CHAPTER ONE

Introduction

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Access to affordable capital and basic financial services is a critical component of healthy communities. Without them, individuals cannot pay bills, save for retirement, or buy a house. Developers need capital to build and rehabilitate housing, commercial properties, and community facilities. Entrepreneurs need equity and debt capital to start and expand their businesses. Yet low-income communities and individuals have always had limited access to financial services, affordable credit, and investment capital. This has hampered efforts to improve conditions in these areas.

Numerous products, programs, organizations, and policies have been designed to address the financial exclusion of low-income individuals and communities. Similar to those readily available to more affluent communities, these include loans and equity investments to create and improve businesses and finance community facilities, nonprofit organizations, and housing developments. They also include basic financial services, such as check cashing, savings and lending accounts, and financial education.

The specialized financial organizations that serve low-income communities are known as community development financial institutions (CDFIs), and include community development banks, credit unions, loan funds, and venture capital funds. CDFIs provide low-income communities with financial products and services, act as a conduit between them and conventional financial organizations and markets, and advocate for policies that empower and protect them.

The important role of government and public policy has been a constant thread in community development finance. The first U.S. developmental financial institutions—savings associations formed by African Americans in the seventeenth century—came into existence in response to laws that codified slavery and discrimination (Immergluck 2004). In the late 1880s, in the aftermath of slavery's abolition and in the face of ongoing discrimination by mainstream banks, African Americans formed the earliest development banks (Immergluck 2004).

Over the last forty years, government and public policy have played a more positive role in helping create and grow the current field of community development finance. Many of the oldest community development financial institutions trace their roots to the first community development corporations (CDCs), which were the result of President Lyndon Johnson's War on Poverty and the 1964 passage of the Economic Opportunity Act.[1] In 1966, New York Senators Robert Kennedy and Jacob Javits introduced amendment I-D to that act, creating the Special Impact Program (SIP). Kennedy and Javits saw SIP as differing from the earlier war on poverty programs in its strong focus on specific distressed communities and its emphasis on economic development as a way to alleviate poverty. To demonstrate these principles, Kennedy and his staff created the Bedford-Stuyvesant Restoration Corporation, the first community development corporation in the country. They ensured that $6.9 million, more than 25 percent of the total 1966 SIP appropriation, would go to fund the Bedford Stuyvesant effort, and organized a coalition of community residents and influential business leaders to steer the corporation (Parachini 1980).

Bedford-Stuyvesant became the model for other SIP program recipients. By 1970, more than twenty-five organizations nationally were receiving federal assistance under the SIP program (Zdenek 1990). In 1972, Title VII legislation, labeled Community Economic Development, further formalized the SIP program's structural components. CDCs funded under Title VII received grants for administrative overhead and program investment funds. The recipient organizations engaged in a broad range of activities, including business and economic development, labor-training activities, and housing and community development (NCEA 1981).

Through trial and error, these early CDCs pioneered some of the community development financial tools and models that currently make up the field. Bedford-Stuyvesant, for example, ran a small business lending program that initially focused on creating jobs by attracting large businesses into the neighborhood. When this resulted in the recruitment of only one IBM plant, Bedford-Stuyvesant instead began using the loan fund to support neighborhood entrepreneurs, in the process creating one of the first business-focused community development loan funds. Bedford-Stuyvesant also helped pioneer housing-oriented lending, by administering a $100 million home mortgage pool targeted to its neighborhood and funded by a group of New York City banks (Moy and Okagaki 2001).

The Job Start Corporation of London, Kentucky, was one of the SIP CDCs that used federal funds to begin its own business ventures. Given the limited business experience of those running the CDCs, and the generally high rate of new business failures, this approach proved an expensive and ineffective way to create community jobs. In 1972, frustrated with the failure of this approach, Job Start began investing capital in outside entrepreneurs in exchange for an equity stake in their enterprises, creating the first community development venture capital fund (Miller 1994).

The Bank Holding Company Act of 1970 enabled bank holding companies to invest in community development if the primary goal was to benefit low- and moderate-income people. This prompted the creation of Shorebank, the first community development bank in the country. Had this legislation not been enacted, Shorebank would have been set up as a credit union (Grzywinski 1991).

Public policy also has provided community development financial institutions with the tools necessary to accomplish their work. The passage of the Home Mortgage Disclosure Act of 1975 (HMDA), which requires financial institutions to file annual reports on home mortgage applicants and borrowers, made publicly available data on whether financial institutions are serving the residential credit needs of their assessment areas. The Low-Income Housing Tax Credit of 1986 provided investors a federal tax credit for investing in low-income housing developments, substantially reducing the costs of financing such projects.

More recently, public policy played an important role in the dramatic growth of the field of community development finance during the administration of President Bill Clinton. Clinton strengthened enforcement of the Community Reinvestment Act (CRA), which Congress had enacted in 1977 to encourage regulated financial institutions to fulfill their "continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered" (NCRC 2005, 1). New CRA regulations, enacted in 1995, recognized community development financial institutions for the first time as qualifying investments and borrowers, giving commercial banks a significant incentive to finance CDFIs.

President Clinton also championed the 1994 creation of the U.S. Treasury Department's CDFI Fund, which finances CDFIs and banks that increase their investments in CDFIs. The CDFI Fund has been a critical source of difficult-to-obtain equity capital, enabling CDFIs to grow in asset size. The fund also has helped increase private sector investments in CDFIs, due to its policy of requiring a private match for its capital. More broadly, the fund has raised the visibility and legitimacy of CDFIs, thus opening other federal and state government funding sources to them (Pinsky 2001). The Clinton administration also was responsible for the New Markets Tax Credit program, which was enacted as part of the Community Renewal Tax Relief Act of 2000. The program's initial allocation will leverage $15 billion in private and public sector capital for investments in low-income communities.

The community development finance field is very cognizant of the importance of government support. It actively lobbied to shape and enact these Clinton administration initiatives and has continued to advocate for their preservation during the G. W. Bush administration. Many CDFIs also see advocacy on behalf of low-income communities as a critical part of their missions. This includes state-level efforts to increase regulation and consumer protections, such as laws curtailing predatory lending and fringe banking. It also includes broader efforts to impact policies ranging from workforce development to environmental protection, and to increase the availability of funding for community development finance, such as state-level development of tax credits and CRA legislation.

The eight chapters that follow acknowledge the roles played by public policy both in helping to create the lack of capital in low-income communities and in trying to mitigate this lack of capital. Each chapter summarizes and analyzes what is known about a specific topic, provides a blueprint for what future research needs to address, and makes public policy recommendations. The book is divided into three sections: creating personal assets, building institutions, and evaluating progress.

CREATING PERSONAL ASSETS

The lack of financial services and access to capital in low-income communities hinders residents' ability to accumulate assets, a critical component of financial stability and sustainability for individuals and communities. Assets act as a buffer, enabling households to weather short-term income fluctuations related to loss of a job or unexpected health expenses. They also serve as a capital reserve for starting or expanding a business.

This section, consisting of chapters 2 through 4, addresses the role of finance in the empowerment and enrichment of low-income individuals. It does so by examining asset creation; the contribution of financial education toward poverty alleviation, and the role of microenterprise development in building personal wealth.

The most direct form of asset accumulation is via savings. In chapter 2, Daniel Schneider and Peter Tufano review data on U.S. household savings, especially by less-affluent households, and discuss theories of savings and the impediments to savings. Americans overall are poor savers, but low-income Americans have a particularly difficult time. The impediments to savings include a combination of factors that influence behavior by households and financial service firms.

For example, most Americans take access to saving and bill paying accounts for granted. This is not the case, however, for the estimated 56 million, primarily low-income and minority adult Americans who do not have a bank account (General Accounting Office 2002). Many of these individuals are forced to use high-cost check-cashing services to meet their most basic financial needs, greatly diminishing their ability to save and build assets.

The chapter discusses a number of innovations that might increase savings, largely adapted from experience with more affluent financial services consumers. Some of these innovations are surprisingly simple, such as making it easier for low-income individuals to sign up for employer 401(K) plans. These innovations either stimulate the demand for savings by providing incentives for families to save or making it easier for them to save; or they stimulate the supply of savings by making it easier or more cost effective for business organizations to serve this population.

Education of all forms is both an asset in its own right and a tool for obtaining and accumulating other types of assets. In chapter 3, Jeanne Hogarth, Jane Kolodinsky, and Marianne Hilgert focus on financial education in particular, providing a snapshot of the current state of financial education in the United States as it relates to low-income communities. Decreasing union membership, more temporary employment, disappearing employer pensions, and declining employer-provided health coverage have meant that individuals, particularly those who are low income and working poor, are increasingly bearing financial risk. This has raised awareness of the importance of financial education and of the need for such education, under the premise that well-informed, well-educated consumers should make better decisions for their families, increasing their economic security and well being and minimizing the chance that their assets will be depleted through predatory financial practices.

Hogarth, Kolodinsky, and Hilgert examine whether financial education leads to greater financial security. There is increasing evidence that it makes a difference in consumers' attitudes and behaviors, but most of these studies have focused on household-level behaviors. Personal debt levels have been reduced and savings and assets have been increased—but virtually none of these outcomes have been related to neighborhoods, communities, or economic development more generally.

The chapter concludes with a brief case study of consumer education initiatives at the Vermont Community Development Credit Union to examine whether financial education outcomes go beyond individuals. The findings hint at the potential relationships between financial education and community involvement and provide some hope that financial education programs really are making a difference in communities.

One much-touted avenue of asset creation is self-employment through microenterprise. In chapter 4, Lisa Servon reviews the challenges facing the microenterprise field in the United States, and suggests strategies for addressing them. U.S. microenterprise programs provide business training or small amounts of credit ($35,000 or less) to businesses with five or fewer employees, and sometimes both. As the U.S. field nears the end of its second decade, experts and practitioners agree that it faces difficulties. There also appears to be relatively widespread consensus on the nature of the problems. These include a lack of standardized data, decreased funding from some key sectors, increased competition, and difficulty in reaching the target market.

Servon argues that, if the microenterprise field does not make some significant changes—at both the program and field levels—it will neither sustain itself nor approach its potential. Strategies to address these challenges fall into three broad categories: restructuring, innovation, and accreditation and standardization.

BUILDING INSTITUTIONS

Chapters 5 through 8 examine ways that institutions can serve low-income communities by providing personal financial services; capital for the production of community facilities, housing, and businesses development; and protection against predatory financial practices. In chapter 5, Julia Sass Rubin profiles community development loan (CDLFs) and venture capital funds (CDVCs). Like all CDFIs, community development loan and venture capital funds experienced tremendous growth in numbers and scale during the late 1990s. Since 2001, however, the economic and political environment has become significantly more challenging, making it increasingly difficult for these organizations to obtain the subsidized capital necessary to continue operations. Rubin discusses the factors responsible for the reduction in bank, foundation, and federal government support for CDLFs and CDVCs. She then reviews potential new sources of capital, including state governments, public and Taft-Hartley pension funds, individual investors, and the capital markets. Rubin also discusses the increasing pressure on CDLFs to find ways to use market-rate capital and on CDVCs to demonstrate market-rate financial returns. Rubin concludes by discussing ways that both CDLFs and CDVCs are redesigning and repositioning themselves in response to environmental pressures.

In chapter 6, Marva Williams looks at alternative depository institutions (ADIs), consisting of community development banks and community development, low income and mainstream credit unions. ADIs can play an important role in providing affordable financial services and loans in underserved, lower-income communities. Williams explores the evolution and recent performance of ADIs and finds that, though community development and low-income credit unions and community development banks do serve low-income communities, mainstream credit unions generally do not. Williams proposes public policies designed to encourage them to do so. She also discusses the importance of developing impact methodologies for ADIs and the need to continue advocating for conventional banks and savings and loans to improve their performance in lower-income neighborhoods.

In chapter 7, Rachel Bratt reviews the history of affordable housing production, focusing on how public, private, and nonprofit-oriented programs have attempted to fulfill the three essential components of the housing finance process—raising equity; securing debt financing; and, in the case of lower-income households, creating mechanisms to maintain the long-term affordability of the units. A home is the most important asset that most American families own. As housing prices and rents continue to climb in much of the United States, production of affordable housing is falling further behind demand, making this basic need increasingly out of reach for millions of low- and moderate-income Americans.

Bratt presents an overall assessment of the mechanisms and programs for financing affordable housing from four political perspectives and vantage points. She concludes with proposals for what should be done about homeownership for low-income households and what is needed to stimulate the production of rental housing affordable to low-income households.

In chapter 8, Kathleen Engel and Patricia McCoy focus on predatory lending. Low- and moderate-income individuals who have been able to purchase a home face the risk of losing it at the hands of such lenders. Predatory lenders market abusive loans to financially unsophisticated homeowners who have home equity but do not have a relationship with conventional lenders. As a result of predatory loans, neighborhoods that once were stable become littered with abandoned and neglected homes, resulting in increased crime, falling home values, rising demands for social services, and lower tax revenues.

Engel and McCoy describe how the rise of securitization, deregulation of price terms, affordable lending incentives, bank closings, and historical credit discrimination together fueled the rise and institutionalization of predatory lending in the 1990s. They then evaluate different possible approaches to redressing predatory lending, including industry self-regulation, consumer education and counseling, Community Reinvestment Act oversight, criminal enforcement, existing private causes of action, and a suitability proposal.

EVALUATING PROGRESS

The last section of the book consists of chapter 9, in which Rob Hollister discusses appropriate means of evaluating community development financial institutions. He begins by reviewing methods of evaluation and examples of attempts to evaluate the impacts of CDFIs. A major theme of the chapter is that there are a variety of parties interested in such evaluations—including foundations, governments, and private investors—and that the method of evaluation should be shaped to the appropriate perspective of a given party, while attempting to ensure that the party has realistic expectations about what an evaluation study may be able to provide.

Hollister reviews the strengths and weaknesses of an array of methods that have been used or suggested to evaluate outcomes associated with CDFI activities and details several quality attempts at such evaluations. He reviews recent developments in evaluation of CDFI performance and concludes by stressing that, in many situations, monitoring activities regarding performance may be more useful than attempts to establish and estimate impacts.

CONCLUSIONS

Low-income individuals and communities face numerous obstacles as a result of their financial exclusion. The community-based financial institutions that are trying to help them overcome these obstacles have accomplished a great deal. However, these communities and institutions still are confronting serious challenges going forward. The climate for community development finance has become significantly more difficult over the last six years, even as the needs of low-income communities have grown and the resources available to meet those needs have diminished.

In the face of these challenges, industry leaders are telling community development financial institutions that they must "grow, change or die" (Pinsky 2006). It already is clear that some prominent and pioneering CDFIs will not survive the transition, but the industry as a whole cannot afford to fail. This book is intended to help facilitate the growth and change that must take place. It identifies information gaps that need to be addressed in moving the field forward and lays out potential directions that private and public institutions can take to minimize and address the financial exclusion of low-income communities.

NOTES

1. Although community development credit unions came about as a result of the War on Poverty, the first credit unions were introduced to the United States from Europe and Canada in the early 1900s (Immergluck 2004; Isbister 1994).

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