

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS: CURRENT ISSUES AND FUTURE PROSPECTS

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INTRODUCTION

Low-income communities and individuals have always had limited access to financial services, affordable credit, and investment capital. The problem has multiple causes, including historical patterns of racial and ethnic discrimination, banks' and thrifts' concerns about profitability, suburbanization and the flight of capital out of the inner city, and the restructuring of the financial services industry.¹ These and other factors have created both a need and an opportunity for financial institutions that specifically target minority and low-income communities. These "alternative" entities, now referred to as community development financial institutions (CDFIs), include community development banks and credit unions; community development venture capital providers; micro-enterprise funds; and housing, business, and facility loan funds. Although diverse in scope and structure, all CDFIs have a primary mission of improving economic conditions for low-income individuals and communities by providing financial products and services that usually cannot be obtained from more "mainstream" financial institutions. They augment this financing with a range of educational services and borrower-specific technical assistance, so as to increase their borrowers' economic capacities and potential.

Despite a growing interest in CDFIs, we still know very little about these institutions. This paper begins to address this gap. It outlines the history of the CDFI industry and describes how CDFIs are responding to three specific needs in low-income communities: basic financial services; affordable credit for home purchase, rehabilitation, and maintenance; and capital for business development. We conclude with a discussion of three key questions facing the CDFI industry: 1. What are the impacts of CDFIs; 2. What is the role of CDFIs relative to conventional financial institutions; and 3. What does the future hold for the CDFIs industry?

¹ There has been a considerable amount written about each of these factors. For example, Oliver and Shapiro (1995) and Squires and O'Connor (2001) have examined patterns of lending discrimination. Jackson (1995) and Kasarda (1989) have analyzed the effects of suburbanization on urban markets. Christopherson (1993), Avery et al (1997), and Stegman (1999) have discussed the impact of the modernization and consolidation of the financial services industry. It is beyond the scope of this paper to assess the relative importance of the various factors.

HISTORICAL CONTEXT

CDFIs are the latest institutional efforts to increase the availability of affordable capital and basic financial services in economically disadvantaged communities. The 1880s witnessed the development of a small number of banks that specifically targeted black communities and were principally owned by African-Americans (W.E.B. Dubois 1907). The 1930s and 1940s saw the emergence of credit unions, many of which were in the rural south and designed to serve African Americans who did not have access to credit. In the late 1960s and early 1970s, a series of multi-purpose community development corporations (CDCs) developed to address the housing and small business needs of many distressed center-city neighborhoods; while a number of federally and state-funded revolving loan funds were created to provide financing to small businesses in these areas.

The 1970s also saw the establishment of the first community development banks, one of whose subsequent success (South Shore Bank) served as the impetus for similar development finance models throughout the country.² The National Federation of Community Development Credit Unions (NFCDCU) formed in 1974, and has worked tirelessly to promote the CDCU model. In 1978, Congress created the Neighborhood Reinvestment Corporation, which subsequently created a number of local lending institutions that provide affordable mortgage financing to lower-income individuals.

The 1980s witnessed the establishment of several community development intermediaries, which provided a variety of financial and consulting services to CDCs and other community-based institutions.³ The Ford Foundation established the Local Initiatives Support Corporation (LISC) in 1980 as a national vehicle for bringing financial and technical support to the growing cadre of CDCs engaged in real estate development. James Rouse created the similarly oriented Enterprise Foundation a few years later. Also in the early 1980s, the Institute

² The Bank was begun in 1973. Taub (1988) describes South Shore Bank's early years.

³ See Liou & Stroh (1998) for a discussion of the history of community development intermediaries.

for Community Economics, an entity dedicated to promoting the development of affordable housing land trusts, helped create a number of other community development loan funds (Rubin 2002). In 1985 these loan funds came together to form the National Association of Community Development Loan Funds (NACDLF), which subsequently became the National Community Capital Association, or NCCA. Like NFCDCU, NCCA has taken an active role in helping to expand a number of development finance institutions throughout the country.

CDFIs also have drawn upon the work of international organizations. Many micro-loan funds can trace their origins to the Grameen Bank's development finance model, one in which individual entrepreneurs receive very small loans to help capitalize their home-based businesses enterprises

The Community Reinvestment Act

One of the major factors behind the growth of the CDFI industry has been the federal Community Reinvestment Act (CRA), arguably the chief cause of the increased investment in lower-income markets. Congress passed the Act in 1977 in response to concerted pressure from a national coalition of community activists. Building on the Home Mortgage Disclosure Act (passed in 1975), which required banks to report the geographical locations of their loans, the CRA mandates that banks address the credit needs of their entire service area, prohibiting them from discriminating against any portion of their markets.⁴ The CRA has never had any specific penalties for non-compliance, however. Regulators may factor a bank's lending record into a decision to approve a merger or a new branch opening, but there have been only a handful of

⁴ Congress had ostensibly addressed the issue of racial discrimination in lending with passage of the Fair Lending Act of 1968 and the Equal Credit Opportunity Act of 1974. The CRA sought to eliminate the more insidious practice of redlining, in which bankers refused to lend in certain geographic markets because of the high perception of risk in those communities. (The term "redlining" resulted from certain bankers' demarcation of high-risk neighborhoods by stark red lines on city maps.) Contributing factors to high-risk perceptions included large numbers of racial and ethnic minorities and high poverty and unemployment rates.

occasions in which such applications have been denied for CRA-related reasons. The law went largely un-enforced for much of the 1970s and 1980s.

Conditions changed noticeably in the past decade. A number of well-publicized studies in late 1980s and early 1990s, especially those in Atlanta, Chicago, and Boston,⁵ highlighted the continued persistence of discriminatory lending practices. These findings spurred renewed pressure by community groups against discriminatory banks and their regulators, particularly in the public comment period associated with banks' merger applications. Unwilling to risk a CRA-related denial and/or bad publicity, an increasing number of banks negotiated reinvestment agreements with the protesters. CRA proponents also benefited from the support of Bill Clinton, who in both his candidacy and his presidency remained a strong backer of the legislation. In 1995, President Clinton signed legislation that revised CRA regulations, placing more emphasis on a bank's lending and investment performance instead of its marketing and outreach efforts. His veto threats effectively killed subsequent attempts to weaken or eradicate CRA requirements. Such heightened federal attention to the CRA forced banks to comply with the law's provisions, and was a major cause of the substantial growth in bank lending in low-income markets in the 1990s (see Belsky, Schill, & Yezer 2001).

The Establishment of the Community Development Financial Institutions Fund

The federal government's role in community development finance has varied considerably in the past few decades. The federal Office of Economic Opportunity (OEO) and related War on Poverty agencies contributed significantly to the creation of many CDCs and low-income credit unions in the 1960s and early 1970s (see Abt 1973 and Immergluck & Gilson 1993). Most of this support disappeared in the 1980s, however, with the Reagan

⁵ The Atlanta Journal-Constitution's "Color of Money" series in 1988 highlighted the tremendous disparities in mortgage lending between Atlanta's primarily black and predominantly white neighborhoods. Pogge, Hoyt, & Revere's 1986 study showed similar trends in Chicago. The Boston Federal Reserve

Administration's elimination of many of the Great Society programs and sharp reductions in funding for low-income housing initiatives. The pendulum swung back a bit in the 1990s, as part of Clinton's economic strategy involved increasing access to credit and capital for those individuals and communities that had historically been unable to obtain such necessary resources.

Increasing enforcement of the CRA was one approach to increasing capital access; expanding the community development banking model was another. Hillary Clinton had been a longtime friend of Mary Houghton, who had been instrumental in the development of the South Shore Bank in Chicago. Ron Grzywinski and others had purchased the bank in the early 1980s to save it from being closed and had committed to turning it into an institution geared toward meeting the financial service and development needs of the declining South Shore community. The bank's success attracted the attention of then-Governor Bill Clinton, who met with Grzywinski and sought to create a similar institution in Arkansas. South Shore Bank's consulting affiliate was instrumental in helping to create this entity: the Southern Development Bancorporation, a CDFI designed to help accelerate economic activity in a 32-county area of southwestern Arkansas.

Not surprisingly, one of candidate Clinton's proposals was the establishment of 100 similar development banks throughout the country. While the idea generated considerable bipartisan support, the specific bank model encountered resistance from supporters of existing community development financial institutions, who believed that their organizations should also be included in the program.⁶ Negotiations resulted in a more inclusive approach, reflected in the

Bank reported that black mortgage applicants in Boston were rejected 60% more often than similarly qualified white applicants (Munnell et. al. 1992).

⁶ In January 1993, the Association for Enterprise Opportunity (a trade association for micro-enterprise funds), the Center for Community Self Help, Community Capital Bank, First Nations Development Institute, the National Association of Community Development Loan Funds, the National Federation of Community Development Credit Unions, and the Woodstock Institute distributed a response to President Clinton's 100 bank idea. Rather than setting up 100 new banks, they advocated that the administration support the many different types of existing institutions that had been doing community development finance work for decades.

Riegle Community Development and Regulatory Improvement Act (PL 103-325), enacted in 1994. The Act authorized the creation of a wholly owned government corporation (the Community Development Financial Institutions (CDFI) Fund) to support a range of CDFIs.⁷ The Fund initially was created as an independent entity, but practical and political considerations resulted in it being moved within the Treasury Department in 1995.⁸

The Fund operates a number of programs designed to increase capital access and availability in traditionally under-served markets. Its largest (“Core”) program has historically been one that provides a range of grants, loans, and equity investments to CDFIs to help them build their lending capacities. One-third of the Fund’s dollars go to the Bank Enterprise Award (BEA) program, which rewards banks for increasing their lending and investing activity in economically distressed markets and/or in CDFIs. Most recently, the Fund has been charged with administering the New Markets Tax Credit program. Enacted in the waning moments of the Clinton Administration, the program provides tax credits to certified community development entities (many of which are CDFIs), to assist them in raising private capital for investment in businesses located in economically distressed communities.

In addition to its financial support, the Fund plays somewhat of a gatekeeper role for the industry by certifying organizations as CDFIs. While certification is no indication of an organization’s quality, it is a prerequisite for receiving financial support from the Fund, from

⁷ The legislation allows for a wide variety of institutional forms to be certified as CDFIs and receive financial assistance from the CDFI Fund, although it does give some statutory preference to insured depository institutions. For a discussion of the politics associated with the Fund’s creation, see Santiago, Holyoke, & Levi (1998).

⁸ There was some discussion about placing the Fund within HUD, but there were concerns about HUD’s future in the mid-1990s. Treasury was a logical choice because of the Fund’s focus on financial institutions, and because other bank regulatory agencies (the OTS and OCC) were already in the Department.

many banks (banks can receive both CRA credit and BEA awards for lending to or investing in certified CDFIs), and from a growing number of state-run CDFI programs.⁹

The Fund has been instrumental to the development of the CDFI industry. As of mid-November 2002 there were 615 certified CDFIs in the country, up from 300 in 1998; many of those organizations have been established in the past five years.¹⁰ Since its inception the Fund has provided a total of more than \$400 million in direct funding to over 250 CDFIs. Through its BEA program, it has helped generate over \$1 billion in additional CDFI-related investments from conventional banks and thrifts.

The list of certified CDFIs highlights the variety that exists in the industry. The 615 groups include 69 banks, thrifts, and bank holding companies; 114 credit unions; 411 loan funds (including Fund-defined intermediaries (CDFIs that lend primarily to other CDFIs); micro-loan funds; and multi-bank CDCs), and 19 venture capital funds. These institutions range in size from \$5,000 to almost \$730 million (based on their total assets).¹¹ The following sections provide more detail on the ways in which different CDFIs address the financial needs in their communities, the issues they have encountered, and the impact they have tried to achieve.

⁹ In order to be certified by the Fund, an organization must 1) have a primary mission of community development, 2) principally serve an eligible low-income or under-served population or geographic area, 3) be principally engaged in the provision of financing, 4) augment the financing with related technical assistance to actual and potential borrowers, 5) maintain accountability to its target market, and 6) be a non-governmental entity. It should be noted that the community development field is not always in agreement with how the Fund implements and interprets the statute.

¹⁰ The data is from the Fund's website (www.cdfifund.gov). The Fund does not yet maintain a database of the incorporation date of the CDFIs that it has certified, nor does it track the organizational characteristics of CDFIs that have not received financial awards from the Fund. It is reasonable to assume that there has been a significant growth in the number of CDFIs since the Fund was created, although it is impossible to know the extent of that growth. There are a number of organizations that have been in existence for many years and have never chosen to apply for CDFI designation. There also are numerous groups that have re-structured themselves in order to meet the CDFI requirements. The Fund maintains a list of certified CDFIs on its website.

¹¹ This data is provided by the CDFI Data Project (CDP), a collaborative initiative that produces comprehensive data for and about the CDFI industry. The CDP FY 2001 Dataset includes 512 CDFIs--the largest dataset ever collected on the CDFI industry and one that represents a significant sample of the industry's institutions.

FINANCIAL SERVICE PROVISION

The availability of basic financial services is critical to the economic health of individuals and communities. Checking and savings accounts are the most basic financial assets that most households own (Williams and Hudson 1999). When held in insured depository institutions, they provide a safe place to keep money, offer an opportunity to build wealth, and are often prerequisites for obtaining other forms of credit. Yet the most recent (1998) Survey of Consumer Finances by the Federal Reserve Board reported that 10 million U.S. households (9.5%) have no transaction accounts with a financial institution, a number which may well be low.¹² Over four-fifths of these households had incomes of \$25,000 or less, with nearly half having incomes less than \$10,000. A 2002 Government Accounting Office study found that 75 percent of the unbanked OASDI (Old Age, Survivors, and Disability Insurance) and SSI (Supplemental Security Income) recipients had family incomes of \$30,000 or less, and that 52 percent of African-American OASDI recipients were unbanked.

Households without basic transaction accounts face a number of financial disadvantages. They typically have to use currency exchanges to cash checks; “the amount that a currency exchange charges to cash one check is roughly equivalent to the cost of a checking account per month” (Woodstock 1997). They also have difficulty establishing the credit history necessary to purchase a home or build other wealth. Low-income households without transaction accounts are 43% less likely to have positive holdings of net financial assets, 13% less likely to own a home, and 8% less likely to own a vehicle than those with such accounts (Carney and Gale 2001: 200). Households that do not have relationships with insured

¹² The results from the 2001 Survey of Consumer Finances are due to be released in February 2003. A preliminary report released in the January Federal Reserve Bulletin indicated that the percentage of households without transaction accounts remained fairly constant between 1998 (9.5%) and 2001 (9.1%). In 2002 the Government Accounting Office estimated the number of households without transaction accounts to be 22 million, based on census SIPP data (GAO 2002).

depository institutions also are more susceptible to predatory lending practices when looking to refinance their homes (U.S. Treasury & HUD 2000).¹³

Among the many factors explaining the number of unbanked households, three are particularly relevant to our understanding of CDFIs: the relative absence of conventional financial institutions in low-income communities, the high cost of financial services, and the lack of basic financial skills and understanding among many individuals.¹⁴ First, there has been a considerable decline in the percentage of bank branches located in central cities in the past quarter century. The decline has resulted from a number of factors, including responses to economic and demographic trends (i.e. suburbanization) and consolidation resulting from mergers and acquisitions (Avery et al 1997), but the end result has been that fewer branches have been conveniently located to concentrations of lower-income, central city households.

Second, providing basic checking or savings accounts generally is a money-losing service for a financial institution. Transaction costs tend to be particularly high for accounts held by low-income households, as these individuals typically have smaller accounts and make smaller deposits and more frequent withdrawals. To compensate for these higher costs, many banks impose a series of account requirements, such as minimum balances, a set number of free withdrawals per month, and fees for using human tellers and overdrafting the account (Papadimitriou, Phillips, and Way 1993).¹⁵

¹³ Predatory lending involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices.

¹⁴ According to the Federal Reserve's Survey of Consumer Finances, the most common reasons cited by individuals for why they do not have a transaction account were: do not write enough checks (28.4%), do not like dealing with banks (18.5%), do not have enough money (12.9%), service charges are too high (11.0%), minimum balance is too high (8.6%), and cannot manage or balance a checking account (7.2%). Location and hours were issues for only 1.2% of those surveyed.

¹⁵ Papadimitriou et al explain that the fees have increased over time because banks have been competing with non-regulated financial vehicles like money market mutual funds, which offer consumers a higher return for their investment. In order to match those higher returns, banks need to increase their revenue (by increasing fees).

Third, many individuals do not appreciate the importance of having basic transactional accounts. Fifty-three percent of respondents in a 2001 survey of households with annual incomes of \$25,000 or less agreed with the statement “we don’t need an account because we rarely have savings” (Federal Reserve Survey of Consumer Finances 2001). Respondents may not realize the importance of the account for building other assets and minimizing their financing costs.

One response to the situation has been the growth of fringe banking entities (including currency exchanges, check-cashing outlets, pawnshops, and rent to own stores) in lower-income communities. In Chicago in the late 1990s, the ratio of fringe bankers to conventional lenders was as high as 12:1 in low-income, predominantly minority communities compared to 1:1 for the city as a whole (Woodstock 1997). These fringe bankers typically offer convenient locations, flexible hours, short lines, and immediate cash without having to wait for a check to clear, characteristics that often distinguish them from conventional banks and credit unions. While a typical check-casher may charge up to 4 percent of the value of a given check, it charges only \$0.75 to issue a money order and also sells envelopes and stamps. In contrast, conventional credit unions and banks can charge as much as \$40 for one overdraft and do not offer the same ancillary services (Caskey 2001: 8; Stegman 1999).

The downside is that fringe banking fees add up quickly. Moderately frequent (10 or more per month) users of these institutions’ services can end up paying two to three times as much--a few hundred dollars over the course of a year--as they would if they had an account at a regulated financial institution (Woodstock 1997). Even more striking is the difference in interest charges for short-term, “payday” loans. For example, a check-casher might charge a 10 percent fee for a two-week cash advance (or \$5 on a \$50 loan). Since many payday loans are rolled over or extended, the annual percentage rate serves as a better reflection of the true

costs of the loan (Stegman 1999, Caskey 2001).¹⁶ A 10 percent fee for a two week loan translates into an annual interest rate of 1,092 percent (compared to a typical annual consumer loan rate of 16.5 percent for a credit union) (Stegman 1999: 67).

There also have been regulatory attempts to address the problem of the unbanked. Most states now have usury laws that limit the fees that can be charged for various financial transactions. The 1991 Federal Deposit Insurance Corporation Improvement Act (FIDICIA) reduced the insurance assessment for ‘lifeline’ checking accounts, which are designed to serve the needs of low-income people (Macey and Miller 1997). Part of the 1995 revisions to the CRA included requirements that conventional financial institutions offer lifeline accounts. Financial institutions also can partner with the federal Treasury Department to offer Electronic Transfer Accounts, or ETAs (see Stegman 1999).¹⁷

Addressing the accessibility and affordability of basic financial services in low-income communities has been a major focus of CDFIs, particularly community development banks and credit unions. The number of insured depository CDFIs has increased tremendously in the past decade. The number of community development banks increased from 27 in 1992 to 39 in 2001, with their total deposit base growing from \$61.5 million to \$108.1 million and their lending rising by 160 percent during this period (Woodstock 2002).¹⁸ Similarly, the number of credit unions specifically designated as low-income grew from 142 in 1990 to 538 in 1999, with a

¹⁶ A 2000 Woodstock Institute survey of payday loan borrowers in Illinois found an average of 12.6 contracts per borrower.

¹⁷ Electronic Transfer Accounts developed in response to a problem borne out of a 1996 congressional amendment to the Financial Management Act, which required electronic deposits for retirement benefits, programmatic benefits, vendor payments, and expense reimbursements. The amendment, EFT99, has saved the government an estimated \$100 million annually in postage and check production costs. It also provided an opportunity to link unbanked recipients of government benefits to financial institutions (Stegman 1999).

¹⁸ The study did not distinguish between the growth in deposits from institutional investors and those from individual account holders, including low-income households.

corresponding increase in deposits growing from approximately \$570 million to just over \$2 billion (NCUA 1999).¹⁹

The majority of community development credit unions (CDCUs) and CD banks are located in low-income areas and/or serve predominantly low-income individuals. They typically provide a range of basic financial services at little or no cost to their members or customers.²⁰ For example, basic savings and checking accounts (or in credit unions, share/share draft accounts) usually have no monthly fees and no or very small (\$5-\$10) minimum balance requirements. CDCUs and CD banks often offer Certificate of Deposits (CDs) that can be purchased for as little as \$100 as well as special savings vehicles such as Christmas accounts and Individual Development Accounts (IDAs) (Tansey 2001).²¹

Virtually all CDCUs and CD banks spend a considerable amount of time working with their members and customers to improve their credit rating and increase their asset-building capacity. By 1995, the typical low-income household had credit card debt of nearly \$1,300 (Bird et al 1997 cited in Carney and Gale 2001: 166-167), and 17 percent of low-income families had credit card balances that exceeded their annual income. Much of the CDFIs' work involves counseling clients/members on ways of reducing and managing their debt and repairing their credit histories.

¹⁹ Low-Income Credit Unions may or may not be certified CDFIs. NCUA and/or the state supervisory authority (in the case of state-chartered credit unions) makes the LICU designation, which indicates that at least 51% of the credit union's members earn less than 80% of median household income for the nation as established by the Census Bureau. To become a U.S. Treasury-certified CDFI, a low-income credit union must meet the CDFI Fund's six certification tests (outlined in footnote X), which usually proves no more than a formality. It is unclear to what extent the growth in designated LICUs results from the chartering of new LICUs or from more credit unions seeking LICU status.

²⁰ Some community development banks, like Community Capital Bank in New York City, do not offer retail banking services. Community Capital started from scratch and the capital raising process was very time consuming. To reduce transaction costs the bank made a conscious decision to not focus on retail banking services (see Tholin 1995).

²¹ IDAs are savings accounts in which a qualified individual's deposit is matched by a donor up to a certain level. The idea is to help low-income individuals build assets that can be used to help purchase a home, start/expand a business, or go to school. See Oliver and Shapiro (1995), Sherraden (1991), and Boshara, Scanlon, & Page-Adams (1998). IDAs are not limited to insured depository institutions; a number of social service programs and non-regulated CDFIs offer such savings vehicles to low-income participants. Several CDCUs are in the process of starting IDA programs. See Tansey (2001).

The Dilemma of Federal Regulation

Unlike other CDFIs, CDCUs and CD banks can take deposits and insure them up to \$100,000 with federal guarantees. Such insurance comes with contingencies, however; the institutions must adhere to a range of financial safety and soundness criteria to the satisfaction of federal and/or state regulators. For example, the groups must maintain appropriate levels of liquid reserves, minimum capital/debt ratios, and acceptable levels of risk in their portfolios. These regulations can effectively limit the types and extent of activities in which the institutions can engage.

A major issue concerns capitalization. Although there is no minimum capitalization requirement for CD banks or CDCUs, there are functional thresholds. Few CD banks will receive a charter unless they can demonstrate that they have at least \$5 million in capital (potentially somewhat less in rural markets). Such monies are critical for the bank to be able to meet the FDIC-mandated capital ratios. Similarly, groups seeking a credit union charter must demonstrate that the institution will have enough members (and enough deposits) to be economically viable. To obtain the necessary capital, CD banks and CDCUs rely on a range of individual, institutional, and social investors.

Regulators assess a financial institution's self-sufficiency, net earnings, and portfolio quality. If they deem the institution's financial condition to be sufficiently sub-par, they can close it. Compared to their more conventional peers, CD banks and CDCUs routinely show weaker financial performance. An analysis of the financial performance from 1996 to 2000, of 80 CDCUs and 33 CD banks relative to their peers, found that the CDFIs typically had fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets (Rajan 2001). South Shore Bank in Chicago, one of the oldest and most successful entities in the industry, has still lagged well behind similar-sized banks on the city's south side in its profitability (see Taub 1988 and Esty 1995). While such findings are not surprising given the CDFIs' focus on lower-income, higher-risk markets and borrowers, they are not necessarily comforting for financial

regulators. Federal and state evaluators do not look as positively on a CDFI's more flexible lending practices as might a socially-minded investor. It is extremely rare, for example, for CDCUs to earn a CAMEL rating of 1 (the highest on a five-point scale of financial soundness and management); most such groups earn 3 ratings, and a sizable number are in the 4 range.

Unlike non-profit, non-regulated CDFI loan funds, CD banks and CDCUs must consistently attain self-sufficiency; they cannot routinely make up operating deficits with grants from sympathetic donors. Yet their activities tend to be inherently more costly than those of conventional financial institutions. They lose a higher percentage of their loan capital. They may compensate for their higher-risk loans by charging slightly higher interest rates, but raising rates threatens the goal of providing affordable credit. Their often-intensive counseling services demand critical staff time and resources, increasing their operating expenses. CD banks and CDCUs consequently depend on attracting lower-cost funds than their more conventional regulated counterparts. Many such groups market themselves to socially-minded investors and depositors who are willing to forsake higher rates of return in exchange for the satisfaction of contributing to the groups' mission. The regulated CDFIs are eligible to apply for low-cost federal money through the CDFI Fund, and low-income credit unions may obtain a certain amount of deposits from investors outside of their fields of membership.²² Many CDCUs rely heavily on the donated services of their members to manage daily operations, counsel potential borrowers, and underwrite potential loans.

The burden of self-sufficiency ultimately prevents CD banks and CDCUs from taking as many risks with their financing as they might wish in support of their development missions.

²² Low-income credit unions qualify for deposits from the National Credit Union Administration (NCUA). They may also increase their net worth by accepting secondary capital investments designated to support institutional growth and stability. Such "investments" are in reality loans that are subordinate to all other debt, carry a minimum five-year term, and have a negotiated interest rate. In 1996, NCUA approved a new regulation that allows LICUs to increase their capital by accepting secondary capital investments. Secondary capital is treated as an equity investment and thus increases net capital ratios and net worth (see Williams 2002). A number of entities make secondary capital investments in CDCUs, including: The

They simply do not have as much margin for error as many of their more conventional financial peers (because of their smaller assets and lower profit margins). They often cannot engage in as many of the financing programs as other CDFIs because of financial and regulatory concerns. For example, relatively few CDCUs have been allowed by the regulators to make small business loans because of the higher-risk nature of such ventures. Neither banks nor credit unions can make equity investments in start-up businesses (although non-regulated bank affiliates may do so).

Despite their limitations, CD banks and CDCUs often represent the closest thing to mainstream financial institutions in their communities. They may well constitute the primary (if not the only) source of affordable financing for many local residents, businesses, and nonprofit organizations. Yet the impact of the CDFIs' activities has not been fully assessed. For example, it is unclear to what extent CD banks and CDCUs are reaching the previously unbanked, or to what extent these depositors/members are better off financially than they were prior to their involvement with the CDFI. A related question is how much have these individuals saved by switching from check-cashing, payday loans, and/or high-interest credit cards to a CDCU or CD bank. Have the CDFIs' credit counseling efforts helped the counselees achieve greater financial self-sufficiency? These are just a few of the critical questions that need to be answered if we are to understand fully the effects of these community development financial institutions.

HOUSING FINANCE

The bulk of development finance--and thus the bulk of CDFI activity--has historically focused on housing. The home is the primary asset for most Americans, and homeownership is a time-tested way of building individual and family wealth. Families frequently borrow against

the value of their homes to finance education and small business development. Homeownership also has traditionally served as a linchpin of a broader neighborhood development strategy, as it tends to contribute to more stable residential areas (Rohe & Stewart 1996). The development or rehabilitation of housing, be it single-family homes or multi-family rental apartments, can spur other economic activity within a community.

Single-Family Financing

For most people, purchasing and maintaining a home requires some sort of financing. Home purchase mortgages and home equity loans easily comprise the largest loan categories in the country. Unfortunately, access to such financing has historically been problematic in lower-income markets. As noted earlier, many banks pursued a policy of redlining poorer neighborhoods, a practice which effectively denied the communities many affordable financing mechanisms.

A significant factor behind the banks' decision was the Federal Housing Authority's long-time practice of refusing to guarantee mortgages made in unstable neighborhoods. The FHA's 1938 underwriting manual stated that "if a neighborhood is to remain stable, it is necessary that properties ... continue to be occupied by the same social and racial classes." While specifically rejecting racially transitioning neighborhoods (the presence of "incompatible racial and social groups" was also a justifiable reason for denying a mortgage), the FHA's guidelines effectively discriminated against many lower-income, potentially transitioning communities as well (cited in Polikoff 1978: 10-15). Since Fannie Mae (then part of the FHA) would only purchase mortgages that were FHA-guaranteed, banks had to conform to the FHA guidelines if they expected to sell their loans on the secondary market.

The Fair Housing Act of 1968 loosened the FHA's lending restrictions, eliminating its "stable neighborhood" criteria and creating a program that encouraged FHA-backed mortgage lending to minorities and lower-income individuals. FHA loans quickly became the primary

source of mortgage financing in many of these areas, providing much-needed credit to historically under-served communities. FHA loans carried 100 percent guarantees for investors, thus transferring the risk away from lenders to the federal government. At the same time, they typically carried higher servicing fees and higher interest rates than those for conventional loans. Lenders consequently had a financial interest both in originating and foreclosing on a large number of FHA loans. For lower-income individuals and communities, aggressive foreclosure practices could and did prove disastrous (see Gordon & Swanson 1977).

A basic problem was that lending in lower-income communities and to lower-income individuals was (and continues to be) riskier than lending in more moderate and affluent markets. On average, mortgage default rates in low-income census tracts are 15 percent higher than in moderate-income ones and 31 percent higher than in middle-income ones (Capone 2001). The ratio of default losses shows similar patterns. Low FICO (Fair Isaacs & Co. credit assessment) scores are associated with higher default rates (Capone 2001). Low-income borrowers have higher risk of defaults than moderate or middle-income borrowers, and the layering of risk (through underwriting) also contributes to higher default rates (Van Order & Zorn 2001). Fannie Mae and Freddie Mac, the two principal purchasers of mortgages on the secondary market, have traditionally been reluctant to buy many conventional loans made in lower-income markets because of the loans' higher risk of default. As a result, banks have often had to keep more of the loans in their own portfolios and thus sought to limit their involvement in these markets.

The end result has been that minority and lower-income markets have tended to have less access to the wide range of financing products available in other markets. The problems caused by the inadequate availability of credit have helped mobilize local activists throughout the country and have resulted in the enactment of various federal laws designed to eliminate discriminatory lending (see the introduction). The activism has also had a number of other important effects. It has spawned local efforts to create alternative financing vehicles for lower-

income communities. Community development banks such as the Community Bank of Lawndale and South Shore Bank (both based in Chicago) were created in part to provide mortgage financing in their economically struggling neighborhoods. Groups such as the Santa Cruz Community Credit Union created special home mortgage programs for their members, augmenting their financing with extensive counseling on the nuances of buying and maintaining a home. A year after enacting the Community Reinvestment Act, Congress passed a series of amendments to the Housing and Community Development Act of 1974. Title 6 of the amendments created the Neighborhood Reinvestment Corporation (NRC), a quasi-governmental nonprofit charged with revitalizing urban communities by mobilizing a variety of local public, private, and philanthropic resources. Much of NRC's subsequent efforts have focused on building the capacity of local affiliates to provide mortgage financing to low-income prospective homebuyers. Most of the members of NRC's NeighborWorks network are now certified CDFIs, and they have collectively provided mortgage financing to over 60,000 low-income families in the past 10 years.²³ The various NeighborWorks lenders have also benefited from their ability to sell many of their mortgages to the Neighborhood Housing Services of America (NHSA), an entity created specifically to serve as a secondary market for those loans.

The growing emergence and activity of CDFI lenders has coincided with substantially increased lending on the part of conventional financial institutions in lower-income markets. Between 1993 and 1997 mortgage lending increased by 40 percent in minority neighborhoods and 31 percent in low-income neighborhoods in cities throughout the country (Wyly et al 2001). Much of the additional volume came from banks and thrifts subject to CRA regulations, but a substantial portion also came from independent mortgage companies and lenders specializing in FHA and/or subprime loans. The increased lending resulted in large part from stronger enforcement of the CRA but also stemmed from lenders' recognition of the economic

²³ See www.nw.org

opportunities present in these markets. Lenders' perceptions of the communities' risk levels had left the areas largely untapped. The increased saturation of higher-income markets, though, coupled with CRA pressures, caused many lenders to re-consider the areas. As they grew to understand the markets and specialized in the nuances of lending there, they found that these communities too could be profitable. Furthermore, the strength of the national economy contributed to improved economic conditions in many neighborhoods that had previously been distressed, increasing residents' income levels and making both the residents and the communities lower credit risks. The reduced risk perceptions contributed to greater willingness on the part of Fannie Mae and Freddie Mac to liberalize their criteria for purchasing mortgage loans originated in these markets, which made it easier for lenders to make and sell more of these loans (see Belsky, Lambert, & von Hoffman 2001).

Conventional lenders have increasingly adapted their products and underwriting criteria to address the needs of lower-income borrowers. For example, many lenders are allowing higher loan-to-value and other debt ratios. An increasing number of products enable borrowers to make down payments of as little as 3 percent of the home's purchase price. In certain areas (Boston, for example), banks have even offered subordinated second mortgages in conjunction with conventional firsts so as to reduce further the amount of up-front equity a borrower must provide (Campen & Callahan 2001). The growing market share of subprime lenders--entities that specialize in making mortgage loans to higher risk borrowers--has been a major factor behind the increased competition and product innovation in these lower-income areas.

The growing involvement of more conventional lenders in lower-income and minority markets has changed the CDFIs' role in these areas. In the era of redlining and more widespread lending discrimination, CDFI banks and credit unions were often the only sources of affordable mortgages for minority and low-income homebuyers. As recently as the early 1990s CDFIs remained the principal mortgage providers for many of these purchasers. Now, however, CDFIs have become much more supplementary lenders. Most of the home purchase lending

on the part of CDCUs and NeighborWorks members involves second (or even third) mortgages, loans subordinate to first mortgages held by more conventional financial institutions. For example, the principal loan product of the various NeighborWorks groups is a “soft” second mortgage covering up to 30 percent of the value of the home and carrying a significantly below-market interest rate. The loan serves to reduce the borrower’s overall interest rate, the amount of the down payment required of the borrower, and the credit risk borne by the conventional lender. In the past five years these CDFIs have added loan products to finance down payment and closing costs. Almost all of the NeighborWorks groups and an increasing number of CDCUs and community development banks offer loans for home repairs; for many lower-income and elderly homeowners, these loans are the only available means for maintaining the livability of their homes. (By facilitating necessary repair and maintenance, the loans also help preclude the physical decline of the neighborhood.)

CDFIs have also focused more on the provision of extensive homebuyer education services. Prospective borrowers often must attend some sort of training on the intricacies of home purchase and repair before being able to obtain a loan. Such education may involve a series of group sessions over multiple weeks (the typical NeighborWorks model) and/or one-one-one meetings with a CDFI staff member. In many cases the process involves staff members helping prospective borrowers address prior credit issues and meet the CDFI’s (and/or a conventional lender’s) underwriting standards. At that point the CDFI usually works with a conventional lender to package a mortgage, with the lender issuing a first mortgage for approximately 70 percent of the home’s value and the CDFI providing subordinate financing to cover most of the remaining property cost. If the borrower cannot meet the conventional lender’s underwriting requirements, the CDFI may provide both the first and second mortgage.²⁴

²⁴ Such a scenario remains relatively rare, since NHSA is generally unwilling to purchase the first mortgages until they have been seasoned for a number of years. The groups have to keep the loans in their portfolios, and the resulting illiquidity limits the amount of money they can use for other loans.

CDFIs have increasingly geared their lending and counseling services toward combating the problem of predatory lending in lower-income markets. The heightened involvement of sub-prime lenders has had a number of benefits for these markets (the chief one being the availability of greater amounts of relatively affordable loan capital), but has also carried some liabilities.²⁵ Certain sub-prime lenders such as Associates First Capital have pursued lending strategies that effectively strip homeowners of their equity. Among the more common “predatory” practices have been excessively high up-front loan fees, required financing of single-premium credit insurance, stiff penalties for prepaying loans, and fee-loaded mortgage refinancing. In many cases the borrower remains perpetually in debt, with monthly payments going entirely for fees and interest. CDFIs such as Self-Help have been especially active in documenting and publicizing predatory lending practices, counseling individuals on ways of avoiding such loans, and marketing their own products as much more consumer- and community-friendly alternatives.²⁶

With the expansion of loan products and services in lower-income markets, households earning 80 percent or more of area median income can now obtain mortgage financing relatively easily. The actual income “floor” undoubtedly varies across regions; low-income individuals have a much easier time buying homes in weaker-market cities such as Cleveland, Philadelphia, and Baltimore than in stronger-market ones such as Boston, New York, and San Francisco. A number of CDFIs and even some conventional lenders have claimed to have

²⁵ The industry is still working to develop a widely accepted definition of predatory lending as well as an accurate idea of its prevalence in minority and low-income markets. “Predatory” loans are a subset of sub-prime loans, many of which are universally viewed as reasonable. The overall proportion of sub-prime loans is low (2-3 percent of all mortgages) and there is no real evidence to suggest that sub-prime lending is disproportionately targeting lower-income households or households with little wealth for housing down payments. (See Pennington-Cross, Yezer, & Nichols 2001). Minorities tend to be more likely to use subprime loans, though, and there is some concern that lenders are pushing a certain proportion of individuals who could qualify for conventional loans toward the more expensive subprime product.

²⁶ See www.responsiblelending.org, the website for the Self-Help-sponsored Coalition for Responsible Lending. Self-Help itself has litigated on behalf of affected borrowers and has worked to refinance their mortgages so that they can build and maintain the equity in their homes.

provided mortgages to individuals making as little as 50 percent of their area's median income. Boston's soft second mortgage program (operated by a consortium of area lenders) has succeeded in targeting half of its loans to individuals with incomes at or below that amount (Campen & Callahan 2001). Approximately 49 percent of the mortgages that the Self-Help Venture Fund has purchased from conventional lenders have been made to individuals earning 60 percent or less of the median income in the area in which they live (Quercia et al 2001).²⁷

The impacts of this expanded mortgage lending are not yet fully known. Clearly thousands more minorities and lower-income individuals have been able to purchase their homes; the national homeownership rate increased by roughly 4 percentage points during the 1990s. What we do not know is how many of these individuals have remained in their homes and to what extent they have been able to build wealth as a result. Housing prices have skyrocketed in certain markets but have remained stagnant (or even declined) in others. Many of the lower-income buyers have purchased older properties that have high maintenance costs and are located in lower-income communities with high proportions of minority residents. Such communities have historically tended to have slower rates of appreciation and more volatile housing price swings than more moderate-income neighborhoods with higher percentages of whites (Quercia et al 2000). To what extent have CDFI borrowers realized equity gains in these areas?

The national economic downturn of the past few years has contributed to 30-year highs in the number of mortgage defaults. What has been the default rate among the traditionally "higher-risk" borrowers who have taken advantage of the more flexible loan products offered by CDFIs and conventional lenders? Researchers have found that higher loan-to-value ratios

²⁷ Self-Help's Community Advantage program purchases single-family mortgages that were originated by conventional lenders to lower-income individuals and did not conform to Fannie Mae's underwriting criteria. Self-Help securitizes the loans with Fannie Mae and guarantees a substantial portion of their value; the originating lenders must use the proceeds from the sale of the loans to Self-Help to make similar loans going forward. The program has helped conventional lenders reach traditionally under-

make refinancing more difficult, and higher debt ratios increase the likelihood of the borrower experiencing financial constraints during economic downturns. At the same time, it is more costly for a lender to foreclose on FHA and similar high loan-to-value mortgages than on more conventional ones (Goetzmann & Spiegel 2001; McCarthy, Van Zandt, & Rohe 2001). Default appears to be less a result of more liberalized underwriting criteria than of life crises affecting particular individuals. In a study of Farmers Home Administration Section 202 loans in the 1980s, Roberto Quercia and his colleagues at the University of North Carolina found that loan-to-value ratios had no significant effect on the likelihood of default, but changes in borrowers' marital status, children leaving the household, and declining interest rate subsidies had substantial effects (Quercia, McCarthy, & Stegman 1995). The risks of lending to lower-income populations and communities may also be lower than commonly perceived. Less than 10 percent of borrowers in the Self-Help Community Advantage program who had FICO scores under 620, and less than 5 percent of borrowers with scores between 620 and 660, were ever delinquent for more than 60 days (Quercia et al 2001).²⁸

CDFIs contend that their extensive counseling of such "higher-risk" borrowers helps reduce the credit risks of financing such individuals. Unfortunately there is very little evidence to support or refute that claim. Abdighani Hird and Peter Zorn's 2001 study of mortgages originated under Freddie Mac's Affordable Gold program (which targets buyers with incomes below 100 percent of area medians) found that counseling tended to reduce delinquency rates by over 13 percent. Borrowers who received classroom counseling from nonprofit organizations (many of which were presumably CDFIs) defaulted 31 percent less frequently than individuals

served populations: 42 percent of the borrowers were minorities and 46 percent had credit scores of 660 or less.

²⁸ Although lower-income borrowers tend to have somewhat higher default rates than higher-income individuals, there ultimately may not be financial effect on the holders of the loans. Low-income borrowers are less likely to prepay their loans even when doing so is financially beneficial; as a result, investors in securities backed by such mortgages tend to experience similar (or even slightly better) overall performance than investors in more traditional mortgage backed securities (Van Order & Zorn, 2001).

with similar characteristics who did not receive counseling services. Unfortunately, the study could not control for differences in risk characteristics among the counseled and non-counseled recipients, as Freddie Mac deemed the data proprietary (Hird & Zorn 2001).

Separate from questions of impact and risk is one of economics: at what income level is it unrealistic for individuals to purchase homes? Two recent econometric analyses suggest that there is an approaching limit to low-income mortgage finance. Stuart Rosenthal (2001) found that removing all borrowing constraints would result in 7.56 percent more renters becoming homeowners, a process that would raise the national homeownership rate by 4 percent. Using a different approach, David Listokin and his colleagues (2001) found that the variety of more flexible mortgage products still allow only 20 percent of renters to purchase a low-priced home; the barrier lies not so much in the credit, but in the renters' dearth of income and assets (for down payment costs).

Multi-Family Financing

As noted in the introduction, the emergence of CDFIs as multi-family housing lenders resulted in large part from the increased role played by CDCs in the 1980s. Groups such as LISC, the Enterprise Foundation, and the Institute for Community Economics formed to bridge the capital gap between the mainstream corporate community and the nonprofit developers. Using corporate and philanthropic donations, as well as some public dollars, they provided CDCs with project-specific loans and grants. At the same time, they worked closely with the CDCs to build their development capacity: ensuring that they had sound financial and accounting practices, helping them identify and manage developers for their projects, helping them address asset management issues, and generally helping them become more "business-like" in their orientation to real estate development. One of the CDFIs' major goals was to enable the CDCs to obtain financing from more conventional private-sector sources, a necessary condition for their longer-term viability as developers.

The CDFIs pursued multiple strategies to attract conventional financing into the CDCs' affordable housing deals. First, they had to show bankers that the CDCs were viable borrowers; here their organization-building activities proved critical. Second, they had to demonstrate that the projects themselves were financially viable. Most bankers (as well as their regulators) were extremely hesitant to commit monies to housing projects serving poor people in low-income communities; the risk of project failure was simply too great. To entice these lenders, the CDFIs had to reduce the perceived risk of the deals. They did so in many cases by providing the initial, most risky project financing. LISC was a pioneer in the creation of "pre-development" loans and recoverable grants: low- or no-interest loans to cover the various land acquisition, architectural, environmental, legal, and other up-front costs associated with preparing a site for development. Once the project was approved and the site prepared, the CDFI would provide the CDC developer with a construction loan so that it could actually build or rehabilitate the planned housing units. As bankers felt more comfortable about the project's likelihood of completion, they would provide the CDC with a conventional mortgage (or mortgages) collateralized by the property; the CDFI's loan would become subordinate to those of the banks.

Obtaining conventional financing for CDC housing projects solved only part of the problem, however. Then as now, such developments required a significant amount of subsidy for lower-income individuals to be able to afford the units. Without a means of reducing project costs significantly, the housing would be affordable to only a very small percentage of the individuals in need. In addition to helping the nonprofit developers identify and obtain various public and philanthropic grant monies, CDFIs such as LISC and Enterprise successfully pushed for the creation of the Low Income Housing Tax Credit as part of the 1986 federal Tax Reform bill. Taxable investors could obtain a federal tax credit for investing monies in low-income housing developments. The resulting equity substantially reduced the costs of financing such projects and contributed to the creation of thousands of additional units for lower-income families (DiPasquale & Cummings 1992; Cummings & DiPasquale 1999; McClure 2000).

The growing sophistication of CDCs and their success in developing and managing housing, increased understanding of and comfort with affordable multi-family financing, the presence of risk-reducing equity and subordinate debt in the deals, as well as the economic and CRA pressures outlined earlier, have resulted in conventional lenders becoming much more involved in financing such projects. Often the largest amount of financing in a multi-family project located in a low-income community now comes from a bank community development corporation, a wholly-owned subsidiary of a conventional bank that focuses exclusively on CRA-eligible financing activities. The emergence of bank CDCs began in earnest in the early 1990s as regulated lenders sought to comply with CRA requirements and compete for the growing amount of business in what had been largely untapped lower-income markets. While enabling their bank parents/affiliates to meet their CRA mandates, the bank CDCs were not subject to the same safety and soundness concerns as the bank itself; they have consequently provided a useful vehicle for making and holding higher-risk loans than the bank's regulators might approve.²⁹

To a certain extent CDFIs such as LISC, Enterprise, the Low Income Investment Fund (LIIF, formerly the Low Income Housing Fund), and Boston Community Loan Fund have been victims of their own success. The increased involvement of conventional lenders in affordable housing projects and housing developments has meant that the CDFIs are typically financing smaller portions of projects. CDFIs are arguably taking more risk now in their housing lending than they were previously: the majority of their dollars are currently loaned out in the form of subordinated debt instruments, often to finance pre- and very early stage development. Often the loans are structured with interest rates at or slightly below market, with balloon repayments timed to coincide with the influx of conventional financing or tax credit equity. Such structures

²⁹ The CDFI Fund generally does not consider bank CDCs to be CDFIs because they cannot meet the Fund's "primary mission" test. In applying the test, the Fund considers the overarching mission of the entity applying for CDFI status as well as all of its controlling entities, affiliates, and subsidiaries. Since

help reduce the overall cost to the CDC (and thus ultimately to the tenant/buyer) but effectively increase the CDFIs' credit risk exposure.

In addition to taking higher-risk positions in housing finance, a number of these CDFIs have worked to develop niches in other areas of community need. Many of the traditional affordable housing lenders now focus as well on the financing of community facilities such as childcare centers, health clinics, and charter schools. Organizations such as LIIF, LISC, and The Reinvestment Fund (formerly the Delaware Valley Community Reinvestment Fund) currently make nearly as many loans for community facilities as they do for housing. CDFIs such as the Nonprofit Finance Fund and the Illinois Facilities Fund focus almost exclusively on such lending. Yet this broadening of activities should not be construed as a reduced commitment on the part of CDFIs to housing, nor as a concerted effort to reduce their activities in that area. These groups would happily do more affordable housing finance if the projects were there. The lack of subsidy (and in some markets the lack of available land) has limited the number of viable projects.

BUSINESS DEBT AND EQUITY PROVISION

Access to both debt and equity capital is critical for entrepreneurs trying to start new businesses and for businesses owners looking to expand. Without the ability to borrow funds, companies must use their own earned income to finance their growth and investments, limiting how quickly they can expand their business and, if the capital shortage is severe enough, possibly causing it to close entirely. Access to equity capital is particularly crucial for young companies, which lack the cash flows necessary for debt repayment. Equity is patient capital, which does not need to be repaid for several years.

most bank CDCs are subsidiaries of conventional banks, whose primary mission is not fostering community development, the CDCs cannot be certified as CDFIs.

Historically, however, access to both debt and equity capital has been very limited for ethnic minority, female, or low-income entrepreneurs, as well as for businesses located in distressed communities. The lack of capital is due to a number of factors, which differ somewhat in the cases of debt and equity. The lack of debt capital for ethnic minority and female entrepreneurs often has reflected discrimination by lenders, and tougher enforcement of fair lending laws has helped to address that aspect of the problem.

As with housing, however, the lack of debt capital for women and ethnic minority entrepreneurs, and for businesses located in distressed communities, also reflects the real and perceived higher transaction costs and risks involved in doing these types of deals. Ethnic minority and women-owned businesses are generally smaller and less well capitalized than those owned by white males (a residual effect of discrimination). As a result, they have less ability to weather business downturns and are at greater risk of defaulting on a loan than larger, better-capitalized entities. Additionally, smaller businesses generally need smaller loans, which are more expensive to administer. They also may require extensive technical assistance in order to become viable borrowers. Most conventional lenders are unwilling to provide technical assistance because it too is administratively expense, and may open them up to issues of lender liability should the businesses fail.

Higher transaction costs and risk also help account for the lack of equity capital in low-income communities. Unlike debt, however, access to equity capital is problematic even in more affluent markets. Investments made by the venture capital industry, the formal source of equity capital for business, are driven overwhelmingly by their financial objective of maximizing returns for their investors. In combination with the inadequate overall supply of equity capital, this leads the industry to focus only on those markets that it perceives as the most lucrative. As a result, venture capital is very concentrated by geography, industrial segment, and size.³⁰

³⁰ In 2001, the last complete year for which data is available, just five states accounted for more than 67 percent of the total dollars invested in the U.S. (NVCA, 2002), leaving the majority of the country severely

Consequently, companies that are located outside of a few major markets, in non-technology related industries, as well as those seeking investments of \$1 million or less, have a very difficult time attracting equity capital.

Although community development banks and credit unions include business loans among their many services, the bulk of the CDFI industry's response to the need for business debt and equity capital has been through three other types of organizations: business development loan funds (CDLFs), micro-loan funds (MLFs), and community development venture capital funds (CDVCs). As with all CDFIs, these three provide technical assistance as well as capital to their clients.

Business Development and Micro Loan Funds

As previously discussed, the business development loan fund (BDLF) model emerged from a variety of origins, including efforts in the late 1960s and 1970s, by a few Community Development Corporations and a group of revolving loan funds, to make loans to businesses in order to promote economic development (Grossman, et. al, 1998). The most recently-created types of BDLFs are multi-bank community development corporations, set up by large banks seeking to meet their CRA obligations.

BDLFs lend capital to businesses and nonprofit organizations, many of which have not been able to qualify for funding from more traditional sources,³¹ with the objective of furthering various social goals (Stevens & Tholin 1991). These goals include promoting economic growth and job creation in low-income areas, stabilizing population declines in distressed communities, improving the availability and quality of community facilities in under-served markets, increasing

undercapitalized. Furthermore, more than ninety percent of all private venture capital investments made during 2001 were in technology-related businesses (PricewaterhouseCoopers, 2003), and the average venture capital investment was more than \$8 million (PricewaterhouseCoopers, 2003). This level of geographic concentration has not occurred with debt because it is more plentiful. Furthermore, banks, the primary providers of business loans, are retail institutions that need to maintain a physical presence in the many communities with which they do business.

the number of businesses owned by women and ethnic minorities, and promoting the growth of businesses that do not harm the environment (Caskey & Holister, 2001).

BDLFs raise their capital from federal and state governments, foundations, banks and financial institutions, socially-conscious individuals, and religious institutions (NCCA 2002). The capital originates in the form of grants and below-market rate loans, which BDLFs re-lend at market rates, using the difference to finance their operations. While most BDLFs provide only business financing, some also finance housing and facility construction and renovation. They offer a number of financial products and services, including term loans, lines of credit, loan guarantees, and debt with equity-like features. This financing is designed to support a broad range of business needs, such as facility purchase and expansion, working capital needs, and equipment purchases. In contrast to community development venture capital providers, most of the businesses that BDLFs finance are existing operations, which have the working capital to repay a loan.³²

BDLFs lend both independently and in conjunction with conventional lenders. This is particularly true for multi-bank CDCs, which often are viewed by the banks that created them as good sources of deal referrals.³³ When lending in partnerships with more conventional institutions, BDLFs generally take a subordinate position, absorbing most or all of the risk.

Because BDLF loans tend to be riskier than those that a bank would be willing to undertake, and at times are unsecured, BDLFs also provide extensive technical assistance to

³¹ A number of BDLFs require that potential borrowers first apply to a conventional lender, and will only accept applicants who have been rejected one or twice by banks and traditional financial institutions.

³² For example, financing to start-up businesses (less than one year old) accounted for less than 30 percent of all the business loans made by NCCA member BDLFs in 2000 (NCCA 2002).

³³ Multi-bank CDCs are different from bank CDC. Multi-bank CDCs are free-standing community development organizations, created and funded by a consortium of commercial banks. Their objective is to finance community development lending and equity provision. Multi-bank CDCs often can be certified as CDFIs because they are not controlled by any one single institution and thus do not have any formal affiliates (per the Bank Holding Company Act). Generally these organizations include board members from each of the participating financial institutions, but no single member (or his/her institution) exerts formal control over the CDC's operations or lending decisions. As noted in an earlier footnote, bank CDCs are usually formal subsidiaries of a particular bank and thus must view that bank as an affiliate.

their portfolio companies. The technical assistance is provided both pre- and post-investment, to help potential borrowers qualify for capital and then assist them with various aspects of operations, once they have obtained funding. The type of assistance provided includes help with writing business plans, putting together marketing strategies, and developing financial systems.

Thus far, research on BDLFs has been very limited, consisting primarily of descriptive statistics collected annually by the National Community Capital Association (NCCA), a trade group whose membership includes a number of BDLFs. NCCA members constitute only a portion of the entire BDLF population, however, and are not necessarily representative of the broader group.³⁴ There has not been any research that has studied the entire BDLF industry, primarily because of the large number of business development loan funds in existence and the high level of diversity among them. The diversity makes it difficult to generalize about findings from a subset of organizations, limiting the usefulness of research that examines only a few BDLFs.

As a result of these research challenges, there are many questions about BDLFs that remain unanswered. We do not know, for example, what the differences are between BDLFs and bank borrowers in terms of their size, credit rating, and default and delinquency rates. Caskey and Hollister, who have conducted some of the more methodologically rigorous studies in the BDLF sector, argue that it very difficult to determine accurately the social impact of BDLFs and “nearly impossible to reach definitive conclusions” about their employment impact (2001: 28).

Since the affiliated bank does not usually meet the CDFI Fund's primary mission test, the bank CDC cannot be certified as a CDFI.

³⁴ For example, one of NCCA's membership criteria is a “commitment to performance” that is demonstrated “by acting as a disciplined lender and/or investor in community development and a responsible steward of other people's resources” (NCCA 2003). This criterion can favor the larger and more established organizations, as well as those with more conservative lending policies.

As with business development loan funds, evaluating the impact of micro-enterprise funds also is challenging, although for a somewhat different set of reasons.³⁵ Micro-loan funds (MLFs) provide training and small loans of under \$25,000, primarily to low-income individuals, with the goal of promoting self-sufficiency (FIELD 2000).³⁶ In that sense, MLFs are simply smaller BDLFs. Unlike BDLFs, however, micro-enterprise programs deal primarily with sole-proprietors, focusing more on enabling individuals to earn some extra income than on fostering broader economic growth. MLFs are a subset of micro-enterprise programs, which work to help predominantly lower-income individuals develop their own businesses. As of 2000, there were approximately 700 micro-enterprise development programs in the United States, and these groups collectively had served more than fifty-five thousand clients (FIELD 2000). Less than one-fourth of these programs do enough lending to qualify as CDFIs.

The US micro-enterprise sector was modeled after the work of several prominent organizations in developing countries, particularly the Grameen Bank of Bangladesh. These organizations had assisted poor and primarily female clients by making small, short-term loans, via peer or solidarity group lending. In this method, a group of borrowers co-guarantee the loans made to each member, "replacing collateral with peer pressure." (FIELD 2003). In addition to serving as a safety net for the lender, the peer group also provided its members with support, networking and training (FIELD 2003).

³⁵ The terms used to describe very small loans to entrepreneurs have varied as the purpose of the lending has changed. Micro loan funds, micro enterprise programs, micro finance programs, and micro credit programs are all terms that have been used at various stages. For example, when micro was first developed overseas, it was called micro-credit. When the micro-credit model expanded from lending to include savings mechanisms, the term micro finance was used.

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³⁶ Micro-loan funds typically make loans under 25,000. Some funds will not make a loan greater than \$10,000 and many make smaller loans. In addition, community development credit unions make small consumer loans, e.g., \$500, on a regular basis.

The US micro-enterprise providers initially attempted to utilize this method, but quickly discovered that the peer group approach was much more difficult to implement than they would have predicted based on experience in developing countries.³⁷ The US programs responded by adjusting their offerings. Today, only 16 percent of micro-enterprise providers use a group lending methodology, while 65 percent make loans to individuals and 10 percent utilize both methods (FIELD 2003).

US micro-enterprise providers also discovered that micro-entrepreneurs were not seeking loans in large numbers. With a few exceptions, the loan volume of micro-enterprise providers was very small, regardless of the lending method they utilized. As of 1999, only 11 percent of all the clients served by U.S. micro-enterprise programs were borrowers (Directory of U.S. Microenterprise Programs, 1999). Instead, the vast majority of clients sought business and financial training.

As a result of these discoveries, the US micro-enterprise field evolved into very different programs, with distinct objectives and ways of defining success. Some organizations focus primarily on training, with the goal of promoting self-sufficiency among their participants. Others focus more on lending and achieving economic and community development objectives. Even within the latter group, some emphasize poverty alleviation and work to assist very low-income individuals to start their own businesses. Others emphasize overall economic growth and prefer to work with micro-entrepreneurs who have been in businesses for several years or more (Else 2000). Additionally, micro-enterprise programs may target specific groups based on their ethnicity, gender, or geographic location.

³⁷ Among other factors, this reflected the low concentration of microentrepreneurs in any specific region, which forced programs to organize groups of individuals who often did not know each other. These individuals were reluctant to undertake financial responsibility for each other and found group participation too time consuming (FIELD 2003). Some of the additional factors that contribute to making peer lending less effective in the US than in the third world are: more impersonal US markets; greater diversity and less interaction among the low-income population in the US, which impedes social capital and trust among group participants; overarching emphasis in the US on individualism; and presence of other, more viable, alternatives to self-employment for U.S. low-income population (see Schreiner 1998. Also, Bhatt et al, 2000).

More so than other development finance strategies, micro-enterprise has garnered political support from both sides of the aisle. Its ideological premise--that individuals can build their own businesses and take control of their lives--offers a modern-day version of the Horatio Alger ideal that appeals both to liberals and to conservatives. In light of its ideological appeal, micro-enterprise has been touted as a solution to a number of problems. Some proponents have viewed it as a way of promoting community and human development (Servon 1996 and 1998; Edgcomb et al 1996; Jones 1999), while others have praised it as a means of alleviating poverty and/or furthering economic development (see Edgcomb et al 1996; Burrus & Stearns 1997; Himes & Servon 1998; Clark et al 1999; Servon & Doshna 2000).

With such broad political support, it is not surprising that micro-enterprise has been the subject of numerous studies. In fact, micro-enterprise programs likely have been assessed far more than any other type of community development finance. Most of the analyses to date, however, have come from the field's proponents.

The bulk of the studies have focused on the characteristics of the different programs and of the micro-entrepreneurs themselves. These studies have shown that most program participants are female and ethnically minority.³⁸ They also are somewhat better educated than the typical American, have often had some previous business experience, and frequently are not relying on their business as their sole source of income (Clark et al 1999).

The existing studies have indicated that, particularly for low-income individuals, the micro-business is usually an "income-patching strategy": a part-time endeavor geared toward generating enough money so that the individual and his or her family can make ends meet. In addition to helping participants generate some income, micro-enterprise programs often provide non-economic benefits as well. A number of studies emphasize the increased confidence, self-

³⁸ A 1998 sample of 405 microenterprise clients tracked by the SELP (Self Employment Learning Project) Longitudinal Survey of Microenterprises showed that 78% of them were female; 42% of them were African-American; 18% were Hispanic and 2% were Asian. Additionally, 83% of the entrepreneurs had completed high school and 58% had some post high school education (insert source).

esteem, financial literacy, and social networks that participants may take away from micro-enterprise programs (Servon 1996, Servon 1998; Edgcomb et al 1996; Jones 1999, Clark et al 1999).

Relatively few studies have taken a critical look at the economic impacts of the micro-enterprise model. Those that have done so often have reported their findings selectively, in ways that appear to over-state the programs' impact. For example, an Aspen Institute study of 405 micro-enterprise program participants (Clark et al 1999) emphasized that over five years, a majority of poor entrepreneurs showed increases in household assets, household earnings, and personal earnings. A third of poor entrepreneurs showed increases in earnings from their businesses. A close look at the data, though, reveals that most of the increase in household assets resulted from increases in home values. Earnings from the micro-business represented only 16 percent of the increase in personal earnings. In fact, the typical entrepreneur in the programs actually experienced decreases in his or her household income, personal earnings, and small business earnings. Similarly, a study of ACCION borrowers from 1991 to 1997 (Himes & Servon 1998) found that individuals who received multiple loans were increasingly likely to have increases in their monthly business profits, business equity, take-home pay, and household income. The less emphasized results were that the business continued to generate only 50 to 55 percent of the entrepreneurs' total household income.

The majority of micro-businesses are small, sole proprietorships in the low-paid retail and service sectors.³⁹ The businesses typically generate few jobs and offer few (if any benefits) to their employees. It is unrealistic, therefore, to view micro-enterprise as a significant economic development or anti-poverty tool. Lisa Servon, perhaps the leading academic expert on the field, has argued that the micro-enterprise strategy lies somewhere between the economic

³⁹ Forty seven percent have gross monthly sales of under \$1,000 and the owner generally is the sole operator and worker (Field 2003). One study found that only 29 percent of them have employees, and two thirds of the employees were working part-time (Servon EDA study).

development and social service worlds, and therefore needs a new framework for evaluating its effectiveness (Servon 1999a). Unfortunately, no one as yet has developed such a framework.

An additional problem for microenterprise providers is the very high administrative costs involved in this type of lending. As a result, microenterprise funds are dependent on ongoing operating support to a much greater degree than any other type of CDFI. Studies of microenterprise funds have found that their earned income covered less than twenty percent of their operating expenses (Edgcomb et al 1994); and most programs were less than 10 percent self-sufficient (Servon 1999a).

Community Development Venture Capital Funds

Community development venture capital (CDVC) funds provide equity and near-equity capital to small businesses. An equity investment consists of a cash infusion into a company in exchange for partial ownership of that company, in the form of preferred or common stock. A near-equity investment consists of a loan that is convertible to equity, or a loan that nets the lender some features, such as warrants, royalties, or participation payments, that enable her to participate in the upside if the investment is successful. Both equity and near-equity investments are forms of patient capital, giving young firms the funds they need in their early years, without requiring the immediate repayment of those funds, as is the case with a traditional loan.

The earliest CDVCs were Title VII community development corporations, which in the early 1970s began making equity investments in businesses as part of their economic development work. Other CDVC funds were begun by individual states, intending to stimulate business growth in low-income areas, and by community development loan funds, which expanded into equity provision in order to meet the needs of their debt clients (Rubin 2001).

Although the industry dates back almost thirty years, most of the growth in the number of CDVC providers has taken place since 1994. This reflects the high visibility that the field of

community development finance received under the Clinton administration, and the easier availability of capital for community development finance, as a result of the creation of the CDFI Fund and the increased enforcement of the CRA. At the end of 2000, the last year for which data is available, there were 50 CDVC providers with \$300 million dollars under management (Rubin 2001).

Unlike traditional sources of equity, such as venture capital funds and small business investment companies, which look for the promise of significant growth rates before investing in a firm, CDVCs will invest in companies that are growing at only a moderate pace, but that have the potential for significant job creation. CDVCs also differ from conventional sources of equity in their willingness to invest in companies located in rural and low-income areas (Rubin 2001).

CDVCs are capitalized primarily by banks, foundations, and federal and state governments, which invest low-interest debt or equity in CDVC funds for periods of ten or more years. Banks and financial institutions are playing an increasingly important role in financing the CDVC industry. They accounted for 56 percent of the capital for the newer equity-focused funds—those that raised their capital and began investing between 1998 and 2000 (Rubin 2001). This reflects the important role that the Community Reinvestment Act has played in capitalizing CDFIs.

While traditional venture capital funds generally focus their investment activities on companies at particular stages of development and in specific industries, most CDVC funds (90 percent) invest in companies at all stages of development and in all industries. This strategy enables CDVC funds to consider the largest possible number of high-quality investments within their geographic regions.

Although few CDVC providers have a specific sectoral investment strategy, the majority of them do target companies that will create manufacturing jobs. They do so because the quality of manufacturing jobs is high, in terms of both wages and benefits. Manufacturing jobs

can also employ individuals with lower education and skill levels, making such jobs an important path to greater economic opportunity (Mayer 1998; Phillips-Fein 1998).

CDVC investments range in size from \$10,000 to more than \$1 million per company.

The average CDVC investment is \$186,000 per round and \$393,000 per company (Rubin 2001). These figures are significantly smaller than the traditional venture capital industry's average investment per round of more than \$8 million (PricewaterhouseCoopers 2003). CDVCs also differ from traditional venture capital in their legal structures. Unlike traditional venture capital funds, which are for-profit and usually structured as either limited liability companies or limited partnerships, community development venture capital providers utilize a multitude of nonprofit, for-profit and hybrid legal structures (Rubin 2001).

As with other types of CDFIs, CDVC funds provide their portfolio companies with intensive technical assistance. This is a critical part of the CDVC business model. Because the majority of CDVC funds are geographically restricted, they are faced with relatively few potential investment opportunities. This restricted deal flow may require the funds to invest in companies with limited management experience. As a result, the funds must play an active role in advising the companies, either directly through fund staff or indirectly through outside experts who are brought in to increase the companies' level of knowledge and market readiness (Rubin 2001).

Like traditional venture capitalists, CDVC providers must exit their investments in order to make a profit and free up capital for new investments. As of December 31, 2000, CDVC funds had exited 63 of their 237 total investments. Thirty-seven of those exits were profitable. The primary form of exit for both traditional venture capitalists and CDVC providers is through acquisition by an external buyer, which accounted for 63 percent of all traditional venture capital exits in 1999 (Venture Economics 2000) and more than half of all CDVC exits to date. Initial public offerings (IPOs), another favorite form of exit for traditional venture capitalists, are extremely rare for CDVCs. Instead, CDVC providers exited 32 percent of their investments via owner and management buy-backs.

Like all CDFIs, CDVCs strive constantly to balance their social and financial objectives. Thus, in evaluating the CDVC industry's impact, both objectives must be factored into consideration. Unfortunately, any evaluation of the industry's performance is limited by its relative youth. Most CDVC funds are less than 7 years old and have exited only a small portion of their investments, making it very difficult to evaluate their financial performance. A financial evaluation of the few older funds is made very difficult by the ongoing operating subsidies that these funds have received from local governments and their parent entities. These fund also have used a combination of debt and equity investments, making it difficult to disaggregate the two in order to determine the financial performance of the equity portfolio.

As with BDLFs, evaluating the social impact of CDVCs has generally consisted of tracking the jobs created by the companies that CDVCs have financed, and is methodologically challenging for the reasons outlined earlier (see Caskey and Hollister 2001). Keeping in mind the limitations of such data, however, Rubin (2001) conducted a preliminary assessment, tracking the jobs created by companies that were financed by three of the oldest equity-focused funds in existence at the end of December 2000. Rubin's research indicates that these companies, which were located in economically-depressed rural regions, jointly had created more than 4,000 jobs, at an average cost of less than \$10,000 in equity invested in the company, per job created. These jobs were primarily in the manufacturing sector, and provided both benefits and average wages that were higher than the average for the region as a whole.

Although job creation totals are not available for the traditional venture capital industry, they are available for Small Business Investment Companies (SBICs), which should be fairly comparable to traditional venture capital. SBICs are privately-owned and -operated companies that are licensed by the U.S. Small Business Administration, which also provides them with access to matching investment capital. They make equity and debt investments in small businesses, with the intention of maximizing profits for SBIC investors. The average cost of a

job created by a company financed by an SBIC is \$35,000 (Christensen 2000), more than three times higher than the CDVC figure.

CONCLUSION

Although there are a number of issues that are particular to each type of CDFI, there are a few that are relevant for the entire CDFI industry. We conclude with a discussion of what we believe are the three most critical, industry-wide issues.

1. What is the impact of CDFIs?

Like all entities engaged in promoting social change, CDFIs struggle with identifying appropriate indicators to measure the impact of their activities. This is not an easy task. The first complexity lies in defining what is meant by impact. Academics define impact in terms of the “but for” question, meaning that a set of outcomes would not have occurred were it not for the specific actions of a CDFI. As Caskey and Hollister have pointed out (2001), however, such impacts are very difficult to measure because of the challenge of separating out all the other, non-CDFI related, factors that can affect a given business or individual.

To the extent that CDFIs have tried to evaluate the effect that they are having on their target communities, they have focused primarily on counting specific outputs (e.g. jobs created, housing units refurbished, mortgages provided). These outputs appear to be proxies for a range of other, more inaccessible measures (e.g. level of improvement in the social and economic health of a given community).

A second issue involves separating out the direct effect that CDFIs financing and technical assistance provision has on their borrowers or portfolio companies (e.g., business purchases a new piece of equipment with the loan they receive from a CDFI), versus the indirect consequences of such activities (e.g., the new piece of equipment enables the business to expand into a new market; hire additional employees; and pay more taxes). Obviously, the impacts become increasingly diffused as we move further away from the original financial

transaction, and measuring and attributing them accurately becomes more difficult. Given the methodological challenges involved in tracking indirect impacts, it is not surprising that, to date, very limited efforts have been made to do so.

For the most part, CDFIs have assumed a direct causality between the financing that they provide and the creation of these outputs, counting both their own and their borrowers' activities, and ignoring other contributing factors.⁴⁰ However, as financial institutions, CDFIs work to achieve their objectives through somewhat indirect means. They make loans and equity investments, collect deposits, and offer various checking and savings accounts. They augment their efforts with assorted education and counseling activities related to their financial products and services. They themselves are not real estate developers or large employers. They do not build projects, but instead help to finance them.

An additional problem is that, because of the diversity that exists between different types of CDFIs, the field has encountered significant challenges in agreeing on a specific set of output measures, and a methodology for gathering them. For example, the most common output measure for business specific CDFIs is job creation. There is little consistency, however, in how individual CDFIs determine what constitutes a new job, and which jobs they attribute to their

⁴⁰ For example, affordable housing lenders often assert that their financing created X number of housing units. While their funding contributed to the project's development, assuming multiple sources of project financing, it was only one of several important factors that made the project possible. While it can be argued that the project would not have gone forward with the CDFI's financing, the same probably can be said for all or most of the other sources of capital in the deal. The issue of job creation is even more complicated. A CDFI makes a loan to a business to enable it to purchase a new piece of equipment. Over time the business is able to grow and hire additional workers. Part of the reason probably lies in the new equipment, which enhances the business's productivity. Other important contributors, however, were a growing market for the business's goods and services and strategic actions by the company's management and workers. How then, can the CDFI take total credit for "creating" the new jobs? Even more troubling is the concept of job retention, which implies that the business would have ceased operations had it not received the loan or equity investment from the CDFI. The CDFI obviously contributed to the health of the business, but the direct causal connection between its activities and the ultimate impact of job creation becomes increasingly vague over time.

own actions. This lack of consistency exists not only between different types of CDFIs, but also between individual CDFIs that provide similar services.⁴¹

Evaluating the impact of CDFIs also is challenging because of the multiplicity of objectives that the industry works towards, a complexity hinted at by the term a “double-bottom line.” As discussed previously, all CDFIs have a social objective, which is their primary purpose. Portions of the CDFI industry, particularly those organizations that finance business creation and expansion, actually have multiple social goals. Some see their objective as economic development, others as community development or poverty alleviation. This distinction has important ramifications for the set of measures that should be used to evaluate their impact.

Many CDFIs also have financial objectives. These objectives differ, depending on the CDFIs institutional form (e.g. credit union vs. venture fund), legal status (for-profit vs. nonprofit), and level of involvement with conventional financial markets. Some common financial objectives include achieving a specific rate of financial returns in order to satisfy investors, keeping portfolio losses to a minimum in order to reach overall sustainability, or insuring that the financial ratios are in line with regulators’ expectations. The presence of these financial objectives raises several questions in relation to the evaluation of CDFI performance. Should both the social and financial objectives of CDFIs be evaluated? If so, how should they be weighted relative to each other? Does the industry need a new, hybrid measure of performance, which factors in both social and financial objectives?

Beyond these issues of multiple objectives and levels of analysis is the broader question of what kinds of measures and data collection are realistic for the industry? Even the measures of outputs that currently are tracked by the majority of CDFIs are very difficult to obtain and can be intrusive to the individuals and companies that CDFIs serve. Additionally, it is extremely

⁴¹ For example, CDFIs that finance housing construction may count housing units created once they are actually occupied or when the units are projected for development (as set forth in the project pro forma). Part of these definitional issues is being addressed through the Common Data Project, a multi-year

difficult to agree on more than a few very basic, descriptive measures that are applicable across the diverse range of organizations that make up the CDFI industry.

It also is very important to set realistic expectations as to what CDFIs actually can accomplish. They are, after all, relatively small in scale, and some sectors of the industry are more educational than financial in nature. Nor is it clear whether most of the small companies that CDFIs are financing are likely to generate much economic impact (Bates 2000a). While the ideology of community and individual empowerment is politically attractive, there is a danger of overstating the impact of the sector relative to other policy approaches. For example, it is highly likely that the effect that the Earned Income Tax Credit has in reducing poverty in a given community greatly overshadows that of even the largest CDFI.

2. What is the role of CDFIs relative to conventional financial institutions?

The role of CDFIs relative to conventional financial institutions is a topic that provokes a wide range of reactions from the CDFI community, reflecting a diverse set of beliefs regarding the broader question of why CDFIs exist. Some CDFI practitioners view their work as a response to the persistent failure of conventional financial institutions to address the capital needs of low-income communities. Others see themselves as entrepreneurs, whose role is to develop new financial products and demonstrate that investing in low-income communities can be profitable. Still others see CDFIs as a means for communities to express their values and beliefs about local control of capital. Finally, there are those who see CDFIs as intermediaries between conventional financial institutions and low-income communities.

Whichever theory they advocate, most CDFI practitioners believe that conventional financial institutions will never supplant the need for CDFI. First, conventional financial institutions are unlikely to offer extensive technical assistance to their borrowers because it is

partnership among the major CDFI trade associations and some of the industry's key funders, but much work remains to be done.

both administratively expensive and may violate lender liability laws. Banks also have been unwilling to take on the most challenging and risky deals without government guarantees, or CDFI partners who can assume the majority of the risk (Rubin & Stankiewicz 2001). Finally, there are several types of financings provided by CDFIs (such as micro-enterprise and community development venture capital), which banks have been willing to undertake only on a very limited basis, through their own community development corporations.

Given the unlikelihood that banks will completely supplant the need for CDFI, the model of interaction between conventional financial institutions and CDFIs that is becoming increasingly common is that of a partnership, with conventional financial institutions providing capital to businesses both directly and through CDFIs, while CDFIs provide those businesses with technical assistance. It is not clear, however, how equal such partnerships are (Rubin and Stankiewicz, 2001). It also remains to be seen whether conventional financial institutions will continue to invest in low-income communities during economic downturns; will continue to expect CDFIs to guarantee any higher-risk loans; and will provide the funds with which to run CDFIs and administer technical assistance?

There are additional questions that must be answered before we can determine what the interaction between CDFI and more conventional financial institutions should look like. For example, are CDFIs more effective than conventional financial institutions in serving low-income communities, both in providing loans and in ensuring their repayment? If CDFIs are more effective, are their practices replicable by conventional financial institutions? Can conventional financial institutions afford to emulate CDFI activities? If so, to what extent has this happened already?

Another issue that may affect the relationship between CDFIs and conventional financial institutions is the possibility of securitizing CDFI loans and equity investments and selling them on traditional financial markets (See Stanton 2003 and Cherry 2000). Securitization proponents see it as a way of providing CDFIs with greater liquidity, which would enable them to undertake

more financings to their target communities. Securitization also is being advocated by those who believe that CDFIs must look more like conventional financial institutions, including being larger in scale, before they truly can be effective and sustainable (Moy and Okagaki 2001).

There are a number of challenges to securitizing CDFI investments.⁴² One very significant challenge is that securitization requires standardization of practices. However, CDFIs make very diverse loans and equity investments, reflecting their efforts to customize their products to the needs of their individual communities.⁴³

An addition constraint is the limited availability of data about the quality and performance of CDFI loans. Conventional financial markets need such data in order to determine pricing and risk levels for these loans. In the absence of such data, conventional markets perceive most CDFI loans as unprofitable, and are reluctant to become involved in any securitization transactions involving these kinds of loans.⁴⁴

Beyond these constraints, opponents see both securitization, and the concurrent push for CDFIs to act more like conventional financial institutions (e.g., to become more self-sustaining and reach scale), as detrimental to the future of the CDFI field. They believe that the increased emphasis on profitability and standardization will detract CDFIs from continuing to offer unique, developmentally oriented products that are designed to serve the needs of low-income communities.

⁴² To date, only one organization, the Community Reinvestment Fund (CRF), has successfully securitized community development loans. CRF, which has sold such loans on the secondary market since 1989, prices the loans itself, thus getting around the issue of inadequate performance data. CRF sells the majority of the loans on the conventional market. The rest are sold to socially-oriented investors. CRF also subsidizes the loans as necessary from a grant-based capital reserve fund.

⁴³ While CDFI housing loans are more similar, and thus more easily standardizable, they make up only a portion of the financings that CDFIs undertake. Even so, many CDFI financed mortgages are perceived as higher risk than the mortgages financed by conventional financial institutions, which makes them more difficult to sell on the secondary market.

⁴⁴ The CDFI Fund recently contracted with ABT Associates to determine whether a securitization model can be developed for the entire CDFI industry and, if so, what such a model should look like. If the Fund determines that securitization is an appropriate strategy for the field, it will prioritize collection of the data necessary for such transactions to occur.

3. What does the future hold for the CDFIs industry?

The most dramatic growth in the CDFI industry occurred during the mid to late 1990s, a period of consistent economic prosperity, strong stock market returns, and a Presidential administration that was very supportive of CDFIs. The current situation is quite different and raises a number of concerns regarding the future viability of the CDFI field.

The most immediate issue is the availability of capital for starting new CDFIs or expanding existing ones. The general economic slowdown has meant that commercial banks, which had become the primary source of capital for several types of CDFIs, have fewer dollars available for investing, lending and granting to CDFIs. Banks also are merging less, which reduces the enforceability of the Community Reinvestment Act and consequently the pressure for banks to make community development investments. Additionally, the Republican controlled congress has not traditionally been friendly to the CRA and may weaken its enforcement, or pass legislation amending the act in such a way as to neutralize its developmental effects.

The decline in the performance of the stock market has affected foundation endowments dramatically, sharply reducing the levels of grant making. It also has reduced the resources that some individuals and religious institutions have available for providing CDFIs with below-market rate deposits and loans.

Finally, the Bush administration's overt hostility to programs initiated by the previous administration, general preference for business interests versus those of community development practitioners, and deficit growing tax policies, have led to significant cuts in the CDFI Fund's budget. Reflecting the priorities and philosophy of the administration, the current management of the CDFI Fund has reduced the availability of operating grants and placed unprecedented emphasis on pushing CDFIs to be self-sustaining. Since most CDFIs are not able fully to cover their costs of operations out of their earnings, pushing them to do so likely will mean cuts in services, especially the more developmental and expensive ones (e.g., making

higher risk loans, technical assistance provision, and counseling to help potential borrowers better manage credit). The probable outcome is that individual CDFIs either will fail or will survive by becoming more like conventional financial institutions and less able to meet the needs of distressed communities.

In addition to making it more difficult for all CDFIs to raise money, these trends could have a disproportionately negative affect on the smaller CDFIs, which are most dependent on a continual stream of grants or new capital infusions to cover their operating expenses. Even before these changes, there appeared to be a real and growing bifurcation within the field between such small, “bootstrap” CDFIs and the large organizations, which have been the subjects of most of the academic and promotional writing and are perceived to be the industry’s leaders. We do not have the data to determine whether this bifurcation is beneficial for the communities that CDFIs serve. Until we understand what relative impact the two types of institutions are having, it is difficult to know if the appropriate policy is to push the smaller CDFIs to consolidate, or to encourage their creation and continuation via operating subsidies.

One of the other key questions is what impact the New Markets Tax Credit will have on availability of capital for CDFIs? The fact that the tax credit is relatively small may mean that it makes a difference only at the margin, favoring CDFIs that are more like conventional financial institutions and individual deals that are more market-rate. This could further hamper the ability of smaller and more developmentally oriented CDFIs to survive. It also is not clear what impact the NMTC will have on the future role of the CDFI Fund, which currently is responsible for administering the tax credit.

Many of the issues and concerns raised in this paper have been ones that the CDFI field has been grappling with for some time. The current economic and political environments add greater urgency to the search for answers. Ironically, these economic and political trends also have created a greater need for CDFI financing, as conventional financial institutions,

foundations, and governments cut back on their assistance to and investment in low-income communities.

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