

REINVESTMENT ALERT

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CRA and CDFIs Revisited: The Importance of Bank Investments for the Community Development Financial Institutions Industry and Implications for CRA Regulatory Review

Introduction¹

Community development financial institutions (CDFIs) are banks, loan funds, venture capital funds, credit unions, and microenterprise entities that have a primary mission of serving lower-income communities and people. According to the CDFI Fund of the United States Treasury, there are currently 71 community development (CD) banks, 333 loan funds, 119 CD credit unions, 20 CD venture capital funds, and 59 microenterprise programs in operation in the United States. There are also 11 CDFI intermediaries and 22 multi-bank community development corporations that are certified as CDFIs. An increasing number of these institutions combine several of these distinct types of financial organizations. Collectively they provide housing, business and consumer loans, investments, and retail banking services to people who are either not served or are underserved by traditional financial institutions, thus helping them enter the financial mainstream. They may help a young couple buy a first house, enable a small business owner to expand her business, provide a low-cost banking account to an unbanked person, or help finance a shopping center or other major development in a neighborhood that desperately needs an economic catalyst to overcome years of disinvestment.

CDFIs are started in a variety of ways and with different sources of funding. However, they rely heavily on investments from regular banks and thrift institutions for loans and investments. These loans and investments are made partly because of certain financial institutions' responsibilities under the Community Reinvestment Act (CRA). That Act provides that regulated banks and thrifts have an affirmative obligation to help meet the credit needs of their communities, including lower-income neighborhoods.

The federal bank regulators are currently considering changes to the regulations that implement the CRA. One change, reducing the current tripartite exam structure for large banks to two exams and eliminating the "investment test," would have a devastating impact on bank and thrift investments in CDFIs. Using a new data source, this alert describes just how important the investments of regulated financial institutions are to CDFIs and, hence, why the investment test should be preserved.

¹Woodstock would like to thank Mary Mountcastle of Self-Help Credit Union and Eliza Mahony of the Corporation for Enterprise Development for commenting on earlier drafts of this report.

The Role of CDFIs in Lower-Income Communities

CRA-qualified investments in community development financial institutions (CDFIs) enable these institutions to leverage the necessary debt capital to maintain adequate lending capacity and to do so with adequate debt-equity balances.² These CDFIs, in turn, are able to meet many credit needs that are unmet by conventional financial institutions. CDFI-capitalized ventures result in shopping centers, affordable housing projects, new small businesses, and other sorely needed financial and social infrastructure in low-income or minority areas.

It is important to note that although CDFIs rely heavily on CRA-qualified investments and loans from banks and thrifts, CDFIs in fact receive funds from multiple sources. One of the most critical of these sources is the federal CDFI Fund. The Clinton Administration made a major contribution to the world of community development finance through the creation of the CDFI Fund. The Fund³, which is located within the US Department of the Treasury, provides investments and capital to qualifying CDFIs around the country. The Fund leverages the investments that banks and other funders make in CDFIs. Currently, the Bush Administration is slashing the appropriation of the Fund, which will cut off a critical source of money for financial institutions that are the lifeblood of many low-income and minority areas that have been shut out of the conventional financial market.

The need for alternative lenders such as CDFIs may be due to discrimination or redlining, or market failures in which private, individual institutions lack incentives to lend to projects where the aggregate social return is positive. CDFIs and other recipients of investments often provide market innovations that are later picked up by conventional lenders. For example, in Chicago in the 1970s and 1980s, South Shore Bank had a critical role in fostering the market for financing the rehabilitation of multifamily apartment buildings. When it began multifamily lending, few conventional lenders made such loans. Decades later, Shorebank finds itself competing with many larger institutions that have entered this sector. Early investments in Shorebank were critical to the development of this market.

The “mainstream” financial market might be failing certain communities for several reasons. In some cases, CDFIs have been responsible for identifying previously ignored or “emerging” markets in urban and rural areas. This can have a ripple effect on the availability of credit in these new markets as larger, more conventional lenders begin to recognize them. It is important to note that very small business loans and loans to business owners with little collateral or capital can be very expensive for larger institutions without a specific mission of serving such populations. Moreover, many small business or first time mortgage borrowers in historically underserved markets require technical assistance or other “high-touch” services that conventional lenders hesitate to provide. Many CDFIs specialize in these types of services. In the cases where borrowers are lacking a credit history, loans with a CDFI can help borrowers “graduate” into loans with more conventional lenders who require more stringent credit records.

Thus, for various reasons, the CDFI industry has become a crucial source of investment and mortgage finance in financially-underserved communities. Other Woodstock Institute research shows that community development (CD) banks far outperform regular banks in serving low-income and minority

²CDFIs include community development banks, community development loan funds, venture capital funds, community development credit unions, and microenterprise entities that are primarily financing agencies.

³The Fund is a critical program that has leveraged billions of dollars of private investment into low-wealth urban and rural communities. The FY 2003 appropriation that was approved at \$74 million was an improvement over the \$68 million that President Bush wanted and the \$73 million suggested by the Senate. However, it is still a significant drop from FY 2001 and 2002 levels.

communities. The data, which describe the performance of banks in Chicago, show that a considerably higher percent of CD banks home loans go to lower-income neighborhoods and borrowers than is true for all other lenders. The same pattern is repeated for loans to minority neighborhoods and borrowers.⁴ These patterns are particularly important considering the Bush Administration's recent statements regarding the importance of minority homeownership in the U.S.

The Investment Test Portion of Large Bank CRA Examinations: Background and Importance

In 1995, the Clinton Administration made significant improvements to the implementation of the Community Reinvestment Act (CRA). These changes included a new emphasis on outcome over process, new weight given to quantitative over qualitative measures, and the introduction of three component tests of CRA examinations for large banks: lending, investments, and services. Small banks (those with assets under \$250 million, which at the time of the passage of the Gramm-Leach-Bliley Financial Modernization Act of 1999 comprised 80 percent of all banks in the country) were allowed to undergo a streamlined CRA examination that did not have separate analyses of investments and services.

Another provision of the Clinton Administration's changes to CRA was the inclusion of bank investments in and loans to community development financial institutions (CDFIs) as CRA-qualifying activities. At the time that these changes to CRA were implemented (the new rules were promulgated in 1996 and revised data and examinations were made available in 1997), the regulatory agencies agreed to revisit several CRA issues in 2002. That review is still underway.

In 2001, the four federal bank agencies, the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) issued an Advanced Notice of Proposed Rulemaking (ANPR) that posed several questions about CRA and its implementation. This ANPR was open for public comment.

Many financial institutions that commented on the ANPR expressed interest in weakening CRA in many respects, including the elimination of the investment and service tests from large bank CRA examinations. The institutions argued that the investment test was especially difficult to comply with, that there were few opportunities for investments in community development projects in many communities, and that a revamped community development test could adequately measure community needs and bank performance in investing in low-income areas.

These arguments are misleading for many reasons. The investment test portion of CRA examinations is critical to evaluating an institution's record of helping to meet the credit needs of its entire community. Investments are critical to the capacity of community development corporations, community development banks, credit unions, loan funds, and others to serve the credit needs of those not well served by CRA-regulated depositories. There is increasing evidence that low-income communities find it hard to raise the equity in order to leverage the debt that increased lending provides. This equity can come directly from CRA-regulated banks and thrifts or indirectly, through bank-run community

⁴See Bush, Malcolm, and Smith, Geoff. *Reinvestment Alert 19: Community Development Banks Substantially Outscore other Banks in Serving Low-Income and Minority Communities: Implications for the Federal Budget and the Community Reinvestment Act*. January 2003. Chicago, IL: Woodstock Institute.

development corporations (CDCs). Many larger banks now have their own CDCs that make equity investments in nonprofit-sponsored projects. Without this source of equity, many vital projects would not get done in lower-income areas.

Given the importance of investments for the credit needs of low-income communities, the investment test portion of CRA examinations should be strengthened, not weakened. Currently, CRA performance evaluations do not distinguish between very different types of investment activity to determine the investment test rating. Grants, deposits in eligible institutions, investments in non-targeted Small Business Investment Company's (SBICs), and other disparate investments are summed with no explicit weighting or disaggregation. The sum of investments is sometimes then compared to a bank's own equity capital. This overly simple analysis does not adequately distinguish between lower- and higher-risk investments, or between higher-return and lower-return investments (the former being very likely to be provided by the private market).

The 1996 regulations do, however, give added weight to investments (and loans and services) that are complex and innovative. Thus, a financial institution should receive extra CRA credit for difficult deals that act, for example, as catalysts for other community development projects. Examples of difficult projects include financing large corner apartment complexes, major shopping centers, and developing brownfields sites. Both banks and community organizations complain about the way that bank examiners regard such investments. Both groups argue that just because a bank made a particular complex investment in one year, it doesn't mean that this type of investment should not be considered innovative and complex in subsequent years. Banks argue that by pursuing numbers to achieve CRA credit, examiners ignore the difficult nature of deals that take a long time to plan and implement and focus instead on total dollar amount of investments. Community groups contend that well-trained examiners should be able to weigh the contributions of both total dollar amount of investments and the complex nature of such investments. To distinguish among the performance of different-sized institutions, each category of investment should be measured relative to a bank's equity capital.⁵

The Scope and Shape of CRA Investments in and Loans to CDFIs

Beginning in 2000, organizations representing CDFIs around the country and their major funders began to meet with the CDFI Fund to discuss the implementation of a CDFI data project that would outline the performance, growth and capacity of the industry.⁶ This partnership resulted in the CDFI Data Project (CDP). In 2001, the CDP issued a survey to CDFIs nationwide to assess various financial and capacity-related measures, using fiscal year (FY) 2000 data from 379 responding CDFIs.⁷ Because different types of CDFIs, which include loan funds, community development credit unions, community

⁵Community groups also argue that grants should be measured against a bank's recent earnings. Moreover, all investments in mortgage- and asset-backed securities should be reviewed for predatory or illegal lending practices.

⁶These partners include the Association for Enterprise Opportunity, Aspen Institute, Coalition of CDFIs, Community Development Venture Capital Alliance, Corporation for Enterprise Development (CFED), National Community Capital Association, National Community Investment Fund, and the National Federation of Community Development Credit Unions. The funders were the Ford Foundation and the John D. and Catherine T. MacArthur Foundation.

⁷This CDP data set contains fiscal year (FY) 2000 information from 379 CDFIs. This sample represents a subset of the 800-1000 CDFIs that operate across the U.S. Data is only included for those institutions that reported on the particular data point. While the CDP has several methods to ensure data quality and consistency, the CDP cannot guarantee the reliability of the data. Also, the CDP dataset understates the size of the industry as it excludes a few large CDFIs. Please contact Beth Lipson at bethl@communitycapital.org or Eliza Mahony at eliza@cfed.org for more information on the CDP.

development banks, and venture capital funds, are regulated by different agencies and at vastly different levels of detail, this survey offered the first comprehensive look into the industry.

Woodstock Institute utilized this data to ascertain the extent to which CRA-related investments in CDFIs are crucial to the industry. An initial examination of the data shows that banks and thrifts are the second most important source of capital for CDFIs, behind individuals. CRA-regulated banks and thrifts provided \$847 million in investments to the CDFI industry, which accounts for approximately 15 percent of total capital for CDFIs.⁸

Capital under management includes borrowed funds (or loans payable related to financing) as well as equity equivalent investments⁹ for loan funds and venture capital funds. Borrowed funds and institutional deposits account for the capital under management from different sources for community development banks.¹⁰ Credit unions are a bit more complex.¹¹ Capital under management for credit unions includes borrowed funds, credit union shares, non-member deposits, and secondary capital investments. As Figure 1 (page 6) shows, though the overall dollar amount of capital that banks and thrifts provide CDFIs is quite large, the majority of that money goes to loan funds. It is important to note that the 144 responding loan funds have the largest amount of capital in general—almost \$2.5 billion of the total \$5.5 billion. Venture capital funds (26 respondents) account for \$205 million in capital, while credit unions (193 respondents) account for approximately \$1.8 billion and the 16 community development banks for \$1 billion.¹²

Figure 2 (page 6) shows that loan funds are particularly dependent on banks and thrifts as a proportion of their total capital. Nearly one-third of capital managed by loan funds is derived from CRA-regulated institutions. CRA-related investments are clearly crucial for these funds.¹³

CDFIs rely on outside sources for investments in order to help them expand into programs that would otherwise prove impossible. The average size of these investments varies by source of funds as well as by the type of CDFI receiving the funds. Table 1 (page 7) breaks out the size of representative investments in CDFIs made by banks and thrifts. The largest investments that banks and thrifts make to

⁸ Respondents were only able to break out \$3.5 billion of the total \$5.5 billion in total capital by source. Credit unions that responded using call report data were unable to break out capital using the same categories as the CDP. Of the \$3.5 billion in capital broken out by source for all CDFI types, 24 percent was provided by banks and thrifts. Moreover, the \$847 million in bank investments in the CDFI industry is the total bank/thrift investment in capital for loan funds, venture capital funds, CD banks, CD credit unions, and others.

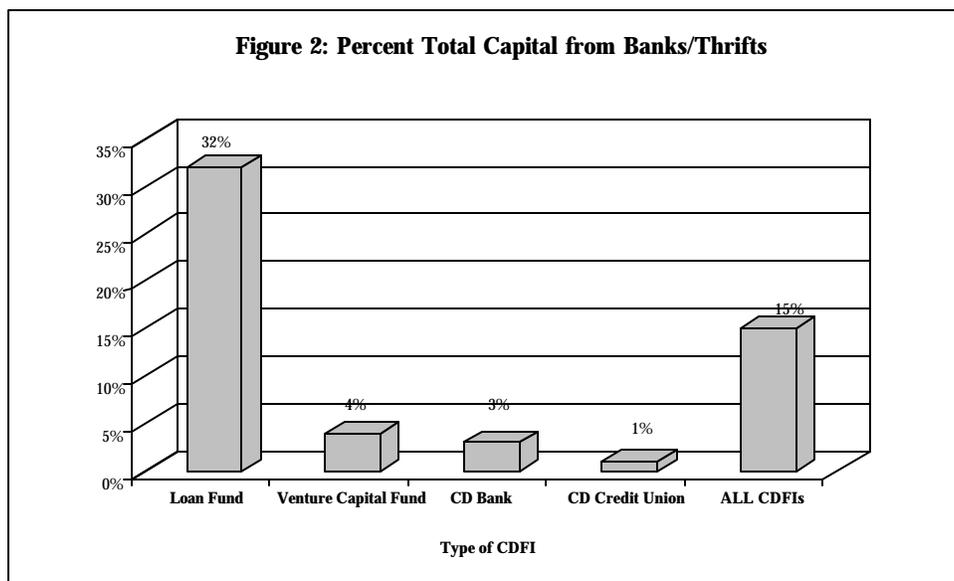
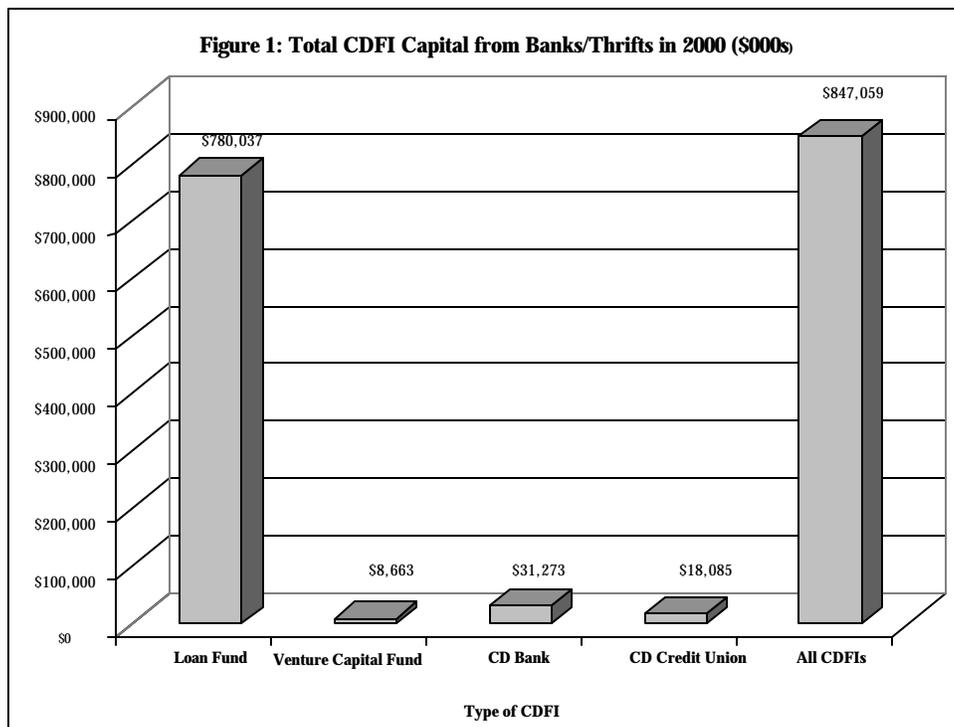
⁹ The CDP defines equity equivalent investments as having the following six attributes: “1) is carried as an investment on the investor’s balance sheet in accordance with GAAP; 2) Is a general obligation of the CDFI that is not secured by any of the CDFIs’ assets; 3) Is fully subordinated to the right of repayment of all of the CDFI’s other creditors; 4) Does not give the investor the right to accelerate payment unless the CDFI ceases its normal operations; 5) Carries an interest rate that is not tied to any income received by the CDFI; 6) Has a rolling term and therefore, an indeterminate maturity. (CDFI Data Project FY2000 Publication p. 24).

¹⁰ Community development banks are specially designated banks that provide capital to rebuild disinvested areas.

¹¹ Community development credit unions specialize in offering affordable and accessible financial services to lower-income people and minorities.

¹² It is important to note that one of the largest community development banks in the country, the Chicago-based Shorebank with assets of almost \$1.2 billion in 2002, is not included in the survey.

¹³ Community development loan funds, which are unregulated institutions that cannot take deposits, lend to and make investments in a range of projects in economically distressed communities. The four types of loan funds are microenterprise, small business, housing, and community facilities and service organizations. Community development venture capital funds provide debt and equity for real estate projects and medium-sized businesses in distressed areas.



CDFIs are in the form of borrowed funds to loan funds. Banks and thrifts provide different kinds of investments in credit unions than in other types of funds, including shares, non-member deposits and secondary capital investments.¹⁴

¹⁴For more information on the importance of secondary capital investments to community development credit unions, please see *Critical Capital: How Secondary Capital Investments Help Low Income Credit Unions Hit Their Stride* by Marva Williams. Chicago, IL: Woodstock Institute. 2002.

Table 1: Average Bank/Thrift Investment by CDFI Type (\$000s)¹⁵

Loan Fund	
Borrowed Funds	1078
Equity Equivalent	213
Total	1291
Venture Capital Fund	
Borrowed Funds	597
Equity Equivalent	750
Total	1347
Credit Union	
Borrowed Funds	944
Credit Union Shares	49
Non-Member Deposits	0
Secondary Capital	101
Total	1094
CD Bank	
Retail Deposits	0
Institutional Deposits	55
Total	55
Total Average Investment	525

Intermediaries' Investments in CDFIS

Another source of capital for CDFIs that is much more difficult to quantify in terms of CRA investments is the money that national nonprofit intermediaries contribute to CDFIs. CRA-regulated banks and thrifts are responsible for some of the money that these intermediaries receive, making the funds that intermediaries direct to CDFIs an indirect investment on the part of the bank or thrift.

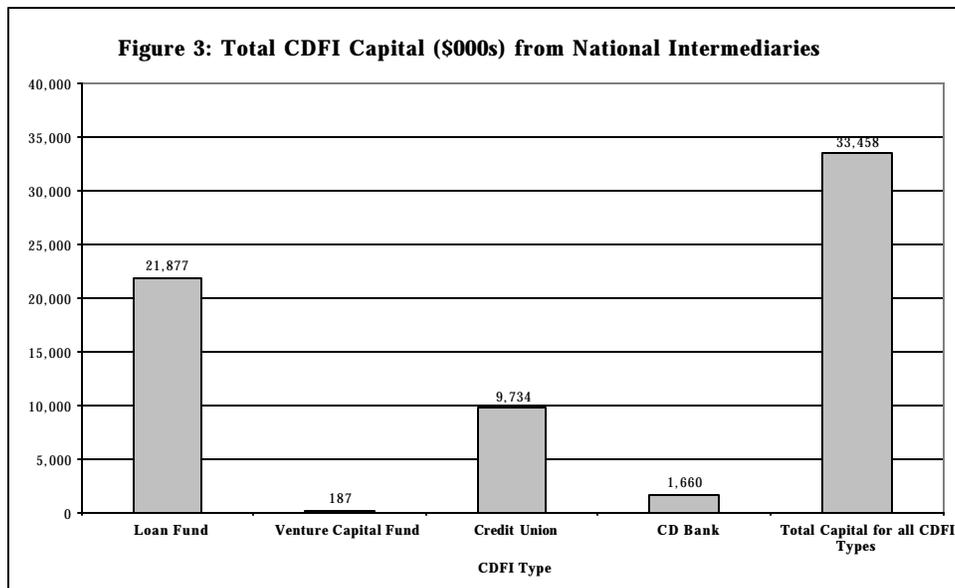
The largest national intermediaries that support and invest in CDFIs are the Local Initiatives Support Corporation (LISC), the National Equity Fund (NEF), the Association for Enterprise Opportunity (AEO),¹⁶ National Community Capital Association, Community Development Venture Capital Alliance, Corporation for Enterprise Development (CFED), National Community Investment Fund and the National Federation of Community Development Credit Unions. Figure 3 shows the amount of capital that each type of CDFI receives from national intermediaries.

Conclusion

This analysis demonstrates that CDFIs rely on investments from CRA-regulated financial institutions for both investment capital and grants, which enable them to fund projects as well as cover some of

¹⁵This represents the average investment made by each source of capital over the number of investors in a given category.

¹⁶AEO supports microenterprise organizations. Microenterprise entities that are primarily financing entities are included in the "loan fund" category of the CDP data.



their operational costs for difficult deals that would be impossible to do without such support. The investment test portion of the current CRA examinations is a crucial incentive for banks and thrifts to make these investments into CDFIs. While some of the investments attract lower rates of return, others command much higher rates and a bank can balance out the returns on different projects to make the investments worthwhile.

Without a separate investment test in the large bank portion of CRA exams, both regulators and financial institutions are likely to place less emphasis on this critical source of funds for CDFIs. This would be a huge loss to communities around the country, as CDFIs are at the forefront of community development activities in distressed areas nationwide. This would be consistent with the Administration's goal of promoting homeownership in minority communities, as CDFIs are a critical source of financing for minority homeowners. CDFIs have proven to be a crucial source of financing for housing, small business and retail development in urban and rural areas throughout the country and should continue to be supported through effective CRA regulation as well as through higher appropriations in the federal budget.

Moreover, the Bush Administration's proposed FY2004 appropriation to the CDFI Fund is \$51 million, which is much less than the \$68 million that the Administration asked for in FY 2003. The Fund actually received \$74 million in FY 2003, which is down significantly from a high of \$118 million in FY 2001. The national Coalition of CDFIs, which represents CDFIs and community development organizations around the nation, recommends that the Fund receive \$80 million for FY 2004. Support for this industry is needed on multiple levels, and the federal government should recognize the achievements of the CDFI industry by protecting these firms through strong enforcement of the investment test portion of CRA exams and by providing adequate funding for these vital financial institutions.

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