that LIIF, and all other CDFIs, are experts at finding gaps and at figuring out how to bridge them. The fact that the gaps are constantly changing, and sometimes even disappearing entirely only to return later, makes this work important and, at the same time, unlikely to be pursued at commercial rates of profit. It is clear that LIIF can do this: when LIIF builds a bridge, the commercial lenders do in fact come. At first they come via capital investments in LIIF itself. Once their comfort level is sufficient, they come via direct lending to nonprofit projects.

Another way to look at this is from the perspective of a single deal – for example, a loan to a charter school in a low income neighborhood. LIIF devoted several years to understanding charter school revenue flows and collateral values and getting to know key players in the field. It uses a combination of its own funds and grants from foundations to pay its costs while it does this, and to underwrite its transaction costs until charter school lending reaches sufficient volume to cover the costs entirely. But recently, a staff member reports walking into the office of LIIF's president to say something like: "You know that $5 million loan for a charter school that's on the list for approval next month? Well, ABC Bank just made the loan. I've wasted all my time. I'm sorry." LIIF's CEO, who understands the impact on the bottom line (all cost, no revenue) and the staff member's morale, nonetheless remarks: "That's wonderful." LIIF works in a narrow and shifting margin, and its fundamental comparative advantage is its ability to spot gaps and figure out how to bridge them. It's hard to know exactly how it is going to work out until the bridge is built. LIIF must not just tolerate ambiguity, but must seek it out and welcome it. That not only goes with the territory, it is the definition of the territory.

## CONCLUSION

The constraint to financing community-building projects is less about the risk of capital loss and more about the costs of finding, underwriting and servicing loans to community projects. These costs are far higher than commercial lenders are willing or able to tolerate. LIIF can do this work profitably, but the profits would not meet the yield hurdles required by market capital. Financing community projects requires intimate understanding of nonprofit development work, collateral values and public revenue streams that are often at the mercy of political fads and shifting imperatives. It is a specialty all its own.

With a record of $620 million in loans over 24 years and recovery of 99.8 percent of those loans, LIIF has clearly shown that credit risk is not the root problem. Such public projects are at least as credit-worthy as those backed by for-profit companies or governments themselves.

From the beginning, banks were among LIIF's biggest supporters. LIIF understood that capital markets were central to bridging the financing gap and that they would participate if LIIF could build (and largely pay for) the "transaction machine." LIIF has done so and has itself become an integral part of those very capital markets.

Poverty in the United States remains stubbornly high. Even in times of economic expansion, many tumble into poverty in the wake of creative destruction. While this is cause for concern, it is not the most important issue. The big question is how to help people get back into the mainstream. This is the challenge that LIIF has accepted and that it has met to a remarkable degree. By the end of 2008, LIIF had financed projects that helped 600,000 people by generating $14.2 billion in income and social returns for individuals and families. By 2014, LIIF will have helped a million people. This is a significant portion of the approximately 35 million people living in poverty in this country.

Will LIIF's work alone lift these million people out of poverty? Certainly not. LIIF does not claim sole responsibility for their progress or even that such progress has moved them to permanent economic security and self-reliance. But anecdotal evidence, loan volume, triple leverage and negligible loan losses all point in the direction of significance.

It is smart policy for a society to see that such bridges are built.

## REFERENCES


1. The financial benefit numbers shown in this chart are estimates prepared by LIIF. While it uses independent studies when possible, these amounts should not be seen as fully analyzed or objectively determined. They are intended only to describe the approximate level of social benefit that flows from LIIF's work. The figures in this table are based on data through June 30, 2009. All other estimates are based on data through June 30, 2008.

2. A term coined by Joseph Schumpeter in his work, *Capitalism, Socialism and Democracy* (1942), to denote a "process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." Creative destruction occurs when something new eliminates something older. Schumpeter goes so far as to say that the "process of creative destruction is the essential fact about capitalism."

3. CDP Publications Committee. *Community Development Financial Institutions: Providing Capital, Building Communities, Creating Impact.* CDFI Data Project, 2006.

4. Deposit insurance is not needed because banks might make bad loans, lose money and go bankrupt. Though that happens now and again, what is really at stake is the liquidity mismatch necessary to capital markets. Depositors rightly want immediate access to their money. Borrowers want loans for as long a term as possible. The banks performing this intermediation must find some way to guard against the consequences of too many depositors wanting their money back at the same time, which could force the bank to sell good loans out of its portfolio at a significant discount and loss to the bank, exacerbating the situation. Deposit insurance helps calm depositors and discourage bank runs. LIIF faces this challenge to some degree, but it is not significant, as most of its lenders are institutions whose loans to LIIF are subject to very specific repayment terms. It is therefore relatively easy for LIIF to manage its liquidity.

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6. Masse, Leonard N. and W. Steven Barnett. *A Benefit Cost Analysis of the Abecedarian Early Childhood Intervention.* New Brunswick, NJ: National Institute for Early Education Research, 2002.

7. Lake, Robin J. *Hopes, Fears and Reality: A Balanced Look at American Charter Schools in 2008.* National Charter School Research Project, Center on Reinventing Public Education, University of Washington Bothell, December 2008.

8. These calculations ignore the time value of money and assume that the social benefits LIIF has generated have occurred over time roughly in proportion to when it received its funds. Further, they do not include one crucial source of support for LIIF, the low-interest loans it receives from banks and others from which it borrows its capital. That support was not included because it comes from private sources.

9. An important exception is that LIIF does not cover the cost of its risk reserves or losses through earnings.

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