NATIONAL COMMUNITY CAPITAL ASSOCIATION

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Lessons for Community Development Financial Institutions

In leading a national network of community development financial institutions (CDFIs), NCCA has defined best practices in the field and helped meet a wide range of financial needs in rural and urban communities. The theme of your conference, "Growth through Change," is particularly relevant. We are at a major crossroad in several areas of public policy and banking. Continued consolidation of the banking industry, potential changes to the Community Reinvestment Act, and an evolving immigration policy are issues we all face. In any field, successful organizations must cope with change, consistently improve efficiencies, and recognize and seize opportunities. The question for you is: How can you increase the impact and reach of your financial institutions while dealing with these environmental changes?

Today I want to discuss some topics to consider as you try to answer this question. I will talk about some lessons I learned 30 years ago in my former job at HUD in funding Neighborhood Housing Services of America, which still provides mortgage financing and related services to low-income people and communities. I will also discuss some practices and ideas used successfully by other financial institutions, including some of your competitors. And finally, I will talk about the Federal Reserve's efforts to promote full access to the nation's financial system, including our support of the CDFI network.

Looking at recent developments, there are some promising trends in your industry. From 2000 to 2002, CDFI assets grew by an estimated 13 percent annually—that is an impressive record considering the slower economic growth early in the period. During fiscal year 2002, CDFIs financed 12,500 businesses and about 37,000 housing units, opened over 36,000 transaction accounts, and had total outstanding loans of $2.3 billion.

In our financial world, growth matters, but that is not your principal goal. The most important goal of CDFIs is to continually move consumers once considered 'high-risk' or 'unconventional' into the financial mainstream, and we at the Federal Reserve fully support this goal. To remain viable and relevant as specialized financial institutions, you must constantly re-evaluate your ability to deliver services at the community level competitively and cost-effectively. Moreover, the financial products that you offer must provide a return, they must be in demand, and your ability to deliver the products must be sustainable. That takes careful planning, assessment, and cooperative, informed efforts among funders and intermediaries at every level. But, to succeed at your main goal, commitment and market awareness at the local level are critical.

When I was an assistant secretary at HUD in the mid 1970s, we provided special funding to a new organization—Neighborhood Housing Services of America—that effectively balanced local market awareness and growth. There are parallels between NHSA and NCCA. Both organizations are affiliated with a broad network of small, independent institutions that offer financial services to underserved markets. And both have achieved very low default rates while doing so.

NHSA grew out of the joint work of the Federal Home Loan Bank Board and Neighborhood Housing Services of Pittsburgh. They had established training for loan officers serving older Pittsburgh neighborhoods in order to show lenders how to make safe, effective mortgage loans to nontraditional borrowers. Their objective was to preserve neighborhoods, rather than tearing them down under programs like Urban Renewal. The Federal Home Loan Bank committed to offering similar training in other parts of the country. Often, these training workshops formed the basis for new NHS chapters, now known as NeighborWorks organizations. Thanks to the network of NeighborWorks offices and the commitments of many national and local organizations, financial institutions, and governments, NHSA continues to stimulate neighborhood revitalization efforts around the country.

At first, the local NHS loan pools were funded almost exclusively by foundations. As demand grew, the foundations could not meet it alone. To help address the shortage of funds, the Oakland NeighborWorks, led by Mary Lee Widener, implemented a national loan-purchase resource, NHSA. The funds that we provided when I was at HUD supported the creation of this secondary market for NHS loans; in fact, we were the first group to provide funding for the program. NHSA bought loans from local NeighborWorks offices, securitized them, and sold the securities to investors at a moderate discount to market rate. This secondary market was critical for NHSA's expansion in two ways. First, it created a renewable funding resource for the revolving loan funds of NeighborWorks. Second, it provided cash flow for NeighborWorks to conduct homebuyer counseling and "hands-on" loan servicing.

One important lesson of the NHSA model is that when you provide full-cycle servicing and counseling, you lower the default rate, which enables you to provide affordable financing. Over the years, these efforts have yielded extremely low default rates, even lower than default rates in the conventional mortgage market. These low default rates keep capital markets interested in the securities and that keeps the cost of capital low.

To achieve similar success, CDFIs must also demonstrate that its borrowers can repay loans, and may even have to arrange credit enhancements beyond customary norms. For the inexperienced borrowers that CDFIs target, intensive services such as initial borrower training; dynamic, hands-on loan servicing; ongoing counseling; and even the ability to intervene if a borrower experiences a crisis may be necessary.

A second lesson from the NHSA story is the importance of relationships with various organizations. NHSA's early successes stemmed from its partnership with the Federal Home Loan Bank. Subsequently, it benefited from the involvement of officials at the Federal Reserve, the OCC, and the FDIC. NHSA has also established strong relationships with insurance companies, pension funds and others that invest in their securities.

The NHSA story offers many lessons for success, and it is a worthy case study of what can be achieved by thinking creatively, planning with a holistic approach, and building on existing resources. Still, there are other lessons you can learn from groups closer to home, including your competitors. While you and your competitors both target the same market segments—those just outside the margins of the economic mainstream—you do so with different goals. The primary goal of CDFIs is to continually move those consumers into the financial mainstream. By contrast, the overarching goal of so-called fringe financial institutions—such as check cashers, currency exchanges, and payday lenders—is profit. With this goal in mind, these firms are successful at connecting with their customers, marketing their services, and managing their costs. For example, one reason that check cashing services are popular is because they make their services convenient. Similarly, currency exchanges and other vendors offer immigrants a network to rapidly process remittances to their family members in other countries. And when these institutions find that they cannot perform a routine activity efficiently, whether it is processing a remittance or rating a customer's credit history, they subcontract it to a business that can. This allows the firms to minimize costs and leverage strong brands, enhancing their marketability.

I am not here to offer explicit support of check cashing services, currency exchanges, and payday lenders, but only to suggest that they might offer some ideas to broaden your impact as community intermediaries. After all, one high priority issue that the NCCA is addressing is the aggressive pricing and predatory lending by some of these firms. The best way to do that is to become a viable alternative; and that means learning from your competitors how to gain further efficiencies in delivering new and existing services.

All of the issues I have touched on, access to financial services for underserved populations, capital markets access, and predatory lending are high priorities for the Federal Reserve System and the Federal Reserve Bank of Chicago. We offer a number of services that can help community lenders, including our newest service, ACH International, which connects our clearing service with that of the central banks in Mexico, Canada, and five European countries. This service allows banks to send funds abroad for a much lower cost per transaction. Additionally, through our consumer and community affairs division, we research and address many topics related to understanding participation in the nation's financial system. We conduct original research, build on research of others, and provide forums where interested parties can share ideas, thereby working to inform the public policy debate. For instance, we hosted a capital markets workshop organized by Wall Street Without Walls earlier this week. If you are interested in our services or our research and events in this area, I encourage you to go to our website, chicagofed.org, for more information.

We are also an active supporter of CDFIs, and support your mission in tangible ways. For many years, we have hosted workshops and training sessions at the Chicago Fed, and we have used our publications to describe the impact of CDFIs in our region. We have encouraged the development of new partnerships between banks and CDFIs; we have brought together the parties that are interested in forming new community intermediaries; and we have helped banks within our five-state region become CDFIs. There are many Fed staff around the country that work with members of NCCA's network; Harry Pestine coordinates most of this work at the Chicago Fed, and I think you won't find a more devoted and informed supporter of your work in the Fed System.

In closing, your role as community intermediaries is one that is growing in importance. As you continually redefine the financial mainstream, the test before you is to determine ways to leverage your strength as a collective group. Some of your competitors at the neighborhood level also work on the margins of the financial system, and you can learn from these organizations, even if you do not agree with their pricing practices.

In our financial world, growth matters, but it cannot be the principal goal. Your local commitment and knowledge are, again, always critical. But your success will also depend on working with the right partners and coming up with creative ways to build broad networks to access capital, market your services, improve efficiencies, and manage the costs of your routine but important functions.