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Weathering the Great Recession: A CDFI Case Study in Patient Capital

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Weathering the Great Recession: A CDFI Case Study in Patient Capital

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The Great Recession challenged all financial institutions. One would expect that nonprofit loan funds devoted to working in low- and moderate-income communities would have been particularly at risk. After all, their borrowers are often small nonprofit entities whose operations are supported by government subsidies, themselves under severe pressure; the communities they work in were hit hard by both the boom and the bust; the funds do not have access to the liquidity that insured deposits provide and have no ability to raise equity capital; and no regulator was looking over their shoulder to make sure they were "safe and sound."

Yet the 500 Community Development Financial Institution (CDFI) loan funds[1] certified by the U.S. Treasury came through the recession not only successfully, but stronger. “We did not have a loan loss from any CDFI during the Great Recession,” said Dan Letendre, managing director at Bank of America, in *Financial Advisor Magazine*.[2] Bank of America 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 rates (an average of 38% in 2010), and first-loss equity generated through a combination of grants and retained earnings.

This working paper describes the experience of one of these loan funds, the Low Income Investment Fund (LIIF), through this period. LIIF’s performance was particularly strong, but as evidenced by Bank of America’s experience, it was not alone among CDFIs in its ability to navigate the Great Recession. LIIF is a national nonprofit CDFI that has invested more than $1.5 billion to serve 1.7 million people. Over the course of 30 years of lending, LIIF has deployed nearly $600 million of on-balance sheet capital[3] and has experienced an historical default rate of 0.64%.[4] This paper discusses why LIIF was successful for its borrowers, their communities, and for LIIF itself, and compares LIIF's performance with that of similarly-sized banks.

Social Enterprises in the Lending Business, But That Are Not Banks

CDFI loan funds are social enterprises; that is, they are businesses with a social purpose. While most are nonprofit, they must run their enterprises to cover their own increasingly complex operations, repay borrowed capital, cover reserves, and build for the future. They lend money to organizations that build and operate affordable housing, community facilities such as charter schools and health clinics, and small businesses. Some CDFIs lend to individuals, primarily for home purchase.

As businesses, CDFIs are subject to all the federal, state, and local rules relating to issues such as environmental and consumer protection. Moreover, the majority of CDFIs qualify as nonprofits under section 501(c)(3) of the Internal Revenue Code, and are subject to a complicated set of accounting and tax rules and must file tax returns that, unlike those of for-profit corporations, are publicly available. And CDFIs are, of course, bound by the contracts and loan and grant agreements they sign with government agencies, foundations, and other funders such as banks.

However, because they are not banks–and thus cannot take deposits or access the federal payments system–CDFI loan funds are not subject to bank capital rules nor to supervision by federal and state bank regulators such as the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, or the Office of the Comptroller of the Currency (OCC). Critically, this means that they develop their own asset management and risk policies, including establishing risk ratings and

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[1] Of the approximately 500 CDFI loan funds, fewer than a dozen have for-profit status.

[2] Ellie Winninghoff. “Grassroots Investing,” *Financial Advisor Magazine*, May 9, 2014, available at http://www.fa-mag.com/news/grassroots-investing-17858.html?section=.

[3] On-balance sheet capital is that which LIIF receives directly from investors, is held on LIIF’s balance sheet, and is general recourse to LIIF. Off-balance sheet capital includes LIIF’s lending through special purpose entities and New Markets Tax Credit transactions.

[4] Write-offs since inception total $3,794,991 out of $594,056,596 of on-balance sheet loan volume, as of May 1, 2014.

corresponding loan loss reserves, and manage troubled loans without external pressure by supervisors to write down loans quickly or to foreclose. Because they are not subject to bank capital rules, CDFIs have much more flexibility around whether to write off or foreclose on a loan that is non-performing today, but that the CDFI believes will recover with no or minimal loss to the lender. Except in the most extreme cases, CDFIs' decisions to write down or write off a loan are not accompanied by the potential that they will be subject to tougher oversight, restricted in their activities, or even shut down. And, since their suppliers of capital (largely banks motivated by the Community Reinvestment Act and foundations) are often as interested in the mission as the loan funds are, they tend toward patience when an otherwise strong loan fund violates a financial covenant,[5] for example by having a singular year in which expenses exceed revenues, that would technically put the loan fund into default. All this means that CDFI borrowers and the communities they serve benefit from long-term strategies, especially when they are most needed, during economically stressful times.

Flexibility + Risk Management

A CDFI loan fund like LIIF, has great flexibility to determine its strategy for dealing with a troubled loan. LIIF's goal is to minimize losses while supporting the sustainability of its borrower partners. LIIF and other CDFIs can take the time needed to advise borrowers, restructure terms to best suit the situation, and postpone implementing legal recovery and/or foreclosure efforts, all of which serve to minimize their balance sheet losses[6] and enhance the ongoing operations of their customers.

This flexibility must be combined with a strong risk management framework to result in low rates of loss on the CDFI's loans, crucial for the financial sustainability of both the individual CDFI and the industry. As with any other lender who expects to stay in business, CDFIs cannot "extend and pretend, as evidenced by LIIF's aforementioned historical default rate of 0.64%.[7] Perhaps even more telling though, of the $121 million in loans LIIF originated between July 1, 2006 and December 31, 2009[8]–the time period that includes the peak of the most recent U.S. housing bubble–LIIF wrote off just $956,874, representing two loans and 0.79% of total volume originated during that time.

LIIF's low loss rate is a result of a proactive and disciplined portfolio management approach. This approach includes portfolio diversification so that LIIF's loans are not concentrated in any particular borrower, project, sector, or geography; annual loan monitoring reviews and risk rating adjustments, where LIIF assesses the performance of loans and the financial status of borrowers (construction loans and troubled loans receive more frequent reviews); and sufficient reserve levels to cover potential losses based on consistently updated risk assessments. In addition to its portfolio management practices, LIIF is in close communication with its borrowers and stays up-to-date on market conditions and their potential effect on its customers.

If a borrower is not able to repay a loan on its maturity date, LIIF may choose to extend or restructure the loan to facilitate repayment (see three examples later in this paper). However, LIIF does not extend loans blindly or without deliberation. LIIF's asset management team works closely with borrowers to impose realistic benchmarks and enforce achievable timelines. LIIF tracks each loan's progress and payment history. LIIF regularly reassesses and evaluates each loan's risk based on a six-point scale with higher scores indicating higher concern about the borrower's ability to repay their loan. Loans risk-rated "4" or higher classify as "Special Attention" and are subject to monthly reviews. Loan loss reserves[9] are assigned based on risk ratings for performing

[5] Financial covenants are terms included in debt agreements between lenders and borrowers. Common financial covenants include certain financial ratios, limits on additional borrowing, repayment terms, and maturity dates.

[6] This patient capital strategy had no impact on LIIF's ability to repay the money it has borrowed to lend out because LIIF does not precisely match the maturities of the money it lends to the maturity of the money it borrows.

[7] Write-offs since inception total $3,794,991 out of $594,056,596 of on-balance sheet loan volume, as of May 1, 2014.

[8] The $121 million represents LIIF on-balance sheet capital only.

[9] A loan loss reserve is cash set aside to cover potential estimated losses on a loan. LIIF calculates the amount of loan loss reserve for a loan based on its assessed risk of default or nonpayment.

loans and on a calculation of potential loss for troubled loans.

LIIF has enhanced its risk management policies and procedures over time. For example, as a result of the tightened credit markets and decline in real estate values during the recent recession, LIIF took four important steps to preempt future problems with outstanding loans:

1) Engaged outside experts to perform credit reviews and stress-test the portfolio;[10]
2) Expanded staffing by creating key management positions to emphasize asset management and lending processes;
3) Revised lending standards and portfolio management policies and procedures to better manage portfolio-level risk, including an updated credit policies and procedures manual, revised underwriting criteria, and an amended loan risk-rating system; and
4) Implemented a stronger early-warning system for underperforming loans with signs of trouble, subjecting these loans to more intensive asset management and heightened oversight, and promptly placing these loans on a Special Attention list if they are delinquent or show the potential for loss.

These changes collectively increased LIIF's ability to better assess portfolio risk and provided a more targeted approach to quickly spot and address troubled loans. As a result, LIIF's loan portfolio continues to be exceptionally strong and well-performing.

LIIF's Portfolio Performance During the Great Recession

To better understand how this combination of flexibility and careful asset management performs, we evaluated LIIF's portfolio performance during the recent financial crisis. The second half of 2006 was arguably the peak of the U.S. housing bubble, a bullish time during which buyers paid top dollar for real estate acquisitions with the expectation that sales prices would continue to rise. The bubble even extended to the community development sector, with multifamily affordable housing developers undertaking more risky transactions, including land acquisitions and for-sale condominium projects in low-income Census Tracts. Many loans that closed during this peak became due in the midst of the financial crisis of 2007-2011.

Between July 1, 2006 and December 31, 2009, the period that includes the peak of the U.S. housing bubble, LIIF originated 100 on-balance sheet loans totaling approximately $121 million (the "Data Set") to support the acquisition and development of multifamily affordable housing, charter schools, child care centers, and other community facilities. Of the $121 million of loans originated during that period, $103 million (85%) have been repaid and $17 million (14%) are still active. Just $956,874, representing two loans and 0.79% of the $121 million of total volume originated, has been written off.

Table 1. Summary of LIIF Loan Performance Originated from 2006-09

	$ Volume	# Deals	%
Repaid	103,018,884	79	85
Active	17,187,375	19	14
Written Off	956,874	2	0.79
Total	121,163,134	100	100

Crucially for this analysis, of the 79 projects ($103 million) from the Data Set that have been repaid, 48% (38 projects) were extended at least once and 24% (19 projects) were extended three or more times.[11] If LIIF had written-off the 19 loans after their second extensions, the percentage of volume written off would have been an estimated 7.43% instead of 0.79%.[12] Of the 19 loans in the Data Set that remain active, 17 loans are performing (Figure 2).

[10] Stress-testing is a method of financial modeling used to assess the performance of a portfolio under different simulated financial scenarios.

[11] We analyzed extended loans as a proxy for non-performing loans.

[12] Based on historical experience, we assumed 22.3% (net of recoveries) of the original principal balance was written off.

Table 2. Summary of Remaining Active Loans Originated from 2006-09

Risk Rating	$ Volume	# Deals	%
1 or 2	13,094,836	12	76
3	3,659,274	5	21
4 or 5	433,265	2	2
Total	17,187,375	19	100

As of June 30, 2014, LIIF had a total of seven Special Attention loans, representing 2.79% of total on-balance sheet receivables. In March 2010, during the height of the financial crisis, LIIF had 25 Special Attention loans, representing 23.52% of total on-balance sheet receivables. Three of these loans are explored in greater detail below.

Example #1 – The Challenges of Affordable, For-Sale Housing Approvals

Key Issues: Converting properties to for-sale condominiums, securing state and city approvals, and navigating market shifts.

In May 2007, LIIF and a partner CDFI closed on an $8.8 million construction loan to enable a New York City based nonprofit community development corporation to acquire seven foreclosed properties and renovate them into condominiums to be sold to families earning up to 165% of the Area Median Income (AMI). All of the buildings were partially occupied, and the project included a tenant relocation plan. The borrower had an 18-year track record and had developed over 500 affordable housing apartments.

The loan term was 36 months, which was anticipated to be sufficient to cover the renovation, condominium conversion process, and sales period. As the effects of the economic downturn began to take hold, however, the borrower had difficulty identifying buyers able to qualify for loans under increasingly tight credit standards. In addition, the project faced delays with its relocation efforts and public sector approvals.

The loan reached its initial maturity date of June 1, 2010 without repayment. LIIF and its partner CDFI worked with the borrower over the course of the next 27 months, and ultimately agreed to five extensions of maturity dates and two modifications of repayment terms. The alternative, foreclosure and ownership of the property, would have saddled LIIF and its partner CDFI with marketing and selling homes to first-time and/or low- and moderate-income purchasers–an expensive and time-intensive process. Furthermore, the property would have been subject to a judicial foreclosure process of potentially a year or more.

The final maturity date of the loan was September 2012, 63 months after closing and 27 months after the initial maturity. While the project had an extended timeframe, the borrower ultimately sold all seven buildings and repaid both lenders' loans in full. Of the seven buildings, only one was without income restrictions, meaning the project served the low-income population originally targeted by the developer. LIIF and its partner CDFI's willingness to work with the borrower also ensured that a quality nonprofit developer could weather the Great Recession and continue to develop much-needed affordable housing in the New York City area.

Example #2 – The Importance of Being Patient

Key Issues: Risks of purchasing and selling land, lenders' ability to appropriately assess the borrower's ability to repay, and patience during an economic downturn.

In June 2008, LIIF closed on a $4.1 million acquisition loan to a California-based nonprofit affordable housing developer to acquire 50 vacant lots located on 11.6 acres of land north of Sacramento. The borrower planned to develop and sell single family homes on the property through the U.S. Department of Agriculture (USDA) Mutual Self Help Housing Program. The USDA Mutual Self Help Housing Program enlists eligible low-income families to build their homes under an experienced developer's supervision, and then provides low-interest permanent mortgages to buyers. The borrower had extensive experience in similar projects, having utilized USDA programs for all 35 of its rural self-help developments, representing over 1,000 units, with no loan defaults.

LIIF underwrote the loan for a 24-month term to provide for development and sale of the lots. Subsequently, the economic downturn hit, affecting suburban and rural real estate markets particularly hard, and dried up the pool of potential buyers for the sites. The loan reached its initial maturity date of June 2010 without repayment. Ultimately, LIIF processed three extensions of maturity dates and three modifications of repayment terms. As in the first example, LIIF continued to have confidence in the borrower and determined that the delays in the project were a result of market forces outside of the borrower's control. Therefore, LIIF concluded the path to fullest repayment and achieving the mission of the original project lay with the execution of the original plan, rather than foreclosing, marketing, and selling the property.

The final maturity date was in July 2013, 60 months after closing and 36 months after the initial maturity. LIIF's strategy was successful and it was able to recover 98% of its capital in this rural, for-sale project and allow the borrower to develop and sell all 50 lots, although for lower prices than had been underwritten. Moreover, the borrower is financially stable and continues to be an important resource for affordable housing development in California's rural communities.

Example #3 – CDFI Collaboration to Preserve Value

Key Issues: Risks in securing public subsidies, and extending CDFI lenders' flexibility to multi-CDFI collaborations and across credit facilities.

In July 2007, LIIF and two CDFI partners closed on an $8.4 million acquisition loan to a California-based nonprofit affordable housing developer to support the acquisition of five scattered properties in the Mid-City area of Los Angeles. LIIF was the lead lender on the loan and also provided an $850,000 predevelopment loan for the project. The borrower planned to renovate the properties into 84 units of housing affordable to individuals and families earning 30% to 50% of AMI. The borrower had a strong track record of securing local subsidy and Low Income Housing Tax Credits (LIHTCs), which, along with a new Section 8 contract, would have been used to finance the construction and permanent phases of the project. Around the same time, LIIF also took a subordinate position on a second loan to the borrower for a different property that the borrower planned to convert into 48 units of affordable housing and 4,000 square feet of office space.

The first loan reached its initial maturity date of March 2009 without repayment. The project experienced multiple obstacles that hindered its ability to secure longer-term takeout financing, including delays in obtaining its Section 8 mark-to-market contract and a substantial subsidy award. Most strikingly, although the project was successful in securing highly competitive 9% tax credits from the California Tax Credit Allocation Committee (TCAC), the borrower could not attract an investor to purchase the credits because at the time–the height of the U.S. financial crisis–investors were more interested in financing single-site new construction in a perceived "flight to quality."[13]

As a result of the economic challenges of the period, the second loan also became troubled, requiring LIIF to develop recourse plans for both. Each loan had a different group of CDFI lenders, with only some overlapping in both loans. Being mission-driven lenders, CDFIs prefer to cooperate instead of engage in an "asset grab," and their cooperation ultimately led to a successful outcome for the borrower and local community. While each lending group worked independently to restructure its credit, the lenders provided enough transparency and communication to acknowledge upfront that value for both projects would be maximized by working with the borrower.

In the case of the first loan, LIIF and its partner CDFIs decided against foreclosure and worked together to balance prudent lending approaches with the borrower's cash flow constraints. The borrower dedicated significant staff time and resources to the work-out and successfully secured alternative financing

[13] To address this challenge, the borrower participated in TCAC's new Cash in Lieu of Credits competitive process and the project ultimately received Cash in Lieu funding; however, it was materially less than originally budgeted.

sources for the LIHTCs awarded by TCAC. Ultimately, LIIF processed four extensions of maturity dates and four modifications of repayment terms and received full repayment on both the multi-lender acquisition loan and its predevelopment loan.

In the case of the second loan, the borrower experienced extended delays in obtaining construction financing for the project, and it was extended six times, for a total of 38 months. The senior lender and LIIF–which was in a deeply subordinate and risky position–were ultimately repaid in full. As in the other examples, LIIF and its partner CDFIs' patience, collaboration, and flexibility enabled the borrower to navigate the Great Recession and remain a high-performing provider of affordable housing and community and social service programs.

An Investment in Ongoing Impact

As non-bank lenders, LIIF and other CDFI loan funds enjoy a great degree of flexibility and autonomy. As mission-driven organizations, CDFIs are also focused on the long-term success of the projects in which they invest and the sustainability of their borrowers. While LIIF's lending track record is exceptionally strong it is not wholly unique among CDFI loan funds. CDFIs successfully translate their flexibility into patient capital for community development purposes. Most, like LIIF, employ rigorous risk management frameworks and have a deep understanding of their borrowers and the markets in which they invest. When losses are incurred, the relatively high level of capitalization achieved by LIIF and other CDFI loan funds provides an adequate cushion for their investors.

This success is evident when contrasted with the performance of regulated lenders during the Great Recession. While not a true apples-to-apples comparison, we also analyzed FDIC data identifying the percentage of charged off loans for all "construction and development" loans[14] between 2008 and 2011 originated by banks with assets of $100 million to $1 billion, that is, those of a size comparable to LIIF.[15] This time period includes the estimated maturity dates of construction and development loans originated between July 2006 and December 2009, consistent with the LIIF Data Set. During this time, 81% of LIIF's write-offs since inception occurred. Notably, however, LIIF's portfolio significantly outperformed commercial banks during this entire period (Table 3).

Table 3. Bank and LIIF Charge-Offs for Loans Originated from 2006-09

Annual % Charged off[16]	Banks ($100M - $1B)	LIIF
2008	1.20%	0.43%
2009	2.89%	0.14%
2010	3.13%	0.27%
2011	2.82%	0.00%
4-Yr AVG	2.51%	0.21%

LIIF's low default and loss rates were clearly beneficial to LIIF. As important, LIIF's ability to spend extra time to work out problem loans has also enhanced the operations of its customers, thereby contributing to the sustainability of communities and the community development sector as a whole. This nimbleness, combined with robust risk management practices, is key to any CDFI's ability to meet the needs of borrowers and low- and moderate-income communities, especially during periods of financial decline. During its 30-year history, including the recent period of the Great Recession, LIIF was successful in safeguarding the capital of its investor base, while providing both financial and social returns. Its ongoing ability to provide "patient capital" contributes to LIIF's healthy balance sheet, the success of community development partners and developers, and the strength of communities.

[14] Includes loans for all property types under construction, as well as loans for land acquisition and development.

[15] Federal Deposit Insurance Corporation Statistics on Depository Institutions Database, available at https://www2.fdic.gov/sdi/.

[16] Annual data derived by averaging quarterly data.

Kimberly Latimer-Nelligan is chief operating officer and executive vice president at the Low Income Investment Fund (LIIF). She oversees LIIF's Community Investment Programs (CIP) which includes the national lending and New Markets Tax Credit business, programs and risk management. Under Ms. Latimer-Nelligan's leadership, LIIF has launched its Fresh Foods and Community Health Collaborative programs. CIP currently manages assets of approximately $600 million and deploys $200 million of capital annually. Ms. Latimer-Nelligan's background in community development is extensive. Before joining LIIF in July 2008, she was with Citibank for over 20 years. Most recently, Ms. Latimer-Nelligan served as the managing director of national lending and investments, overseeing a $3 billion business within Citibank Community Development. During Ms. Latimer-Nelligan's tenure at Citibank, Citi's national lending, structured finance, and equity investments for community development were consolidated under her leadership. In addition, she successfully organized and established Citi's program in charter schools. Ms. Latimer-Nelligan serves as the board chair of the Community Reinvestment Fund. She also serves on the boards of Raza Development Fund and the National Affordable Housing Trust. She received her BA from Hobart and William Smith Colleges and her MBA from Columbia University.

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