Ben S Bernanke: Community development financial institutions – challenges and opportunities

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Global Financial Literacy Summit, Washington DC, 17 June 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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I am pleased to be back at the Town Hall Education, Arts, and Recreation Campus for the Global Financial Literacy Summit. I commend the organizers and participants for their commitment to financial literacy. As Americans struggle with very difficult economic and financial circumstances, the importance of financial literacy and financial education has never been more evident. Organizations such as our host today, Operation HOPE, with its local Hope Centers, provide a vital service by helping adults and young people gain the financial knowledge they need to achieve their economic goals.

Community-based organizations such as Operation HOPE offer training and counseling to people in traditionally underserved markets, helping them to manage credit, buy homes, and start small businesses. As we reaffirm our commitment to increasing financial literacy as a means of improving economic opportunity, we should recognize that the contributions of community development organizations go well beyond providing information and guidance to individuals and families. These organizations also facilitate economic growth and development by offering a broad range of services and financing in low- and moderate-income communities. In this regard, a uniquely important role has been played by a group of specialized lenders known as Community Development Financial Institutions, or CDFIs. This morning I would like to offer a few thoughts about this important set of institutions and the challenges they face in the current economic and financial environment.

We don't have to look too far to see the contributions of CDFIs. In this portion of Washington, D.C., east of the Anacostia River, CDFIs and other community-based organizations are working with private partners and with government in multifaceted efforts to spur development, add quality affordable housing, increase commercial activity, and better connect these neighborhoods to the broader regional economy. Community-based organizations such as CDFIs can play critical roles in these important undertakings because of their detailed knowledge of neighborhoods' economic needs and strengths and because of their commitment to their mission of community development.

CDFIs and their role in community development

CDFIs come in various forms. They may be banks, credit unions, nondepository loan funds, or venture funds. Generally, CDFIs strive to provide affordable and appropriate financial services to people and communities who traditionally lack access to such services. Depending on the institution and local needs, they may offer financing for homeownership, rental housing, commercial real estate, health care, small businesses, microenterprises, charter schools, and child care facilities, among other purposes.[1] CDFIs often also work with traditional lenders to attract private capital for community development. A nearby example of such cooperation is the redevelopment of the long-vacant former Camp Simms National Guard site in Southeast D.C. That project, which included a local CDFI in partnership with

[1] Paul Weech (2009), "Observations on the Effects of the Financial Crisis and Economic Downturn on the Community Development Finance Sector," Working Paper Series 2009-5 (San Francisco: Federal Reserve Bank of San Francisco, May).

the D.C. government, a private developer, and a local community development corporation (CDC), led to the creation of a shopping area that included a much-needed grocery store and other commercial services.

In many ways, the formation of CDFIs represented an important milestone in the ongoing evolution of policy strategies for community development and revitalization. During much of the past century, federal community development efforts were large-scale, top-down affairs. As we have seen in the sphere of international development assistance, centralized, large-scale development efforts – though not without their successes – often imposed a one-size-fits-all approach that failed to take sufficient account of the particular needs and characteristics of local communities. In many cases, the results were disappointing or worse; for example, the so-called urban renewal programs of the 1950s and 1960s had what ultimately proved to be devastating effects on some areas. In response, the policy focus has shifted over time toward using tools that allow more-customized approaches to local needs, such as block grants and housing vouchers. The growth of local CDCs and the passage of the Community Reinvestment Act in 1977, which required most deposit-taking institutions to lend and invest throughout their business areas, exemplified the trend toward a more bottom-up approach to development.

By the late 1980s, new alliances formed among the public, private, and nonprofit sectors, creating a network of institutions that understood and were committed to serving local communities.[2] In 1994, the Congress created the CDFI Fund, housed within the Treasury Department.[3] The Treasury recently estimated that the fund attracts $15 in nonfederal investments for every dollar it invests in a CDFI.[4]

In addition, the government provided new market-based incentives to attract private capital to community development. For example, the Low-Income Housing Tax Credit program, created in 1986, offers credits to investors in affordable rental housing. The affordable housing developments, in turn, often rely on community-based organizations to help with development, financing, and property management. More than 2 million units of affordable rental housing have been built as a result of investors using the incentives offered by the program since its inception.[5]

Today, nationwide, there are more than 1,000 certified CDFIs with a collective $25 billion in assets.[6] These organizations have loaned and invested billions of dollars in our nation's most distressed communities and have attracted many conventional investors into underserved areas. For small businesses in particular, CDFIs provide critical funding because many traditional creditors view such loans as too risky or, sometimes, too small to be profitable. As a complement to lending, CDFIs offer training and technical assistance to their customers, directly or through partnerships, thus increasing borrower capacity and mitigating loan risk. Successful CDFI borrowers often graduate to conventional financing as their needs grow,

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2 David Erickson (2006), "Community Capitalism: How Housing Advocates, the Private Sector and the Government Forged New Low-Income Housing Policy, 1968-1996," Journal of Policy History, vol. 18 (2), pp. 167-204.

3 The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 107 Stat. 2369.

4 U.S. Department of the Treasury, Office of Performance Budgeting and Strategic Planning (2009), FY 2010 Budget in Brief (Washington: Department of the Treasury).

5 National Council of State Housing Agencies (2007), State HFA Factbook: 2006 NCSHA Annual Survey Results (Washington: NCSHA).

6 CDFI Data Project (forthcoming), "Providing Capital, Building Communities, Creating Impact – Fiscal Year 2007". Previous reports can be found at http://cdfi.org/index.php?page=dataproject-c.

thereby attracting the participation of mainstream lenders while freeing up CDFI resources to plant new seeds in the community.[7]

Current challenges and opportunities for CDFIs

CDFIs have certainly not been spared from the financial disruptions of the past two years. While many CDFI portfolios have continued to hold up relatively well despite the financial crisis, rates of delinquencies and defaults on CDFI loans have risen as economic conditions have worsened.[8] In light of the mission of CDFIs, it is not surprising that their financial concerns often reflect economic distress in the broader community: the once-thriving local business that is shutting its doors, the affordable rental housing complex that is struggling to make payments as tenants lose jobs and fall behind, and the after-school youth center that cannot repay its loan because its donor base has shrunk. Even as the capacity of CDFIs has become more constrained, economic conditions and pullbacks by mainstream lenders have increased the demands being placed on these organizations to provide credit and services.[9]

Traditionally, CDFIs have been able to fund a majority of their operating activities through earnings.[10] However, those earnings have come under pressure as loan losses have risen, deal volumes have declined, and sources of capital for new activities have become more expensive or unavailable altogether. Moreover, CDFIs' main sources of outside capital and operating support are facing significant pressures of their own. Funding from philanthropic sources has been reduced as endowments have suffered capital losses and rates of giving have declined.[11] Indeed, two-thirds of foundations surveyed recently reported that they plan to reduce the number and size of their grants in 2009, and cuts are expected to continue in 2010 and beyond.[12] Funding from state and local governments that sometimes support CDFIs is also dwindling, reflecting increased fiscal pressures. And mainstream financial institutions have reduced their support of CDFIs, both by providing less direct funding and by extending less credit in support of projects done in partnership with them.

Just as banks are adapting to the changing financial landscape, the community development industry can adopt changes to help it emerge stronger from this crisis. CDFIs are taking steps to minimize losses, strengthen their portfolios and liquidity positions, and assess existing activities and planned investments in light of the worsened financial and economic environment.

As CDFIs move past the immediate hurdles, however, careful consideration will need to be given to more systemic changes to correct weaknesses that have emerged in the current CDFI model. Notably, the reduction of funding by key participants highlights the importance of broadening and diversifying the industry's funding base. For example, in the case of the

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7 See "Observations on the Effects of the Financial Crisis," note 1.

8 The net charge-off rate in fiscal year 2007 was 0.55 percent (see "Providing Capital, Building Communities," note 6). From a survey of CDFIs in fiscal year 2008, a charge-off rate of 1.7 percent was reported. See Opportunity Finance Network (2009), CDFI Market Conditions Report: Fourth Quarter 2008, OFN, April.

9 In the fourth quarter of 2008, 63 percent of reporting CDFIs reported an increase in credit applications, while over the prior quarter, 52 percent saw an increase in delinquencies. See CDFI Market Conditions Report, note 8.

10 Earned revenues represent 53 percent of CDFI total operating revenues. See U.S. Department of the Treasury, Community Development Financial Institutions Fund (2007), Three Year Trend Analysis of Community Investment Impact System Institutional Level Report Data FY 2003-2005 (Washington: Department of the Treasury, CDFI Fund).

11 At last report, philanthropic sources made up 12 percent of capital and 25 percent of operating funds for CDFIs. See Three Year Trend Analysis, note 10.

12 Steven Lawrence (2009), "Foundations Address the Impact of the Economic Crisis," Foundation Center, Research Advisory, April.

Low-Income Housing Tax Credit markets, major investors, including several large banks and government-sponsored enterprises, sharply curtailed their investments in affordable housing as the value of the tax credits declined along with their profits.[13] Continuing and expanding the current efforts to attract new investors to the Low-Income Housing Tax Credit market could mitigate the overreliance on a few market investors. The same could be said for investors in projects supported by the New Markets Tax Credit, a program of the CDFI Fund meant to attract investment to low- and moderate-income areas.

Other ongoing efforts to access institutional funding and the capital markets should continue so that CDFIs can tap more-reliable sources of funding at wholesale prices. For instance, the Federal Housing Finance Agency recently introduced its rules for public comment on how certified CDFIs can become members of the Federal Home Loan Bank System and access its lower-cost funds, as permitted under recent legislation. Such funding, with known pricing and terms, would be reliable and would help CDFIs manage their balance sheets more efficiently and inexpensively.

Prior to the financial crisis, some CDFIs had been making progress in gaining access to secondary financing markets. Although these markets remain disrupted, such efforts hold promise, especially to the extent that CDFIs are able to produce high-quality data and analysis of proposed investments. Good data, together with qualitative knowledge, is critical for identifying previously unrecognized market opportunities, assessing investment performance, and helping guide investors to make better decisions.

Finally, cultivation of nontraditional funding sources might prove fruitful. Increased interest by socially motivated individual investors has expanded the pool of investment capital for community development. One CDFI has created a product similar to a mutual fund where individuals purchase "community development notes" that are invested in community development organizations. The fund has raised capital from about 4,700 individuals and invested about $160 million; further, it has performed well, with an average 3 percent rate of return to investors and very low loss rates.[14] Even during the recession, new investors have been drawn by the appeal of supporting low- and moderate-income communities while earning relatively good rates of return. Other developments, such as emerging peer-to-peer lending platforms, also hold promise.

While community development finance is a small part of our overall capital and credit markets, the Federal Reserve recognizes that these financial flows are critically important for many low- and moderate-income communities. In fact, the Board of Governors has been working with several of the Federal Reserve Banks to promote research on how best to promote CDFIs' effectiveness and financial stability.[15]

The current crisis points to the importance of a strong network of healthy community-based organizations and lenders. As many communities struggle with rising unemployment, high rates of foreclosures, and vacant homes and stores, these organizations lead efforts to stabilize their neighborhoods. Rather than pulling back, CDFIs are introducing new products and programs to help communities respond to the crisis. For instance, a number of groups

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[13] Angelyque Campbell and Jennie Blizzard (2008), "Community Development Finance: Innovative Paths to Capital during the Credit Squeeze," Federal Reserve Bank of Richmond, MarketWise, Fall/Winter.

[14] Data from audited financial statements on the Calvert Foundation Community Investment Notes, as of year-end 2008. Since the fund's inception in 1995, the portfolio reports an overall 0.20 percent loss rate, none of which has been realized by investors. See Calvert Social Investment Foundation (2009), "Community Investment Note: Due Diligence Brief," Calvert Foundation, April. Also see the Calvert Foundation's website at www.calvertfoundation.org.

[15] For instance, in May 2009 the Board hosted a Community Development Finance Summit to discuss promising strategies for CDFIs facing challenges in the current crisis. The Federal Reserve Bank of San Francisco has conducted research on these topics through its Center for Community Development Investments, and the Federal Reserve Bank of Boston has worked with key partners to identify and promote best practices.

are purchasing homes, which might otherwise sit vacant, from loan servicers who take possession of foreclosed properties. These homes are repaired and then sold or rented to families. Because foreclosures and resulting vacancies impose costs on neighborhoods and local governments, facilitating occupancy can help maintain neighborhood stability.[16] These efforts are difficult, time consuming, and challenging to finance – exactly the kind of thing in which CDFIs specialize. CDFIs and other groups across the country are working hard to stabilize neighborhoods because they do not want to lose the progress attained by years, and sometimes decades, of investment in low- and moderate-income communities.

Indeed, this community stabilization work is important for the overall economic recovery. Healthy and vibrant neighborhoods are a source of economic growth and social stability. CDFIs and other community groups are already responding to the evident needs, but they will require many willing partners to ensure success in the long run, including governments, mortgage servicers, and mainstream lenders. Strong community organizations can accomplish a great deal, but their capacity will be severely limited without the willing partnership of many other institutions.

Conclusion

As the effects of the financial crisis and the resulting economic downturn have spread, there has been increased focus on preserving the gains made in low- and moderate-income communities over recent decades. Accomplishing that objective requires preserving the institutions that helped build these communities. Without strong CDFIs, attracting investments and capital to rebuild and revitalize communities would be even more difficult. Economic recovery, like economic development, is a bottom-up as well as a top-down process. Through their work at the community level, CDFIs, together with other community development organizations, can help build a sustainable recovery for all of us.

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[16] In particular, recent research points to the adverse spillover effects of foreclosures on local property values. See, for example, Zhenguo Lin, Eric Rosenblatt, and Vincent W. Yao (2009), "Spillover Effects of Foreclosures on Neighborhood Property Values," Journal of Real Estate Finance and Economics, vol. 38 (4), pp. 387-407.