

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

CURRENT ISSUES AND FUTURE PROSPECTS

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INTRODUCTION

Affordable credit, basic financial services, and investment capital are critical to the health of communities. Individuals need mortgages to purchase and maintain their homes. Developers require financing to build and rehabilitate commercial properties, community facilities, and affordable housing. Businesses need credit and equity capital in order to grow. Community residents (as well as local institutions) have to have safe, affordable financial accounts where they can keep and build their assets. Unfortunately, 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 (Oliver and Shapiro 1995; Squires and O'Connor 2001), suburbanization and the flight of capital out of the inner city (Kasarda 1989; Jackson 1995), banks' and thrifts' concerns about profitability, and the restructuring of the financial services industry (Avery et al 1997; Stegman 1999). The lack of such financing has consistently hampered efforts to improve conditions in these areas. It also has created an opportunity for an alternative type of financial institution.

Community development financial institutions (CDFIs) emerged in response to that need. CDFIs have a primary mission of improving economic conditions for low-income individuals and communities. Consisting of a wide range of organizational types (including community development banks and credit unions; community development venture capital providers; micro-enterprise funds; and housing, business, and facility loan funds), these “alternative” entities provide a range of financial products and services that often are not available from more “mainstream” lenders and financiers. The CDFIs augment their financing with a range of counseling and educational services that increase their borrowers' economic capacities and potential. There currently are more than 650 such entities throughout the country, ranging in asset size from \$5,000 to almost \$730 million (CDP 2001).¹

¹ These figures reflect data from a subset of CDFIs and may consequently under-report or over-report asset size slightly. Information on asset size is not available for all certified CDFIs.

This paper describes how CDFIs have crafted a set of financial products and services that provide capital for community development and revitalization. It outlines the history of the CDFI industry and details how CDFIs are responding to three specific development needs: basic financial services; affordable credit for home purchase, rehabilitation, and maintenance; and loan and equity capital for business development. It concludes by considering CDFIs' place in the broader context of financial service provision in lower-income communities.

HISTORICAL CONTEXT

CDFIs are the latest institutional efforts to address the financial needs of economically disadvantaged communities. The 1880s witnessed the development of a small number of banks that specifically targeted black communities that had been unable to obtain conventional banking services (Du Bois 1907). The 1930s and 1940s saw the emergence of credit unions, many of which were in the rural south and were designed to serve African Americans who did not have access to credit.

A series of multi-purpose community development corporations (CDCs) emerged in the late 1960s and early 1970s to provide loans and equity investments to businesses and address the housing needs of many distressed communities. At the same time, 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 (Taub 1988).

The late 1970s and early 1980s witnessed the birth of several community development intermediaries. These entities have collectively provided a variety of financial and consulting services to CDCs and other community-based institutions (Liou and Stroh 1998). 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. A year later, the Ford Foundation and six other investors established the Local Initiatives Support Corporation (LISC) as a national vehicle for bringing financial and technical support to the growing cadre of CDCs engaged in real estate development. James and Patty Rouse created the similarly oriented Enterprise Foundation three years later.

The growth and vitality of the CDFI field has also been greatly enhanced by the trade associations that represent different types of community development financial institutions. These entities hold regular conferences and workshops to build awareness and train new practitioners. They also lobby Congress to increase the availability of resources for their members. The earliest trade association, the National Federation of Community Development Credit Unions (NFCDCU), which was created in 1974, has worked to promote the CDCU model. The National Association of Community Development Loan Funds, which subsequently became the National Community Capital Association (NCCA), was formed in 1985. Like NFCDCU, NCCA has taken an active role in helping to expand the number of development finance institutions throughout the country. Since 1991, the Association of Enterprise Opportunity has focused on furthering the work of organizations supporting micro-enterprise. The Community Development Venture Capital Alliance was incorporated in 1994 and has overseen a dramatic increase in the number of CDVC providers.

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 an increased investment in lower-income markets that occurred in the mid to late 1990s. 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, CRA mandates that banks address the credit needs of their entire service area and prohibits them from discriminating against any portion of their

markets.² However, the law did not contain any specific penalties for non-compliance (and still does not). Regulators could factor a bank's lending record into a decision to approve a merger or a new branch opening, but they could not impose any direct financial penalties for poor community reinvestment performance. The Carter, Reagan, and Bush administrations offered little public support for CRA, and the law consequently went largely un-enforced for much of the 1970s and 1980s. There were only a handful of occasions on which banks' merger or acquisition applications were denied for CRA-related reasons.

Conditions changed noticeably in the 1990s. A number of well-publicized studies in the late 1980s and early 1990s, especially those in Atlanta, Chicago, and Boston,³ highlighted the continued persistence of discriminatory lending practices. These findings led to 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 or bad publicity, an increasing number of banks negotiated reinvestment agreements with the protesters.

CRA proponents also benefited from the strong and consistent backing of President Bill Clinton. With Clinton's public support, regulators revised CRA in 1995 so that banks were judged more on their actual lending and investment performance in low-income and minority communities than on their marketing and outreach efforts in these areas. The changes contributed to a sharp growth in lending in these communities. Clinton's veto threats effectively killed subsequent congressional attempts to weaken or eliminate CRA's provisions. The

² 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 perception of high risk in those communities. Contributing factors to high-risk perceptions included large numbers of racial and ethnic minorities and high rates of poverty and unemployment.

³ 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 Federal Reserve Bank of Boston reported that Black mortgage applicants in Boston were rejected 60 percent more often than similarly qualified White applicants (Munnell et. al. 1992).

administration's strong commitment to 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 direct programmatic 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 (Abt 1973; Robinson & Gilson 1993). This support was reduced during the Nixon administration and withdrawn entirely in the 1980s, a result of the Reagan administration's elimination of many of the Great Society programs and its sharp reductions in funding for low-income housing initiatives. The pendulum swung back a bit in the 1990s, as part of President Clinton's economic strategy involved increasing access to credit and capital for historically underserved individuals and communities. In addition to emphasizing enforcement of the CRA, Clinton championed legislation that created the Community Development Financial Institutions (CDFI) Fund, which has become a critical source of capital for the CDFI field.

Clinton first became interested in community development finance while governor of Arkansas. In the mid 1980s, he met with the South Shore Bank principals as part of an effort to promote economic growth in the state's lower-income areas. The meeting led to a partnership that resulted in the bank's consulting affiliate helping to create the Southern Development Bancorporation, a CDFI that targets an economically distressed 32-county area of southwestern Arkansas.

Clinton's experience with South Shore Bank led him to propose the establishment of similar development finance institutions throughout the country as one of his presidential campaign proposals. Eventually the idea resulted in the 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 CDFI Fund) to support a range of such development finance institutions.⁴ The fund initially was created as an independent entity, but practical and political considerations resulted in its being moved within the Treasury Department in 1995.⁵

The fund operates a number of programs designed to increase capital access and availability in traditionally under-served markets. Its largest program has historically been one that provides a range of grants, loans, and equity investments to CDFIs to help them build their lending capacities. Another third of the fund's dollars are earmarked for the Bank Enterprise Award (BEA) program, which rewards banks for increasing their lending and investing activity in economically distressed markets or in CDFIs. Since its inception, the fund has provided a total of more than \$400 million in direct funding to over 250 CDFIs. Through BEA, it has helped generate over \$1 billion in additional CDFI-related investments from conventional banks and thrifts. 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 help them raise private capital for investment in businesses located in economically distressed communities.

⁴ Clinton's initial proposal called for federal monies to support the creation of 100 development banks throughout the country, an idea that generated some opposition from existing non-bank community development lenders. The Association for Enterprise Opportunity, 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 offered an alternative approach in January 1993. Rather than setting up 100 new banks, they proposed that the legislation support community development banks as well as the many other types of existing institutions that had been doing community development finance work for decades. Their view ultimately prevailed: 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).

⁵ 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.

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. Certification also enables CDFIs to attract money from many banks (since 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. As noted earlier, there are currently more than 650 certified CDFIs in the country, roughly triple the number from the mid 1990s.

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 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 a recent (2001) survey of consumer finances by the Federal Reserve Board reported that 9.1 percent of U.S. households (nearly 10 million) have no transaction accounts with a financial institution, and that number may well be too low (Aizcorbe, Kennickell, & Moore 2003). In 2002 the Government Accounting Office estimated the number of households without transaction accounts to be closer to 22 million, based on census SIPP data (GAO 2002). The GAO's 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. Unbanked households have difficulty establishing the credit history necessary to buy a house or build other wealth. For example, low-income households without transaction accounts are 43 percent less likely to have positive holdings of net financial assets, 13 percent

less likely to own a home, and 8 percent less likely to own a vehicle than those with such accounts (Carney and Gale 2001: 200). Households that do not have relationships with insured depository institutions are more susceptible to predatory lending practices when looking to finance or refinance their homes (U.S. Treasury 2000).⁶ In addition, many of the unbanked use money orders to pay bills and rely on check cashers or currency exchanges to convert their paychecks into cash; these transactions carry fees that can be considerably higher than those associated with insured depository accounts.⁷ 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). The percentage of unbanked households paying these types of fees is unclear, however. A recent survey by the Office of the Comptroller of the Currency found that only 34 percent of the unbanked incur any check-cashing costs, and only one-third of those incurred costs over \$100 annually (Dunham 2001).

Even more striking is the difference in interest charges for short-term “payday” loans, the fastest growing segment of the fringe banking industry (Caskey 2003). For example, a check-casher might charge a \$25 fee for a \$200 two-week cash advance. The individual would write out a check for \$225, receive \$200, and the check casher would agree to hold the check for two weeks before cashing it. Since many payday loans are rolled over or extended, the annual percentage rate may be a better reflection of the true costs of the loan (Stegman 1999; Caskey 2001 & 2003).⁸ In the example above, a 12.5 percent fee for a two-week loan (\$25/\$200)

⁶ 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.

⁷ The amount of the fees varies by institution and by geography. Users of fringe banking institutions in Illinois, for example, tend to bear especially high financial burdens. See Woodstock Institute 1997 and Dunham 2001.

⁸ A 2000 Woodstock Institute survey of payday loan borrowers in Illinois found an average of 12.6 contracts per borrower.

translates into an annual interest rate of 325 percent (compared to a credit union's typical annual consumer loan rate of 16.5 percent).

Among the many factors explaining the number of unbanked households, two are particularly relevant to our understanding of CDFIs: the relative absence of conventional financial institutions in low-income communities and the high cost of financial services.⁹ 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 (e.g., suburbanization) and consolidation resulting from mergers and acquisitions (Avery *et al* 1997). But the 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 less money in their accounts and make smaller deposits and more frequent withdrawals. To compensate for these higher costs, many banks have imposed 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).¹⁰ Such fees often make it prohibitive for low-income households to own the accounts.

⁹ According to the Federal Reserve's Survey of Consumer Finances (Aizcorbe, Kennickell, & Moore 2003), the most common reasons cited by individuals for why they do not have a transaction account were as follows: do not write enough checks (28.6 percent), do not like dealing with banks (22.6 percent), do not have enough money (14.0 percent), service charges are too high (10.2 percent), minimum balance is too high (6.5 percent), and cannot manage or balance a checking account (6.6 percent). Location and hours were issues for only 0.4 percent of those surveyed. John Caskey, who has studied issues of fringe banking extensively, argues that the most important reason is the decline in real income for lower-income households over the past few decades (see Caskey 1994).

¹⁰ Papadimitriou *et al* explain that fees have increased over time in part because of the deregulation of the financial services industry. Banks have increasingly been competing for investments with non-regulated financial vehicles such as money market mutual funds, which offer consumers a higher return for their investment. To match those higher returns, banks need to increase their revenues. Increasing fees is

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. There were 142 credit unions specifically designated as low-income in 1990 and 538 in 1999, with deposits in these entities increasing from approximately \$570 million to just over \$2 billion (NCUA 1999).¹¹ Similarly, the number of community development banks grew from 27 in 1992 to 39 in 2001. The banks' total deposit base grew from \$61.5 million to \$108.1 million and their lending rose by 160 percent during this period (Woodstock 2002).¹²

The majority of community development credit unions (CDCUs) and CD banks are located in low-income areas 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.¹³ 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 certificates of deposit (CDs) that can be purchased for as little as \$100, as well as special savings vehicles such as Christmas accounts

one solution. Recent technological advances may enable banks to reduce these costs in the future, however.

¹¹ Low-income credit unions may or may not be certified CDFIs. NCUA or the state supervisory authority (in the case of state-chartered credit unions) makes the LICU designation, which indicates that at least 51 percent of the credit union's members earn less than 80 percent 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 certification requirements (having a primary mission of community development, serving and maintaining accountability to an eligible target market, qualifying as a financing entity, providing development services to borrowers and potential borrowers, and not being governmentally controlled), but certification for such an entity usually proves no more than a formality. It is unclear to what extent the recent growth in credit unions designated as low income results from the chartering of new LICUs or from more credit unions seeking LICU status. It is also important to note that the term "CDCU" was adopted by credit unions that have a specific commitment to community development, in particular those institutions that are members of the National Federation of Community Development Credit Unions. Not all low-income credit unions have this explicit commitment. Similarly, not all CDCUs qualify as LICUs.

¹² The study did not distinguish between the growth in deposits from institutional investors and those from individual account holders, including low-income households.

¹³ Some community development banks, like Community Capital Bank in New York City, do not offer retail banking services. Community Capital was a *de novo* institution and its capital raising process proved

and individual development accounts (IDAs) (Tansey 2001).¹⁴ Virtually all CDCUs and CD banks spend a considerable amount of time working with their members and customers to increase their financial literacy skills, improve their credit rating, and increase their asset-building capacity. CDFI staff members often view such work as their most important activity, given their members' low levels of financial literacy.

The Strengths and Limitations of Insured Depository CDFIs

Unlike other CDFIs, CDCUs and CD banks can take deposits and federally insure them up to \$100,000. In this way, they offer a safe, yet accessible place for individuals to keep their money. The depository structure enables CD banks and CDCUs to leverage far more debt from an initial investment than other CDFIs, thus providing them with more capital with which to provide development financing. Most regulated CDFIs have an equity or net asset base of 5 percent or less of their total assets; for every dollar of equity, they can take on nearly \$20 of deposits or other liabilities (NCIF 2002). In contrast, most non-regulated CDFIs maintain equity/net asset ratios of at least 15 percent. Furthermore, deposits represent one of the cheapest forms of capital available to CDFIs. Interest rates on savings and checking accounts are typically much lower than rates on more conventional loans, which tend to be the primary source of capital for non-regulated CDFIs.

At the same time, depository insurance comes with contingencies. Regulated CDFIs must adhere to a range of financial safety and soundness criteria to the satisfaction of federal or state regulators. For example, CDCUs and CD banks must maintain appropriate levels of liquid

extremely challenging and time consuming. To reduce transaction costs, the bank made a conscious decision to not focus on retail banking services (see Tholin 1995).

¹⁴ 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 buy a house, start/expand a business, or obtain additional education. 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

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 with their more conventional peers, CD banks and CDCUs routinely show weaker financial performance. An analysis of the financial performance of 80 CDCUs and 33 CD banks from 1996 to 2000 found that the CDFIs typically had fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets relative to their non-CDFI peers (Rajan 2001). South Shore Bank in Chicago, one of the oldest and most successful entities in the industry, has historically lagged well behind banks of similar size and similar location (the south side of Chicago) 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

low-income participants. Several CDCUs are in the process of starting IDA programs. See Tansey (2001).

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, which increases their operating expenses. CD banks and CDCUs consequently must attract lower-cost funds. Like all CDFIs, they are eligible to apply for low-cost federal money through the CDFI Fund. Many regulated CDFIs also 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. Low-income credit unions may obtain a certain amount of deposits from investors outside their fields of membership. Many CDCUs also rely heavily on the donated services of their members to manage daily operations.¹⁵

The burden of self-sufficiency ultimately prevents CD banks and CDCUs from taking as many risks with their financing as they might wish to undertake in support of their development missions. They simply do not have the margin for error 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

¹⁵ 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

concerns. For example, regulators have allowed relatively few CDCUs to make small-business loans because of the higher risk involved in such lending. 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.

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, buying and maintaining a home requires some sort of financing. Home purchase mortgages and home equity loans easily make up 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

National Federation of Community Development Credit Unions, the CDFI Fund, the National Community Investment Fund, and the National Community Capital Association.

neighborhoods, a practice that 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 changing 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 changing 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, eliminated its "stable neighborhood" criteria, and created 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 default 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 have sought to limit their involvement in these markets. The 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 CRA and other legislation designed to eliminate discriminatory lending. The activism has also resulted in the creation of specific alternative financing mechanisms. South Shore Bank was created in large part to ensure affordable mortgage financing in Chicago's South Shore neighborhood. Organizations such as the Santa Cruz Community Credit Union have created special home mortgage programs for their members, augmenting their financing with extensive counseling on the nuances of buying and maintaining a home. There are now more than 220 members of the Neighborhood Reinvestment Corporation's NeighborWorks network, many of which are CDFIs. Most of these groups provide mortgage financing to low-income prospective homebuyers as part of a broader community revitalization strategy. NeighborWorks members themselves have collectively provided mortgage financing to over 60,000 low-income families in the past 10 years.

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 40 percent in urban minority

neighborhoods and 31 percent in urban low-income neighborhoods (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 from lenders specializing in FHA or subprime loans. The increased lending resulted partly from stronger enforcement of CRA and partly from lenders' recognition of the economic 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 2000).

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 such markets has changed the CDFIs' roles. 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 many 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.)

Extensive homebuyer education services are integral parts of CDFIs' asset-building strategies. 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) or one-on-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 (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.

CDFIs have increasingly geared their lending and counseling services to combating the problem of predatory lending in lower-income markets.¹⁶ 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.¹⁷

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 claimed to have provided

¹⁶ 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 to 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 2000). 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.

¹⁷ See www.responsiblelending.org, the web site 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.

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).¹⁸

The impact of this expanded mortgage lending is not yet fully known. Clearly, thousands more minorities and lower-income individuals have been able to purchase their homes; the national homeownership rate increased 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 make refinancing more difficult, and higher debt ratios increase the likelihood that the borrower will

¹⁸ 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-

experience 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).¹⁹

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 Hirad 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 with similar characteristics who did not receive counseling services. Unfortunately, the study

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

¹⁹ 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).

could not control for differences in risk characteristics among the counseled and non-counseled recipients, as Freddie Mac deemed the data proprietary (Hirad & 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 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 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 credit but in the renters' dearth of income and assets (for down payment costs).

Multi-Family Financing

Just as CDFIs serve as intermediaries between low-income households and conventional financial markets, they often serve as a conduit between nonprofit housing developers and mainstream capital providers. CDFIs have been instrumental in the growth and maturity of the CDC industry. Most of the larger community development loan funds (LISC, the Enterprise Foundation, the Low Income Investment Fund, and The Reinvestment Fund, to name a few) have historically concentrated a large portion of their efforts on building the financial and organizational capacity of CDCs and similar nonprofits to develop affordable housing.

Virtually every housing development, particularly those serving lower-income individuals in low-income communities, requires a mix of debt and equity financing. Public and philanthropic monies can only go so far; private-sector capital is essential for larger scale development. To attract such financing, CDFIs have consistently pursued a number of strategies simultaneously. First, they have worked to make the CDCs viable borrowers in the eyes of mainstream lenders. They have helped the groups develop sound financial and accounting practices, identify and

manage developers for their projects, address asset management issues, and generally become more “business-like” in their orientation to real estate development.

Second, the CDFIs have worked to demonstrate the financial viability of the projects themselves. For many years most bankers (as well as their regulators) were extremely hesitant to commit monies to housing projects 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, for example, 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, a CDFI would often provide the CDC developer with a construction loan so that the CDC could actually build or rehabilitate the planned housing units. As the project moved along and 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 then would become subordinate to the bank’s.

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 (LIHTC). Since its implementation in 1986, the LIHTC has enabled taxable investors to 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).

As CDCs have become more sophisticated and the risks of housing lending have been reduced, conventional lenders have become much more active in financing such projects. As a result, CDFIs are often financing smaller, arguably riskier portions of projects than they were previously. The majority of their dollars tend to be loaned out in the form of subordinated debt instruments that typically 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 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 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 LISC, the Low Income Investment Fund (formerly the Low Income Housing Fund), 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

A healthy, growing business sector provides goods, services, and employment opportunities and is therefore critical to the economic vitality of a community. The creation and

expansion of such businesses requires access to debt and equity capital. 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. Access to equity capital is particularly crucial for young companies, which typically lack the cash flows necessary for debt repayment. Equity is patient capital, which does not need to be repaid for several years.

Historically, however, access to both debt and equity capital has been very limited for ethnic minority, female, and low-income entrepreneurs, as well as for businesses located in distressed communities. The lack of debt capital for ethnic minority and female entrepreneurs often has reflected discrimination by lenders; tougher enforcement of fair lending laws has helped to address that aspect of the problem. The lack of credit 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, the companies are less able to weather business downturns and are at greater risk of defaulting on loans than are 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 both because it is too administratively expensive and because it may open them up to issues of lender liability should the businesses fail.

Higher risks and transaction costs also help account for the lack of equity capital in low-income communities. Yet access to equity capital is problematic even in more affluent markets. Investments made by the venture capital industry, the primary source of equity capital for business, are driven overwhelmingly by the financial objective of maximizing returns for investors. Since investment capital is limited, the industry focuses only on those markets it perceives as the most lucrative. Companies located outside of a few major markets, in non-technology related industries, or with investment needs of \$1 million or less have a very difficult

time attracting equity capital. Although some CD banks and CDCUs provide small-business financing, most of the CDFIs business-related efforts have been through business development loan funds (BDLFs), community development venture capital funds (CDVCs), and micro-loan funds (MLFs).

Business Development Loan Funds

BDLFs lend capital to businesses and nonprofit organizations, many of which have not been able to qualify for funding from more traditional sources, with the objective of furthering various social goals. 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 the number of businesses owned by women and ethnic minorities, and promoting the growth of businesses that do not harm the environment (Caskey & Hollister 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. BDLFs 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. Most BDLFs provide only business financing, but some also finance the construction and renovation of affordable housing and community facilities.

BDLFs lend both independently and in conjunction with conventional lenders. 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 their portfolio companies. The technical assistance is provided both pre- and post-investment, to help potential borrowers

qualify for capital and then to assist them with various aspects of operations. The type of assistance provided includes help with writing business plans, putting together marketing strategies, and developing financial systems.

Research on BDLFs has thus far been very limited, consisting primarily of descriptive statistics collected annually by the National Community Capital Association (NCCA) on its members. NCCA members constitute only a portion of the entire BDLF population, however, and are not necessarily representative of the broader group.²⁰ 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, particularly in trying to compare these entities to more conventional lenders. 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.

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 it to participate in the upside if the investment is successful. Both equity and near-equity investments are forms of patient capital that enable young firms to obtain the funds they need in

²⁰ 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.

their early years without immediately having to begin 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 30 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 as well as the greater availability of such capital for community development finance that resulted from the creation of the CDFI Fund and the increased enforcement of CRA. At the end of 2000, the last year for which data are available, there were 50 CDVC providers with \$300 million under management (Rubin 2001). Their capital has come primarily from banks, foundations, and federal and state governments, which have generally invested low-interest debt or equity for periods of 10 or more years (Rubin 2001).

CDVCs differ from traditional sources of equity capital, such as venture capital funds and small business investment companies, in a number of important ways. Unlike traditional equity providers, 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 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).

While traditional equity providers generally focus their investment activities on companies at particular stages of development and in specific industries, most CDVC funds 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. The majority of CDVC funds do target companies that are likely to create manufacturing jobs, which typically offer higher wages and better benefits than service-sector jobs. Manufacturing jobs also can 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 use 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. 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 seven 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 funds 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).

Micro-Loan Funds

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).²¹ Unlike BDLFs, micro-loan funds 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-

²¹ 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. 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

enterprise development programs in the United States, and these groups collectively had served more than 55,000 clients (FIELD 2000). Less than one-fourth of these programs do enough lending to qualify as CDFIs.

The U.S. micro-enterprise sector was modeled primarily after the work of several prominent organizations in developing countries, particularly the Grameen Bank of Bangladesh. These organizations assist poor and mostly female clients by making small, short-term loans via peer or solidarity group lending. In this method, a group of borrowers co-guarantees the loans made to each member, “replacing collateral with peer pressure.” In addition to serving as a safety net for the lender, the peer group also provided its members with support, networking, and training (FIELD 2000).

Many of the U.S. micro-loan providers initially attempted to use 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.²² The U.S. programs responded by adjusting their offerings. Today, only 16 percent of micro-lenders use a group lending methodology, while 65 percent make loans to individuals and 10 percent use both methods (FIELD 2000).

U.S. micro-enterprise providers also discovered that micro-entrepreneurs were not seeking loans in large numbers. With a few exceptions, the loan volume of U.S. micro-enterprise providers was very small, regardless of the lending method they used. As of 1999, only 11 percent of all the clients served by U.S. micro-enterprise programs were borrowers

addition, community development credit unions make small consumer loans (e.g., \$500) on a regular basis.

²² Among other factors, this reflected the low concentration of micro-entrepreneurs 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 2000). Some of the additional factors that contribute to making peer lending less effective in the U.S. than in the Third World include more impersonal U.S. markets; greater diversity and less interaction among the low-income population in the U.S., which impedes social capital and trust among group participants; the overarching emphasis in the U.S. on individualism; and the presence of other, more viable alternatives to self-employment for the U.S. low-income population (see Schreiner 1998 and Bhatt, Painter, & Tang 2000).

(Langer, Orwick, & Kays, 1999). Instead, the vast majority of clients sought business and financial training.

As a result of these discoveries, the U.S. 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.

More so than other development finance strategies, micro-enterprise has garnered political support from both sides of the aisle. Its 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 that 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, Klein, & Clark 1996; Jones 1999), while others have praised it as a means of alleviating poverty or furthering economic development (see Edgcomb, Klein, & Clark 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.²³ 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).

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

Relatively few studies have taken a critical look at the economic impact of the micro-enterprise model. One of the few that has is an Aspen Institute study of 405 micro-enterprise program participants (Clark et al 1999), which reported 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. Most of the increase in household assets resulted from increases in home values, however. 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 more likely to have increases in their monthly business profits,

²³ A 1998 sample of 405 micro-enterprise clients tracked by SELP (Self Employment Learning Project) Longitudinal Survey of Micro-enterprises showed that 78 percent of them were female; 42 percent of them were African-American; 18 percent were Hispanic and 2 percent were Asian. Additionally, 83 percent of the entrepreneurs had completed high school and 58 percent had some post-high school education (Clark *et al* 1999).

business equity, take-home pay, and household income. Yet the businesses still generated 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.²⁴ 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 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.

CONCLUSION

CDFIs emerged in response to a need for accessible, affordable financial products and services. They support asset building at the household and neighborhood level through the provision of transaction accounts; capital for housing purchase, development and maintenance; and capital for business development and expansion. Their efforts, in conjunction with legislation (the Fair Housing Act, CRA, HMDA), concerted pressure from community activists, and the saturation of suburban markets, have contributed to an increased availability of conventional financing in previously underserved areas. In light of these changes, the CDFIs' role is no longer quite as clear as it once was.

Determining the CDFIs' appropriate role in ensuring that lower-income areas have adequate access to financial services requires an understanding of two key issues: the relationship of CDFIs to conventional financial institutions and the social and economic impact of the CDFIs themselves. Each of these issues has been the source of considerable

²⁴ 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 such businesses have employees, and two-thirds of the employees were working part-time (Servon 1998a).

controversy both within and outside of the CDFI industry. The following sections examine the issues in more detail.

CDFIs and 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 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. A somewhat similar view is that CDFIs are a means for communities to express their values and beliefs about local control of capital. Proponents of these views consequently see CDFIs as necessary alternatives (or even competitors) to conventional financial institutions.

Another perspective is that CDFIs are necessary supplements to the existing financial system. Such a view holds that CDFIs are intermediaries between lower-income, historically under-served communities and conventional financial markets and institutions. Many CDFIs coming from this perspective work closely with conventional financial institutions, with formal or informal systems of client referral and partnership lending. A subset of these CDFIs view themselves as entrepreneurs, whose role is to develop new financial products and demonstrate to more mainstream institutions that investing in certain “high-risk” markets can be done in a way that is beneficial to the community and profitable for the lender.

Whatever their role, CDFIs alone cannot meet all of the financial service needs of lower-income communities. At the same time, most conventional financial institutions currently are not (and likely never will be) providing the more specialized and costly products and services that CDFIs currently offer, such as extensive technical assistance, micro-loans, and pre-development financing. So how can we best ensure adequate financial service provision in these markets? Is it better to develop additional resources for furthering the work of CDFIs (for example, by securitizing CDFI loans and equity investments and selling them on traditional

financial markets) or to provide education and incentives to enable conventional financial institutions to serve these markets, with CDFIs taking a more supportive or ancillary role? Answering the question requires a level of data on CDFI activities and portfolios that is not currently available. Acting on the answer likely requires a different economic and policy environment.

Assessing CDFIs' Impact

Like all entities engaged in promoting social change, CDFIs struggle to identify appropriate indicators for measuring the impact of their activities. Part of the challenge lies in defining what is meant by impact. CDFIs generally have described the effects they believe they have on their target communities in terms of specific, quantifiable measures: jobs created, housing units refurbished, mortgages provided, and the like. These initial outcomes are assumed to lead to broader, longer-term effects such as improvements in the social and economic health of a given community.

Unfortunately, such indicators can mean different things to different people. In an industry as diverse as community development finance, definitions of outcomes and methodologies for collecting them vary widely. For example, the most common outcome measure for business-specific CDFIs is jobs created. There is little consistency, however, in how individual CDFIs determine what constitutes a new job, how long the job must last in order to be counted, and whether the job can be attributed to the CDFI's own actions. This lack of consistency exists not only between different types of CDFIs but also between individual CDFIs that provide similar services.

Many community development practitioners, advocates, researchers, and policymakers want to determine whether the specific actions of a CDFI brought about a certain outcome or if the outcome would have occurred anyway, without the CDFI's intervention. There have been few, if any, good causal studies of CDFIs, however. Most of the analyses end up focusing too

much on the CDFIs' activities and do not adequately take into account the range of other, often more significant factors involved in creating a given outcome.

Consider a few examples. Most affordable housing developments have a number of different funding sources; a CDFI may well provide pre-development or gap financing. Was the CDFI's involvement critical to the deal? Yes, but each of the other capital providers could easily argue that their monies were equally essential to the deal's viability. In a different case, 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 that growth likely stems from the enhanced productivity resulting from the new equipment, and part also results from the growing market for the business's goods and strategic actions taken by the company's management and workforce. Is the CDFI therefore responsible for "creating" the new jobs? The CDFI's financing and related technical assistance likely contributed to the improved health of the company, but the direct causal connection between its activities and the growth of the company's workforce becomes increasingly vague over time.

What, therefore, is a realistic way to assess the impact of CDFIs? A positive step would be to think in terms of direct and indirect effects of a CDFI's activities. Direct effects are those that result immediately and specifically from a CDFI's financing or technical assistance (a business purchases a new piece of equipment with a CDFI's loan dollars, a family purchases a home thanks to a CDFI mortgage, etc.). Indirect effects are those that come about later as a result of factors *including, but not solely related to* the CDFI's activities (the new piece of equipment enables the business to expand into a new market, hire additional employees, and pay more taxes; the new homeowners help stabilize the surrounding community; etc.). Obviously, the impact becomes increasingly diffused as we move further away from the original financial transaction, and measuring and attributing them accurately becomes more difficult.

It also is important to calibrate expectations of the impact of CDFIs more appropriately. CDFIs are, after all, relatively small in scale. They are principally financial institutions: they make

loans and equity investments, collect deposits, and offer various checking and savings accounts. They augment those activities with related education and counseling activities; some CDFIs provide more extensive services than others. But the CDFIs themselves are not real estate developers or goods producers. They do not build projects or manufacture products but instead help to finance them. They are unable to affect their borrowers' markets in any significant way. The ideology of "bootstrap capital" and community and individual empowerment is politically attractive, but the impact of any CDFI is inevitably limited relative to broader economic and political forces. Affordable homeownership ultimately depends less on the structure of the CDFI's loan than on the strength of the local housing market and the effect of national interest rates. An expansion of the earned income tax credit is likely to have a much greater impact in reducing poverty in a given community than will the efforts of even the largest and most effective CDFI.

The Future of CDFIs

The most dramatic increases in financial service provision in lower-income markets occurred during the mid to late 1990s, a period characterized by consistent economic prosperity, abnormally high stock market returns, and a Presidential administration that made a substantial commitment to community investment. Clinton's support of both CRA and the CDFI Fund was critical to the growth of the CDFI industry and to the expanded efforts by conventional lenders to serve historically under-served communities. Conditions have changed dramatically in the last few years, however. The Bush administration has sharply reduced funding for the CDFI Fund and has shown no interest in supporting CRA or development finance more broadly. The economic slowdown has resulted in 30-year highs in foreclosure rates and has dampened conventional lenders' enthusiasm both for direct loans in lower-income markets and for subsidized support of CDFIs. Reversing these trends (and continuing the improvements that

have occurred in these areas) requires a more concerted effort to demonstrate both the effectiveness and the importance of community development finance.

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