Federal Reserve System Conference on Sustainable Community Development

Session on "Public Policy — Enterprise Zones and CDFIs"

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Over the last 30 years, public strategies for combating poverty and unemployment have shifted their emphasis from the direct delivery of services (such as job training and education) to enhancing economic activity that increases employment and produces income.

However, policymakers discovered that using public money to finance economic activity in low-income areas presented a host of political, budgetary, and bureaucratic problems. This discovery led to further change: Public policy shifted from direct to indirect means of financing investment. Instead of using public agencies to make grants, loans, and investments, public policy now tends to use government's spending, tax, and regulatory authority to influence the private sector's investment and lending decisions.

Thus, the 1970s and early 1980s witnessed the birth of CRA, CAP, enterprise zones, and community development banks.

The papers presented in this conference session describe three different strategies for increasing the use of public authority to influence/subsidize private investment in low-income areas:

- State tax incentives — enterprise zones
- Financial intermediaries — New Markets Venture Capital Companies (NMVCCs) and Community Development Financial Institutions (CDFIs)
- Federal tax incentives — the New Markets Tax Credit (NMTC) Program

Enterprise Zones

This conference session's paper on California enterprise zones raises several important questions: Assuming that it is reasonable to view state expenditures as investments intended to produce a stream of benefits by avoiding social welfare costs or increasing revenue, what are the costs and what are the compensating benefits? Are the state tax incentives structured under the California program the most efficient way to achieve these benefits? What alternative strategies might have been employed? For example, would investor-level incentives (such as tax credits) that encourage financial investment in growing firms have worked as well or better?

Financial Intermediaries: CDFIs

Several related developments and challenges have created an environment of future uncertainty and competitive challenge for CDFIs.

The Culture of CDFIs

CDFIs tend to regard themselves as assisting underserved borrowers by carrying out transactions too risky or costly for the private sector. However, some of their commercial competitors look at the same underserved borrowers in the aggregate and see a large, potentially profitable market. Consequently, those competitors spend time and money developing efficient ways to serve this market, using rapidly evolving information and financial technologies. If successful, these competitors will push CDFIs into increasingly small, risky transactions. In such an environment, some CDFIs will find it hard to survive.

The Current Business Model

Because lending to "unbankable" borrowers entails significant concentrations of risk, holding loans in portfolio limits CDFIs' ability to carry out their mission without jeopardizing their financial viability. As a result, large numbers of borrowers may still go unserved.

Inability to Innovate

Most CDFIs are transaction driven and have little time or money to develop new lending strategies. However, the CDFIs' failure to make good use of financial/information technology not only compromises their current performance but also may make future viability problematic. Their challenge is competition from banks as well as other financial services companies. As one observer put it, money is simply alpha-numeric data, and anybody with a significant information infrastructure is thus a potential player in the finance business. ("What has Brown done for you lately?")

Demographic Change

An increasing number of financial services companies recognize that Hispanics, Asians, and African-Americans will comprise more than 50 percent of the U.S. population in 50 years. For many of these companies, the demographic shift will change investing in low-income communities from a good deed to a business imperative, making competition for CDFIs even more likely.

The New Markets Tax Credit (NMTC) Program

Because it subsidizes the entry of new players, the NMTC may exacerbate CDFIs' competitive challenge from capital markets players that long ago adopted several techniques for managing risks and costs that CDFIs have yet to embrace. For example, many commercial and investment banks employ securitization as a liquidity- and risk-management strategy, but this technique is not widely employed in the CDFI industry.

A $15 billion allocation for private lenders/investors in low-income areas may have several effects on the CDFI industry and investment in previously underserved markets. It will help make the equity returns of investing in an unfamiliar market more competitive. The federal government essentially will fund 39 percent of each equity investment, thus lowering investors' effective basis in transactions. The higher return will allow a larger equity base in difficult transactions, thus lessening the amount of leverage and making debt easier to secure. It undoubtedly will produce new products, players, and strategies:

- In the current depressed market, investors looking for higher returns may well find that NMTC deals are more desirable than they would be in a more robust market environment.
- Demographic change will increase the attractiveness of programs that subsidize entry into new markets.
- Information may be among the most important products of the program.
- Assuming an average transaction size of $500,000 to $1 million, NMTC would finance between 2,500 and 5,000 transactions.
- Performance data on these investments and loans will help investors/lenders understand and price the risk associated with financing currently underserved markets.
- Some difficulties are likely to arise in structuring NMTC transactions. These include other tax policies (such as elimination of double taxation of dividends) and compliance problems (such as recapture), which may make investors reluctant to embrace transactions until the uncertainties are eliminated.

Performance: What Is It?

If we're looking at a double bottom line, which line takes precedence?

The Social Line

Most initiatives originate in efforts to combat poverty and unemployment. Yet, partly because their objectives mean different things to different people, it is far from clear what metrics to use in measuring performance.

Many people object to the increasing "market orientation" of community development finance, contending that increased use of private capital will compromise pricing and underwriting flexibility. In addition, many projects need deep subsidies. (Note that all subsidies are ultimately financed by private money. Thus, large private organizations, such as airlines and telephone companies, can and do provide them without intermediation by public bureaucracies.)

The Financial Line

Very few CDFIs are star performers from a financial standpoint. However, if low-income communities truly represent an underserved market, it may well be that the costs of serving the market can be financed by the prices charged to customers.