Redefining Risk in Service of Mission

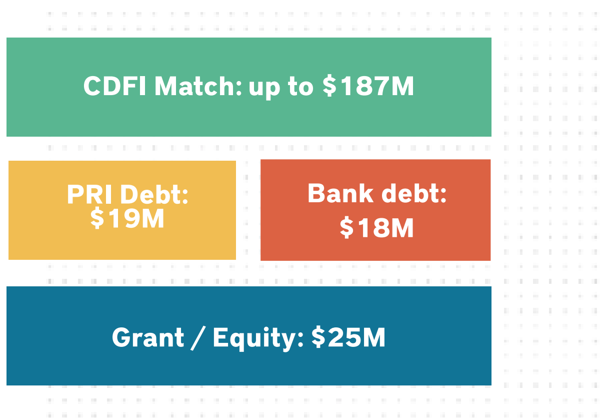
LENDING CASES FROM BAY AREA LISC

BY ELIZABETH WAMPLER

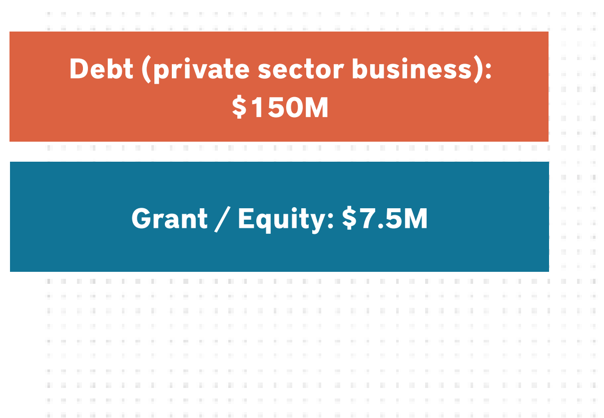
LISC Bay Area wants to transform how lending works for communities of color so we can help create a Bay Area where every person has a place they can call home, financial security, and self-determination over their lives. Together with the Partnership for the Bay's Future in 2019, we launched the Family of Loan Funds, one of the nation's largest-ever private-sector housing funds, with the goal of investing at least $500 million by the end of 2025 to produce and preserve affordable homes in the Bay Area–and do so with more risk tolerance than lenders typically tolerate.

What was the plan? The Family of Loan Funds is two new, time-limited loan funds: the Bay's Future Fund (BFF) and Community Housing Fund (CHF). The two are structured as separate legal entities that leverage investor resources with CDFI lending capacity and capital. The Bay's Future Fund combines a grant or equity investment from the Chan Zuckerberg Initiative (CZI) with relatively low-cost debt investments from philanthropic, corporate, and banking partners. The originating lenders – including LISC, Corporation for Supportive Housing (CSH), and Capital Impact Partners (CIP) – committed to match the investor resources with their own lending dollars to increase the scale of resources available. The credit enhancement dollars have no hard return requirement and cushion the other investors from potential losses. This structure allows all the investors to accept more risk in exchange for more impact while prioritizing moving resources to communities of color in line with our racial and economic equity goals. The Community Housing Fund is structured with Meta providing a very low interest rate loan which leverages credit enhancement dollars raised by Destination Home and LISC.

Bay's Future Fund Capital Stack



Community Housing Fund Capital Stack



HOW DID WE DO?

This is the question LISC is asking ourselves nearly five years after we launched, nearing the end of our origination period. To date, both funds have deployed $423 million, and the Family of Loan Funds is receiving loan payments and extending more dollars into new loans with those repayments.

We also want to know - how far did we, as CDFIs and investors, move our existing systems toward thinking and acting differently about risk and therefore moving resources to community-based organizations led by and serving people of color? How did the specific changes to our underwriting practices reduce or change our risk assessments and help community-driven real estate projects move forward?

The Family of Loan Funds was created to provide capital that was 'out of the box' compared to traditional affordable housing lending practice. As a result, many of our deals have indeed been out of the box and we've served organizations and project types that don't have a robust ecosystem behind them. This includes a huge range of loans, from supporting middle income housing and private developers to supporting small, new, BIPOC-led CLTs and neighborhood-based CDCs across the Bay.

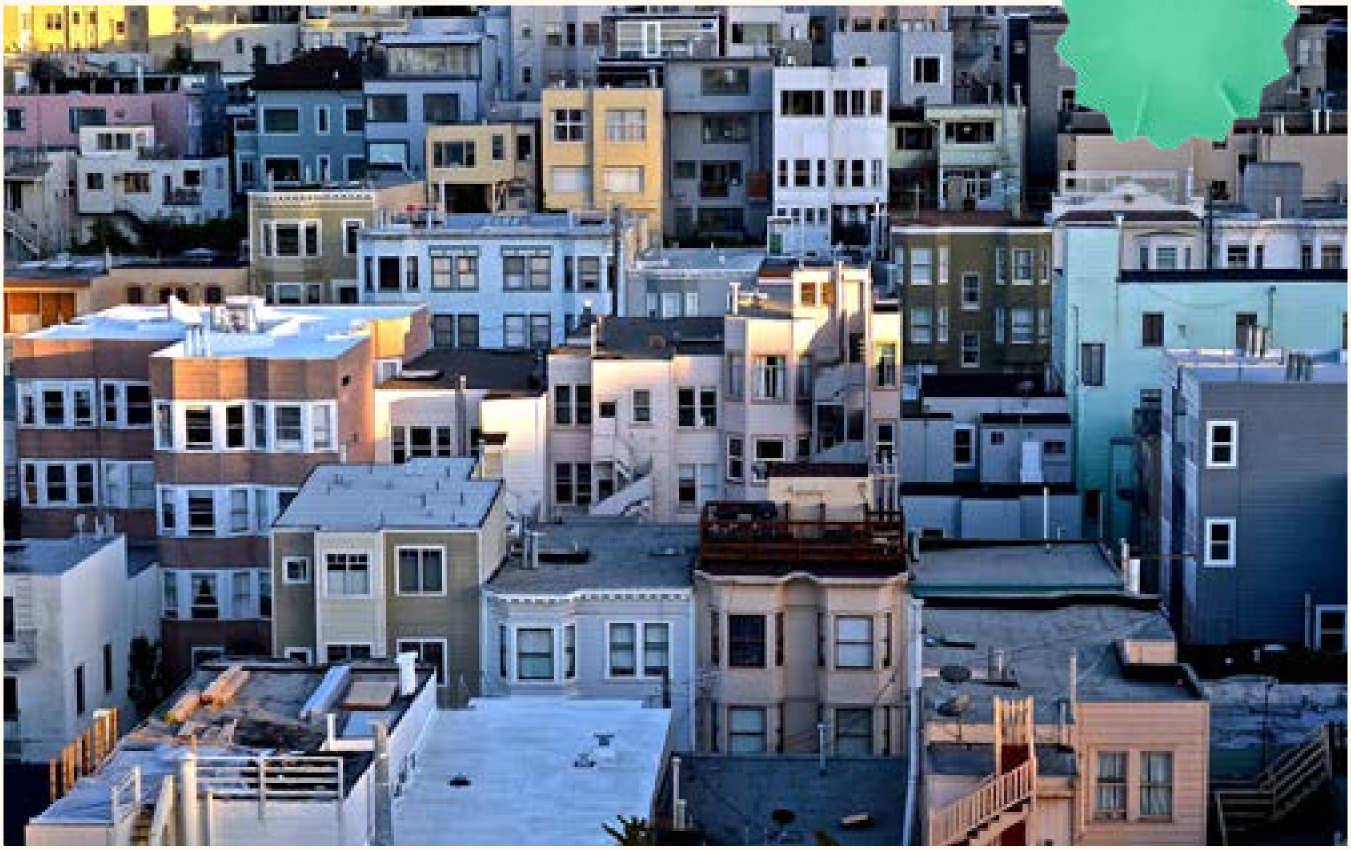
Because these projects were so different from each other, case studies are a useful way to illustrate what we accomplished and how the structures of the funds supported our work. We hope they also provide models for other CDFIs that share our goals.

TWO TOOLS HELPED US AS WE ADMINISTERED THESE FUNDS AND WORKED WITH PARTNERS TO ACHIEVE OUR GOAL

1. To focus on the Fund's goals, LISC developed an Impact Reporting Dashboard that included quantifiable metrics connected to economic and racial equity goals. The metric "% borrowers of color" was translated into the underwriting guidelines of BFF, meaning the fund was set up to support developers led by people of color.

2. Accomplishing a lending goal requires the right financing structure. The credit enhancement from CZI made it possible for BFF's investors with more traditional risk tolerance to take on more perceived risk (like lending to developers without a long track record), invest in the fund, extend the fund's overall risk tolerance and, in consequence, expand its impact.

Case Study #1

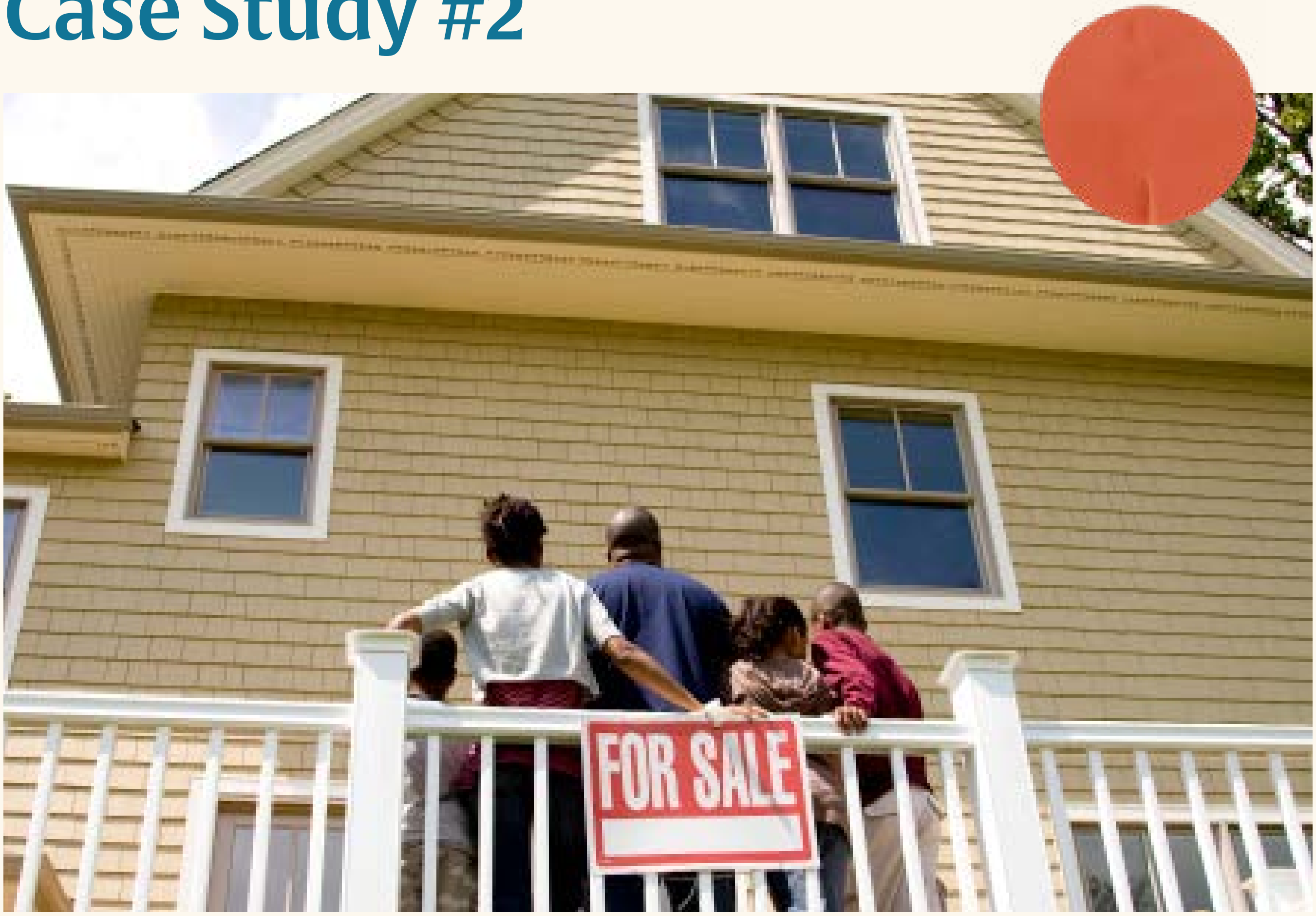


CDFIs were created to fill gaps that banks and traditional lenders won't step into, including being able to lend to projects that have more perceived risk. However, today the degree of real or perceived risk that CDFIs are willing to take on can look similar to that of traditional lenders.

A Black leader of a nonprofit housing organization in the East Bay had a plan to expand her organization's impact by acquiring privately owned buildings where tenants were at risk of being displaced and making them permanently affordable. To do this, she needed lenders to 1) take a risk on her and her organization, which had never done this kind of work before, and 2) take a risk on providing financing specifically for acquisition/rehab, which requires longer loan terms and projects smaller cash flow margins than new construction. The developer identified a 17-unit apartment building in Oakland as a good acquisition opportunity. After partnering with another experienced affordable housing developer to provide her with guidance and technical support, she came to LISC.

Through BFF, LISC offered the developer a 10-year loan term for her project, giving her time to complete rehab work and stabilize the building by getting all of the units occupied at an affordable rent. Most importantly, BFF enabled LISC to underwrite to a lower debt service coveratge ratio – which meant the project could afford to have lower cash flow for a few years. Because BFF was set up to tolerate more risk, especially for emerging developers of color, LISC could make our terms work. With a combination of funding from the City of Oakland and a BFF loan, the developer purchased the building, ensuring rents remain affordable for the people living in the property, who earn between 30-90% AMI.

Case Study #2



Lower-cost debt means more resources go to project outcomes and mission goals – rather than interest and fees. Lower interest rates enable access to capital for tighter affordable housing project budgets, while higher interest rates can limit the size of projects by limiting the total financing they can afford. However, because CDFIs relend borrowed capital from financial institutions, the final interest rate to affordable housing developers can be high after factoring in interest paid to funders and our own spread to cover costs. Interest rates aren't the only term that matters for opening up access to capital, but they are a critical piece of the puzzle.

A local Bay Area nonprofit housing developer identified a budget gap in a project aiming to provide 59 affordable homes to formerly homeless families and people earning extremely low incomes. The budget gap came from a combination of changing state regulations and inflation. The developer needed a new, low-cost source of permanent financing to allow them to take on a larger loan and close their financing gap.

LISC used CHF – which offers a 2% interest rate - to provide a 16-year loan to the developer, filling their gap and replacing a more expensive permanent bank loan. CHF's low interest rate was possible because the investor in the fund accepted a very low rate of return, and the Fund leveraged credit enhancement dollars to absorb potential losses and mitigate risk. Since securing the financing from LISC, the developer has opened the building, and it is serving residents making up to 50% AMI.

Case Study #3

Accessing 'better' debt capital (lower cost, more flexible underwriting, and larger loans) can be particularly challenging for neighborhood-based and BIPOC-led affordable housing developers. Because of how investors assess risk, they often prioritize organizations that already have extensive resources. This results in larger developers with access to cheaper, more flexible, and sometimes more risk tolerant financing, while smaller organizations (whether established or emerging) have access to financing with less attractive terms, such as higher interest rates, lower loan amounts, or higher minimum debt service coverage ratio requirements.

An experienced, place-based community development corporation (CDC) in Oakland was looking for more innovative financing to support the purchase of three residential buildings with a total of 40 units from a single private owner. The CDC had already borrowed over $10 million at high interest rates to support the acquisition and needed more resources to fully acquire and rehab the buildings. More high-interest rate financing would increase the project's operating costs and potentially force the CDC to charge higher rents to pay back their debt.

Debt (bank + CDFI partnership): $154M

Grant / Equity: $10M

An innovative loan provided through the Bay's Future Fund was able to meet their need. By combining credit enhancement money from CZI (which lowered the requirements for developer equity in the project) with capital from Morgan Stanley, BFF was able to offer a large, low-cost loan with a 10-year term that both saved the project from paying over $1M in interest and allowed the CDC to cap rents at an affordable level. These buildings are home to low-income tenants of color; the CDC has been able to stabilize rents for all tenants and will maintain the building as affordable housing.

Case Study #4

The three stories above involve experienced and well-established CDCs and non-profit developers. Most lenders and CDFIs do not lend to organizations without a development track record. Recognizing the racialized dimensions of this policy and practice, LISC and other CDFIs have been examining how they can better work with emerging organizations.

A new Bay Area CLT emerged out of a long history of community organizing against gentrification in their community. The community members who founded the CLT wanted a vehicle to expand community control of land and housing to provide permanent affordable housing to community residents and thereby promote neighborhood stability. A landlord who was going out of business and wanted to sell to the land trust brought them their first building, a 4-unit residential acquisition and rehab project. The organization assembled a team of staff and consultants with experience in these types of projects, but still needed a lender to provide them with the resources to acquire the building; this was a particular challenge as they had no organizational track record in this area.

The more flexible underwriting terms in BFF allowed for lending to an organization with no prior experience, so LISC was able to provide a $1,590,000 loan for the CLT to buy the property and complete repairs. A soft commitment from the local government to provide the permanent financing and pay back LISC's loan was also critical to the project's success. The CLT purchased the building and is working with 10 African American, Latino, and multiethnic residents with low income to rehab the property and explore long-term limited equity ownership possibilities.

WHAT'S NEXT?

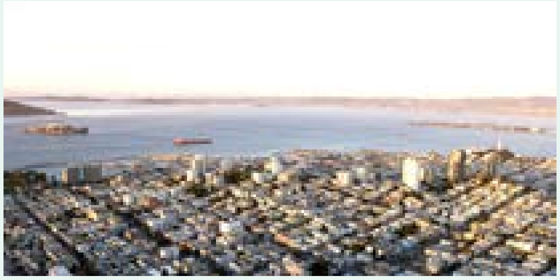
Our team is proud of the impact we made with the Family of Loan Funds. And we're eager to take these learnings, and leverage them to go farther in our work to provide access to capital for community-centered real estate in historically disinvested communities.

The loan fund structure allowed us both to blend grant and loan money together and to raise a set of investors' risk tolerance. Can we take the learnings and experience from the Family of Loan Funds and use them to redefine risk altogether? Could this set of investors get comfortable with tolerating more risk without grant dollars backing it up? If so, could they set a new baseline for lending and underwriting standards?

Community leaders rethinking capital and community stewardship are asking investors to consider the risk of not investing in community-led projects and BIPOC-led organizations. **We invite everyone in the investment space to join us in asking how we can recalibrate our risk assessments to focus less on the costs of investments and more on the cost of not investing in community-driven priorities.**

A NOTE ON METHODOLOGY

What can one deal or even a handful of deals teach us about the larger housing ecosystem of our city, region, or state? By nature, each deal we do is a unique product created by a set of people, organizations, money, and timing that can never be replicated precisely. However, analyzing one deal, or a handful, through a systems lens can help us more easily see the entire ecosystem we are working in – including what parts of the system are working well and where there are gaps and a need for more systems supports. One deal or a handful of deals can also shift systems by proving that particular types of deals are feasible or less risky than they are currently perceived.



Deal review is a process created by the Center for Community Investment (CCI) that looks at deals as "system events." In this process, a group of people unpacks the terms and details of a specific deal or project along with the web of policies, relationships, market dynamics, etc., that made the deal possible or made it really hard or even made it not happen, in the case of deals that we ended up not doing.

Systems change practitioners often use the image of the iceberg to illustrate how the events or outputs of a system are just the tip (what we see), but there's a lot more to the system that generates those outputs. CCI developed the process of 'deal review' to help practitioners look at the parts of the iceberg underneath the water to better understand the current boundaries of the system–and where it might be expanded.

Deal review can also help us see the impact we are making as we work to change the investment ecosystem within which deals take place. CCI points out that "we can also use deals to change the system itself. ... Catalytic deals are designed not only to achieve specific social or environmental goals but also to spark change in the system."

The Bay Area LISC team used deal review to consider the impact of our lending through the Family of Loan Funds. We asked where we have been able to push the boundaries on traditional lending and what transformative impacts might come out of this new lending. This piece sums up some of our learnings from that process.

About the Center for Community Investment

The Center for Community Investment (CCI), a sponsored project at Rockefeller Philanthropy Advisors, works to ensure that all communities, especially those that have suffered from structural racism and policies that have left them economically and socially isolated, can unlock the capital they need to thrive. Our work is supported by the Robert Wood Johnson Foundation, The Kresge Foundation, JPMorgan Chase & Co, and The California Endowment.

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