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The Function and Relevance of CDFIs

At the annual conference of the Opportunity Financial Network, an address by Federal Reserve Board Chairman Ben S. Bernanke highlighted the role of CDFIs in promoting economic growth and opportunity. The portion of his speech suggesting ways CDFIs can help pave the way to further gains is presented. In general, CDFIs provide coordinated development activities and community-specific information that the market may not supply on its own. CDFIs structure loans and use public and private credit enhancements both to increase borrowers' ability to qualify for loans and to spread the associated credit risk among a mix of private creditors and other providers of funds. Local knowledge and specialized financial expertise that CDFIs provide will continue to add significant economic value and complement market forces in the support of community economic development. CDFIs are likely to contribute to the shared goal of expanding economic opportunity for many years to come.

EDITOR'S NOTE: At the annual conference of the Opportunity Financial Network - an organization of community development financial institutions and funds - last November in Washington, D.C., an address by Federal Reserve Board Chairman Ben S. Bernanke highlighted the role of CDFIs in promoting economic growth and opportunity.

"Ensuring that every American has the chance to improve his or her economic circumstances through hard work, saving, entrepreneurship and other productive activities is essential for building healthy communities and achieving sustainable economic growth," said Bernanke.

While U.S. households overall have experienced notable gains in terms of some key indicators of economic opportunity over the past decade or so, Bernanke noted, some challenges remain which CDFIs can help meet. He cited the following measures of progress:

- As the pricing of credit risk has become more sophisticated and more consistent, as scale economies have reduced costs and as funding sources have increased, lenders have been able to extend credit to households and businesses mat might previously have been considered uncreditworthy.
- The national rate of homeownership increased from 1995 through mid-2006, reaching nearly 69 percent of all households last year. All major racial and ethnic groups have made gains in homeownership, but in percentage terms the largest increases have been made by minority households.
- Between 1997 and 2002, the number of businesses owned by Asians, Blacks, Hispanics and women grew more than 20 percent for each group - more than twice the national rate increase for all businesses.

The portion of the Federal Reserve chairman's speech suggesting ways CDFIs can help pave the way to further gains follows. Li addition to Federal Reserve sources, Bernanke cited statistics and other information from Inside Mortgage Finance Publications (2005 and earlier years), Mortgage Market Statistical Annual; Department of Housing and Urban Development Office of Policy Development and Research; U.S. Small Business Administration, Office of Advocacy; U.S. Census Bureau, Survey of Business Owners; Kenneth J. Arrow (1951), "An Extension of the Basic Theorems of Classical Welfare Economics," in J. Neyman (éd.), Proceedings of the Second

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CDFIs as a solution to market failures

Many factors have contributed to the economic gains that I have cited, including broad macroeconomic forces and advances in the delivery of financial services. CDFIs have also played a valuable role by analyzing the economic potential of lowerincome markets and developing strategies and marshaling resources to tap that potential.

As CDFI leaders, you are keenly aware of the economic challenges you work to overcome each day. Economists find it useful to think about these challenges in the context of die economics of market failure. Standard economic analysis tells us that when competitive conditions prevail in a market, the resulting prices induce firms and individuals to allocate resources in a manner that tends to maximize social welfare.

However, economists also recognize that various deviations from idealized market conditions, termed market failures, can inhibit the efficient allocation of resources. In one type of market failure, called a neighborhood externality, the actions of one person affect the well-being or economic welfare of others in the local area, but the individual taking the action neither bears the full costs of nor reaps the full benefits from those actions. Because the individual does not bear the full consequences of the actions taken, he or she may act in a way that is not in the best economic interest of the neighborhood as a whole.

For example, the failure of some owners to maintain their properties can lower the value of well-maintained properties in the same neighborhood. Ultimately, such spillover effects from neglected properties can lead to under-investment in the whole community, potentially harming all neighborhood residents and businesses.

A related type of market failure studied by economists is known as an information externality. An information externality may arise when information about economic opportunities in an area has the potential to benefit many investors but is costly to gather. As a result, no single potential investor may find obtaining the data to be profitable. For example, on average, lowerincome areas have fewer owner-occupied homes and record fewer home-purchase loans than higher-income areas do. Lower transaction activity makes accurately gauging property values and evaluating credit risks in those areas more difficult, which may inhibit the extension of credit.

Alternatively, lower-income people may have shorter and more-irregular aedit histories, making an evaluation of their individual creditworthiness more difficult and costly. Because a potential investor who bears the costs of obtaining data about underserved neighborhoods may be able to obtain only a portion of the full economic benefits, these data may remain uncollected.

One purpose of CDFIs is to help overcome these and other market failures that inhibit local economic development. For example, by facilitating larger-scale property development projects, coordinating public and private investment efforts and working to improve amenities and services in a local area, CDFIs may help to solve collective action problems and reduce neighborhood externalities. CDFIs can counter information externalities by assuming the cost of learning about their local communities and developing specialized financial products and services that better fit local needs. In general, CDFIs provide coordinated development activities and community-specific information that the market may not supply on its own.

Among other benefits, the familiarity with each community that CDFLs develop can help to gauge and control risk. For example, the use by CDFLs of appraisers who specialize in evaluating properties in a particular community produces more reliable estimates of the value of the loan collateral. Likewise, CDFLs structure loans and use public and private credit enhancements both to increase borrowers' ability to qualify for loans and to spread the associated credit risk among a mix of private creditors and other providers of funds.

Although these specialized techniques can reduce credit risk, they are labor-intensive and, consequently, expensive. Most private lending institutions reduce costs by adopting processes that are highly standardized and automated. Such systems are not necessarily compatible with lending to borrowers who require substantial screening, counseling and monitoring or with acquiring specialized information about community development lending. Part of the explicit mission of CDFLs is to assume the costs of conducting such research and analyses in underserved communities.

CDFIs have also developed techniques and strategies - such as flexible underwriting criteria, specialized loan products and intensive financial education programs - to meet the financial circumstances of their communities. Moreover, in recent years, CDFIs have been working to expand their role as information brokers beyond the local communities they serve. Through national initiatives to collect industry-wide data and to securitize community development loan portfolios, CDFIs are working to expand access to credit and capital in lower-income markets.

In short, knowledge and expertise together with the ability to build new relationships - are the principal contributions that CDFIs bring to the marketplace and to underserved communities.

Is community development lending profitable?

Can private-market participants profit from community development lending? Data based on Community Reinvestment Act examinations tell us much about the volume of such loans but less about their performance and profitability.

However, a Federal Reserve survey found that nearly all banks reported that their community development activities were profitable, at least to some degree. About two-thirds of the banks also reported receiving some benefit from their lending unrelated to loan profitability, such as an improved image in the community.

Since the Federal Reserve report, studies undertaken by the CDFI Data Project show that, for 2004, charge-off rates for CDFI portfolios were similar to those for the banking industry as a whole. These studies and market data suggest that banks and other private organizations may become an increasingly significant source of competition for CDFIs. That is good news, not bad news. Indeed, the surest sign of a CDFI's success is that private investors see viable investment opportunities in the neighborhoods in which the CDFI has been operating.

The continuing relevance of CDFIs

Although in some sense the mission of CDFIs is to make themselves unnecessary, I expect that the knowledge and goodwill they have accumulated in local communities will continue to make them relevant. For example, I mentioned earlier the loan pricing disadvantages faced by members of minority groups that have appeared in the HMDA data. CDFIs may be able to help reduce those discrepancies by using their local knowledge and financial expertise to offer alternatives to conventional subprime lending.

The **Opportunity Finance Network,** for instance, will be competing with subprime lenders via a mortgage-credit platform that centralizes some CDFI lending processes and directly links counseling and lending services. At the same time, CDFIs continue to expand their ability to attract private investment funds, for example, through increasing transparency and developing the means of providing objective evaluations of their financial and mission-related effectiveness.

These efforts demonstrate the ability of CDFIs to adapt their business strategies to evolving markets, as indeed they have done throughout their 30-year history. I expect the local knowledge and specialized financial expertise that CDFIs provide will continue to add significant economic value and complement market forces in the support of community economic development. Thus, CDFIs are likely to contribute to our shared goal of expanding economic opportunity for many years to come. BN