COMMUNITY REINVESTMENT
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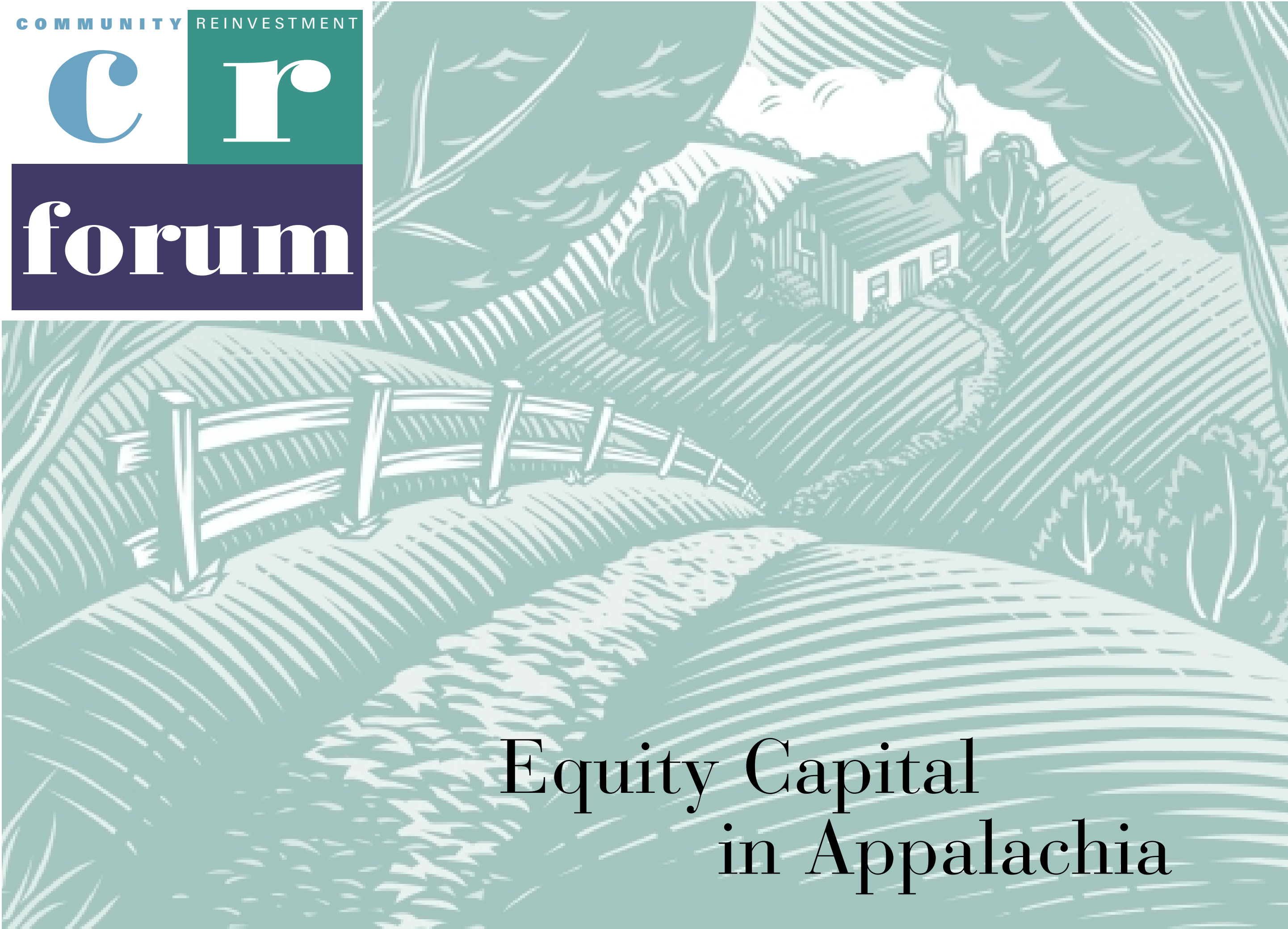
VOLUME ONE | ISSUE THREE | PUBLISHED BY THE FEDERAL RESERVE BANK OF CLEVELAND



Equity Capital in Appalachia

In recent years, there has been growing interest in financing small businesses located in distressed geographies through "developmental equity." Also referred to as developmental venture capital, it stands apart from other forms of financing in that it represents investment—and not debt—in small companies. Distinct from traditional venture capital, which is driven purely by financial returns, developmental equity is commonly referred to as the "double bottom line." While behaving like an investment that expects returns, developmental equity also seeks to serve social ends such as alleviating poverty and creating jobs in regions long plagued by economic depression.

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> "AN IMPORTANT KEY TO THE SUCCESS OF SMALL AND LARGE BUSINESSES IS HAVING ACCESS TO CAPITAL AND CREDIT. FIRST AND FOREMOST, I WOULD EMPHASIZE THAT CREDIT ALONE IS NOT THE ANSWER. BUSINESSES MUST HAVE EQUITY CAPITAL BEFORE THEY ARE CONSIDERED VIABLE CANDIDATES FOR DEBT FINANCING. EQUITY ACTS AS A BUFFER AGAINST THE VAGARIES OF THE MARKETPLACE AND IS A SIGN OF THE CREDITWORTHINESS OF A BUSINESS ENTERPRISE…THE NEWER THE FIRM, THE GREATER THE IMPORTANCE OF THE EQUITY BASE."
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> **Federal Reserve Chairman Alan Greenspan**
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> *Remarks from address to the Federal Reserve System Research Conference, Arlington, Virginia, March 9, 1999*

DEVELOPMENTAL equity, according to Julia Sass Rubin of the Harvard Business School, uses "long-term 'patient' capital investments in businesses to produce a positive, social and economic outcome, such as poverty alleviation, economic growth, and wealth creation among disadvantaged populations."

Locale, focus, deal size, and management differentiate developmental equity and traditional venture capital. Traditional fund investments tend to be concentrated in a few states, are dominated by the technology industry, average $7.7 million in size, and require limited management involvement. Developmental funds, on the other hand, focus on low- and moderate-income geographies, are not dominated by any one industry, average smaller deal size ($50,000 to $1 million), and provide businesses intense technical assistance.

One area where developmental equity is being explored is the Appalachian region of the United States. Encompassing 406 counties in 19 states, Appalachia is 42 percent rural. More than 90 percent of municipalities report unemployment and poverty rates well above the national average as well as lower-than-average per capita market income.

CLOSING THE EQUITY CAPITAL GAP

Recognizing that new methods were needed to stimulate economic growth in the region, in 1998, the Appalachian Regional Commission (ARC) convened a committee and employed Rubin's services to study Appalachia's significant equity gap. Rubin, currently completing a doctoral dissertation in developmental venture capital, has written extensively about the region's economy. In her paper, "Options for Increasing Access to Equity Capital in Appalachia," Rubin studies why the region has been so long ignored by traditional venture capitalists, identifies the challenges for developmental equity funds; and delineates opportunities for equity development available to both ARC and to community development financial institutions.

According to Rubin, a number of venture capital funds and small business investment corporations (SBICs) exist in the 13 Appalachian states, though none are located in the ARC region. These funds expect and get rates of return on investments that would be difficult to generate in economically depressed areas like Appalachia. Most venture capital firms and SBICs concentrate their activities where there is the most growth potential; in fact, 75 percent of traditional venture capital is invested in technology-related businesses–an industry that has little representation in Appalachia.

Established venture capital funds are very selective in the deals they will enter, often screening hundreds of deals to identify one or two that seem financially promising. To minimize their risk and cost, traditional venture capitalists focus on later-stage companies with established performance records and larger capital requirements. The average traditional equity investment is now more than $7 million.

Businesses in Appalachia do not fit this profile. The region's flow of deals is limited; often, businesses are in the opening stages of development, with equity requirements closer to $50,000, not $5 million.

DEVELOPMENTAL EQUITY: A FOCUS IN THE FOURTH DISTRICT

One of the longest standing and most successful developmental venture capital funds resides in the Fourth District. It also rightfully has claim to being the only such fund in the Appalachian United States. With its central headquarters in London, Kentucky, the Kentucky Highlands Investment Corporation (KHIC) invests in businesses located in its target area and encourages other businesses to move there. It provides a menu of services to area businesses, including equity, real estate construction, management and management consulting, and subordinated and collateralized debt. Fund manager L. Ray Moncrief, executive vice president and chief operating officer, is responsible for the investing activities of KHIC and Mountain Ventures. Moncrief was

4TH DISTRICT profil

Credit Union Preaches Gospel of Savings

As a student at John Hay High School in Cleveland 40 years ago, Rita Haynes volunteered as a cashier in a school banking program sponsored by Society Bank (now KeyBank). "It got me interested in math, because we had to balance at the end of the day," she recalled. "The program gave me such a great feeling. We would go downtown to that great big bank and deposit our money, and we felt that we were a part of it."

She married soon after graduation and joined Mt. Sinai Church with her husband. The church had a small credit union, and the young Mrs. Haynes was asked to help out. "That," said Haynes, "is how it became my ministry." Today, Haynes is the manager and chief executive officer of Faith Community United Credit Union, located on Cleveland's east side—one of a growing number of faith-based credit unions in the Fourth District.

Faith Community began in 1952 as the state-chartered Mt. Sinai Baptist Church Credit Union. In 1990, it changed its name to Faith Community United Credit Union and expanded its membership beyond the congregation to include anyone living, working, or worshipping in Cuyahoga County. Faith Community has become the largest African-American-owned, low-income community development credit union in Ohio, with $6.4 million in assets and almost 4,000 members.

"We attract people who have difficulty getting to a bank, or who just feel more comfortable doing business with us," Haynes explained. For more than 50 percent of the credit union's customers, Faith is the only depository financial institution they use. Faith Community United Credit Union is certified as a low-income institution, meaning that at least 51 percent of its members earn only 50 to 80 percent of the median income.

Credit unions like Faith Community offer members benefits in the form of higher interest on savings accounts, lower loan rates, added services, and reduced fees. For an initial membership purchase of 10 shares ($50), members are entitled to all the services the credit union offers: check cashing, money orders, savings, Christmas club, vacation club, car loans, first and second mortgages, and even a special personal computer loan fund.

PEOPLE HELPING PEOPLE

Because the credit union's mission differs from that of a commercial bank, and because it does not have to make a certain profit for its shareholders, Faith's underwriting standards are less stringent than traditional banks. "Our mission is to lend money and to distribute profits back to the membership," explained Haynes. "Of course we make profits from interest and fees, but we try to loan out most of our money because the purpose of the credit union is people helping people. Those who can save, save, and loan it out to those who need to borrow. That is why we can afford to make loans to people that a lot of banks wouldn't."

Delinquencies run between 2 percent and 5 percent, higher than what is traditionally considered acceptable to banks. Borrowers are reminded that failing to pay back a loan as agreed hurts other members as well as the credit union. Faith's aggressive collection philosophy means that loan officers work closely with borrowers to help them pay back an amount they can manage.

Teaching money-management skills is an important part of Faith's mission. According to Haynes, "We educate people to use credit wisely and not to overextend themselves." At one point, the credit union required members to have 20 percent of the amount they wanted to borrow in a savings account. Although Faith no longer requires such a guarantee, it prefers borrowers to keep some money in a savings account, particularly when larger loans are requested.

Loan officers counsel members who are turned down for loans because of high debt ratios or poor credit history. The credit union also works with Consumer Credit Counseling and other nonprofit organizations, using grant money from a local foundation to help customers repair their credit. Participants must provide a written explanation of how they got into debt, and then they are assigned a mentor. The program boasts an 80 percent on-time payback rate; most of the remaining 20 percent pay, although not as agreed.

SAVING GRACE

Faith Community United Credit Union recently launched a product called the Grace loan. "It's really a payday loan," explained Haynes, "but we call it a Grace loan, for God's grace. We don't run a credit check. The only requirement is that the recipient must be on direct deposit so we know their check is coming." The product was designed to prevent customers from using high-priced check-cashing outlets for quick cash in emergencies.

"Say, for example, a customer's car has two tires blow out. Winter is approaching, and he needs that car to get to work. There's a tire sale going

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“We attract people who have difficulty getting to a bank, or who just feel more comfortable doing business with us.”
—Rita Haynes

on and he doesn't want to wait until payday—he needs it right now. We will advance him the money."

According to Haynes, the product has skyrocketed. "We counsel customers, that's the difference. We are not trying to get them hooked like the payday lenders." As part of the bargain, Faith requires borrowers to save a portion of the fee they would have been charged by a payday lender to cover future emergencies.

Because the credit union is a certified Community Development Financial Institution, banks depositing funds with Faith Community may earn CRA credit under the investment test. Banks can also receive credit under the service test by providing technical assistance to the credit union staff as they begin to provide small-business lending. Faith also partners with WECO (Working for Empowerment through Community Organizing) on special programs like microenterprise lending and Individual Development Accounts.

"We believe in our members," said Haynes. "We let them know at the very beginning they are somebody. Even people on welfare have accounts with us. We help get them into the mainstream by allowing them to have an ATM card, to maintain checking and savings accounts, and to use direct deposit. I think this gives them faith in themselves and in the future, and that is what faith is all about."

Credit Through Faith

Today, in burgeoning numbers, faith-based groups are managing credit unions that supply access to capital and credit for less advantaged persons in their communities. As an outgrowth of community development credit unions, nearly 850 faith-based credit unions operate nationwide. Churches are a natural home for these credit unions, which have surfaced particularly in communities of color, where there are no other available financial services, and where the church is recognized as the leader of social and civic activity. Seventy-five percent of new credit union charters are granted to faith-based organizations. Approximately 100 are based in the Fourth Federal Reserve District and represent the continuing need to provide low-income individuals with pathways to participation in our country's mainstream economy.

Credit unions date back to the 1840s in Germany, when people of modest means formed cooperatives to gain entry to banking services they could not otherwise have accessed. The first credit union in the United States was established in 1908 at St. Mary's Church in Manchester, New Hampshire. Calling it St. Mary's "Bank," for want of another word, it made financial services available in the form of savings and loans to their membership, who were typically low-income community residents and congregates of the church.

BUILDING ECONOMIC FREEDOM

Many faith-based credit unions are community development credit unions because of the nature of the populations they serve. A form of economic self-help, community development credit unions provide a way for people in low-income areas to pool their money and make loans to one another.

Community development credit unions differ from standard credit unions in that their mission—to serve low-income individuals—affords them special designation by regulators. The CDFI (Community Development Financial Institution) classification allows them to raise capital through nonmember foundations such as the George Gund Foundation, the John D. and Catherine T. MacArthur Foundation, and the Calvert Social Investment Fund. In addition to secular investors, religious groups such as the Adrian Dominican Sisters, the Methodist Board of Global Ministries, and the Presbyterian Church Foundation have provided loans and deposits to help the movement grow.

Faith-based credit unions distinguish themselves from community development credit unions because they are driven by religious beliefs and an obligation to work with the less fortunate in their congregations. According to Rev. Perry E. Henderson Jr. of Dayton, Ohio, faith-based credit unions "reinforce the philosophy of self-help, self-development, and self-affirmation."

Groups interested in starting faith-based community development credit unions can contact the National Federation for Community Development Credit Unions, which offers financial and technical assistance. For information, call program officer Dianah Shaw at 212/809-1850, ext. 218. The NFCDCU also publishes several books on faith-based credit unions; see Faithful Stewardship: a Guide to and for Faith-Based Credit Unions. Additional information can be found on the Web at www.natfed.org, www.nonprofit.net/woodstock/CDFI.html, and www.ncua.gov or by calling the Faith Center for Community Development at 212/785-2782.

IN MY opinion

The Community Reinvestment Act: Where Do We Go from Here?

BY RICK TAYLOR
HOUSING POLICY DIRECTOR
COALITION ON HOMELESSNESS
AND HOUSING IN OHIO

__Rick Taylor__ is the housing policy director for the Coalition on Homelessness and Housing In Ohio (COHHIO) and the Ohio Community Reinvestment Project (OCRP). OCRP is a statewide membership organization that represents approximately 120 nonprofit fair housing and civil rights groups, housing development organizations, homeless service providers, community development corporations, community-based groups, and government agencies. Created in 1995, OCRP promotes investment in Ohio's low-income communities and communities of color. To date, OCRP has successfully negotiated cooperative agreements with three financial institutions, resulting in an estimated $34 million in reinvestment. While he is relatively new to the community reinvestment world, Taylor comes from a background in supportive housing. He served as the planning and development coordinator of Neighborhood Properties, Inc. in Toledo, Ohio, a not-for-profit housing development organization providing supportive housing options for people with mental illness.

The views stated in this article are those of the individual author and are not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Even as I finish writing this article, the future of the Community Reinvestment Act–and its ability to direct much-needed resources into traditionally underserved communities–remains unclear. On November 12, President Clinton signed into law the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. The signing of this bill came after weeks of negotiations among the House/Senate Conference Committee and representatives of both the Treasury Department and the Clinton Administration. This deal, which fundamentally changes the landscape of the financial services industry in the United States, culminates nearly 25 years of work by financial institutions, insurance companies, and securities firms.

While some would have us believe that Gramm-Leach-Bliley ends "depression-era" restrictions, allowing banks, insurance companies, and securities firms to provide an unprecedented level of financial services to customers, others contend that it rolls back the very law that has made the American dream of homeownership a reality for millions. It seems that everyone has an opinion on this issue: Local Initiatives Support Corporation supports the bill, while the National Community Reinvestment Coalition opposes it. But regardless of your ideological slant, it is clear that the financial services industry has changed, for better or worse.

In my opinion, CRA survived an overtly aggressive and unprecedented attack by Senator Phil Gramm and the Senate Banking, Housing, and Urban Affairs Committee. Under the guise of financial modernization, this committee set out to destroy the very tool that has channeled $1 trillion in loans and investments into minority and working class neighborhoods. The committee misstated facts and misrepresented the terms of agreements in an attempt to paint CRA advocates as extortionists, or as organizations simply out to make a buck. It wasted countless hours and precious resources conducting what could best be described as a witch-hunt. Perhaps the people would have been better served, had the time and resources spent over the past several months been used to address the affordable housing crisis in this country?

In spite of this attack, the Community Reinvestment Act survived. When comparing the language found in the Senate version (S. 900) of the bill to that of the Conference Committee report, it appears that CRA's merits won out over the rhetoric. The final report indicates that CRA will remain vital and relevant in the new financial landscape. This statement, however, should not be construed as a wholesale endorsement of the financial modernization legislation passed by this Congress and signed by President Clinton.

This was an opportunity to build upon the success of the Community Reinvestment Act by bringing it in line with an industry that has changed dramatically over the past 22 years. This was an opportunity to bring insurance companies and securities firms under the umbrella of the CRA to ensure that a

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new generation of "red-lining" is not born. This was an opportunity to ensure that minority and working class neighborhoods will continue to benefit from reinvestment activities. As it stands, however, this opportunity was lost. The Community Reinvestment Act was, in a sense, sacrificed for the benefit of corporate America. While the financial services industry prepares to enter the 21st century, CRA remains stuck in 1977.

The Gramm-Leach-Bliley Act offers some token concessions with respect to CRA. The Committee report preserves the current CRA review-and-comment process for banks acquiring or merging with another bank; it extends CRA to cover banks and bank holding companies commencing new activities or acquiring or merging with nonbank entities; it eliminates the "small bank exemption" provision; it eliminates the "safe harbor" provision; and it does not allow for the creation of wholesale financial institutions.

These token concessions, however, come at a price. Gramm-Leach-Bliley requires full disclosure of agreements between banks and community-based organizations made pursuant to, or in connection with, the Community Reinvestment Act. While requiring disclosure from both parties, this provision prohibits regulatory agencies from monitoring CRA agreements to determine whether banks are meeting agreed-upon objectives. While the full scope and magnitude of this "sunshine" mandate is still in question, it is likely to adversely affect community-based organizations' ability to successfully negotiate agreements with banks.

Gramm-Leach-Bliley institutes a revised examination schedule for banks with less than $250 million in assets. The final legislation extends the time between routine examinations for banks (urban and rural) with outstanding CRA ratings to once every five years, and once every four years for banks with satisfactory CRA ratings. Examinations for banks with less-than- satisfactory ratings would be left to the appropriate regulator's discretion.

Finally, Gramm-Leach-Bliley requires that the Federal Reserve Board conduct a comprehensive study of CRA, focusing on default rates, delinquency rates, and the profitability of loans made in conformity with CRA. In addition, the Treasury Department is required to study the extent to which adequate services are being provided as intended by CRA. Both reports must be completed and submitted to the House and Senate Banking Committees no later than March 15, 2000. Is it possible to conduct more than a cursory examination of CRA in four months?

Financial institutions, insurance companies, and securities firms have been advocating this legislation since the 1970s. Since the beginning of 1999 alone, the financial services industry has spent more than $30 million on lobbying activities. Careers have been built and portfolios have been banked on the hope that our financial services industry would some day be modernized. If not for our actions, there is little doubt that this modernization would have completely destroyed the Community Reinvestment Act.

While many of the details regarding the "sunshine" mandate, the revised examination schedule, and the required CRA studies will be spelled out in the final regulations, it is worth noting that the result could have been much worse. Granted, Gramm-Leach-Bliley does not contain the pro-CRA provisions that advocates called for. But neither does it contain provisions that would effectively exempt more than 80 percent of the nation's banks from CRA.

The Community Reinvestment Act has produced tremendous increases in safe and sound lending for working class and minority communities. Recently, Federal Reserve Board Governor Edward Gramlich estimated that $117 billion in CRA-related home, small business, and community development loans are made on an annual basis. Just last year, borrowers in low- and moderate-income census tracts received more than 1.2 million home loans and half a million small business loans. While the fight goes on, it is imperative that we not lose sight of the collective difference made by CRA over the past 22 years.

CR FORUM
ACKNOWLEDGEMENTS

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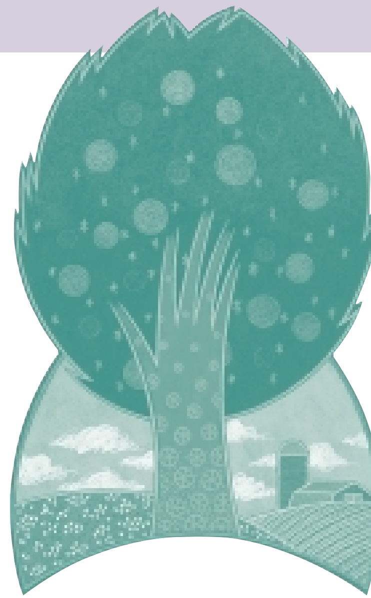
They may require extensive technical assistance in the form of management help to expand. Traditional funds are unlikely to engage in such handholding. But these are issues that beg the attention of any organization proposing to enter into a developmental equity program.

Development finance organizations considering moving into developmental equity must recognize the challenges of offering equity to such businesses. Developmental venture capital does not offer the same level of financial return as traditional venture capital, making fundraising slow and difficult. The need for extensive technical assistance and the small size of the deals makes overseeing such investments costly. Not only that, equity investments require a unique skill set that is very different from that of lending; finding qualified individuals with both the necessary business skills and an understanding of economic development can be difficult.

GROWING DEVELOPMENTAL VENTURE CAPITAL FUNDS

Rubin has found that there are options for ARC to increase the number of successful developmental venture capital funds in the region, and she makes several recommendations for raising capital and developing fund management capacity. Not surprisingly, banks and foundations have played key roles in backing the 30-plus funds that exist in the United States today. Banks can, in some cases, receive CRA credit for investing, and many have made commitments to equity funds ranging from $50,000 to over one million dollars. Foundations that focus on economic development make good sources for capital pools, including the Ford, Heron, and MacArthur foundations.

Government sources such as the U.S. Small Business Administration (through its SBIC program) and the Community Development



Finance Institution Fund of the U.S. Treasury, utility companies, individual social investors, and revolving loan funds may provide additional funding. Some states have tax credit programs that encourage investment in equity funds. Organizations must attend to the legal corporate structure of their funds in order to appropriately approach funding sources. Rubin's study reveals that "a freestanding DVC (developmental venture capital) fund should be capitalized at a minimum level of $10 million."

Vital to the success and longevity of any developmental equity fund are the people who manage it. Since developmental funds cannot afford to hire traditional venture capitalists, it is incumbent upon them to train staff. The Community Development Venture Capital Alliance, for instance, is a national trade association for developmental equity funds that offers core training at its annual conference. In addition, it is proposing a fellowship program to enable fund staff and other qualified individuals to apprentice with existing developmental venture capital funds for two years.

The Appalachian Regional Commission has formed a committee comprising ARC, developmental fund staff, banks, and nonprofit development finance agencies to fine-tune the equity capital initiative for all of Appalachia. ARC hopes this committee's efforts will create more developmental equity pools and the means to develop staff capability to manage such funds to expand economic opportunity throughout the Appalachian states.

a featured speaker at the recent ARC equity capital sessions co-sponsored by Federal Reserve Banks in Pittsburgh and Charlotte and provides management and consultation to organizations interested in developmental venture capital.

# of interest

Fed Governor Addresses Fourth District Concerns

The Honorable Edward M. Gramlich, member of the Board of Governors of the Federal Reserve System and Chairman of the Committee on Community Affairs, visited the Fourth District on two occasions this year. In June, he spent time in Pittsburgh meeting with public officials and community leaders at a private reception, touring Pittsburgh neighborhoods, and serving as the keynote speaker for the "Making Cities Work" luncheon.

In September, Governor Gramlich traveled to Cleveland. Typically, when Federal Reserve Governors travel, a large portion of their time is spent talking to people. During his trip to Cleveland, the Community Affairs staff provided Governor Gramlich opportunities to also hear from people. Gramlich toured two Cleveland neighborhoods, Fairfax and Tremont, highlighting projects where the Community Reinvestment Act played a role in involving the banking community. Gramlich noted the extent to which the CRA has been able to stimulate housing activity, although it has not been able to do the same for small business.

Representatives of the banking community, community development organizations, and municipal government met with Gramlich in a roundtable discussion, "Key Elements of Community and Economic Development." Panel members addressed a broad range of topics including the difficulty of complying with new CRA requirements of large institutions, the importance of public–private partnerships, and the continuing need for the CRA and similar legislation to provide the proper incentives for community development. Participants admitted that although CRA deals are profitable for financial institutions, they are not as profitable as other deals and often require a lot more work.

Governor Gramlich concluded his visit by delivering the keynote address at the 11th Congressional District Small Business Conference, sponsored by Rep. Stephanie Tubbs-Jones. In his address, the Governor remarked on Cleveland's impressive development activity; based on his observations during his visit and the comments of local community development professionals, he concluded that Cleveland's rejuvenated housing market is ready for the addition of renewed commercial activity.

Developer and general contractor Keith Sutton (right) tells Governor Gramlich how CRA-stimulated investment is helping Tremont homeowners and businesses ensure the neighborhood's economic resurgence.

"Making Cities Work" in Cleveland

Building on the success of the Pittsburgh office's "Making Cities Work" program, the Cleveland Fed's main office launched the first of its programs in November. International real estate development consultant Donovan Rypkema delivered the luncheon address, "Preservation for Profit," sponsored in partnership with the Cleveland Restoration Society.

In his sold-out address, Rypkema discussed the seven economic benefits of historic preservation: jobs, heritage tourism, small-business incubation, downtown revitalization, small-town revitalization, neighborhood stability, and neighborhood diversity. The economic of impact of rehabilitation, he posited, is greater than that of manufacturing activities because rehabilitation generates more jobs and more household income due to its labor intensity. Because more labor is required for rehabilitation, it promises greater economic benefits.

Historic buildings are ideal for small businesses. While newly constructed commercial buildings may be too large for the needs of a small business, historic buildings are the ideal size and are more affordable. High-tech companies around the country are locating in old industrial and retail buildings in areas such as Seattle, Portland, Boston and Cambridge, and "Silicon Alley" in Manhattan. Preservation of our older structures provides communities with space for emerging businesses.

Rypkema stressed that for historic preservation to be successful, it must be part of an overall economic development strategy. Common denominators of success include effective partnerships, sufficient time to complete the project(s), and an available package of both regulations and incentives.

During his visit, Rypkema also conducted an informal technical assistance session with representatives from local community development companies and toured three of Cleveland's historic neighborhoods—Shaker Square, Ohio City, and Slavic Village—remarking on the work that Cleveland has done to maintain its historic neighborhoods. The Cleveland Fed extends special thanks to Reid Robbins, John Wilbur, and Marlane Weslian for hosting the tour of their neighborhoods.

To receive a copy of Rypkema's remarks, "Preservation for Profit," contact Laura Kyzour at the Federal Reserve Bank of Cleveland at 216/579-2846.