Economic Commentary

ISSN 0428-1276

Community Development Corporations

by Judy Z. Menich

Over the past 20 years, considerable attention has focused on community development and revitalization, largely in response to the economic problems of our nation's older, industrialized cities. Although urban revitalization and reinvestment traditionally have come under the purview of federal agencies such as the Department of Housing and Urban Development and the Economic Development Administration, there is a growing trend toward encouraging greater private-sector involvement in such efforts. In particular, legislation such as the Community Reinvestment Act of 1977 places affirmative responsibility on financial institutions to undertake the promotion of community development. The stagnation and decline of many large urban areas have prompted financial institutions to search for methods to arrest these unfavorable trends. To be successful, efforts to revitalize urban areas must rely on the initiative, creativity, and capital investments of the private sector. Financial institutions, like community residents, have a vested interest in the economic vitality of their communities—a fact that has sharpened their interest in community development projects.

This *Economic Commentary* examines one vehicle that enables financial institutions to participate in and stimulate the economic revitalization of their local communities—the community development corporation. A community development corporation (CDC) is a legal entity organized to engage in redevelopment activities—that is, projects that are intended to meet the economic, physical, and/or social needs of a community. This article also briefly reviews the provisions of both the Bank Holding Company Act of 1956 (as amended) and the Community Reinvestment Act that relate to the formation and activities of a CDC. Although financial institutions have participated as junior partners in the projects of hundreds of community-based CDCs throughout the country, this article focuses on CDCs that have been initiated by banks and bank holding companies.

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

Regulatory Background

The 1970 amendments to the Bank Holding Company Act of 1956 authorize the Board of Governors of the Federal Reserve System to approve applications by bank holding companies to engage in nonbanking activities that are closely related to banking. Included among these permissible activities is the provision enabling "... equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas." The inclusion of this activity reflects the Federal Reserve System's policy of encouraging bank holding companies "to take an active role in the quest for solutions to the nation's social problems."[1] Although the Federal Reserve Board's published interpretation of the 1970 amendments highlights projects specifically targeted to low- and moderate-income areas, other projects designed to promote community welfare also are permitted. The Federal Reserve Board does not delineate specific investments, but instead allows bank holding companies considerable flexibility to develop and implement their own projects.

Permissible investments include, but are not limited to, projects that (1) construct or rehabilitate housing for low- and moderate-income groups; (2) construct or rehabilitate ancillary local commercial facilities necessary to provide goods and services principally to serve low- and moderate-income neighborhoods; and (3) create employment opportunities for low- and moderate-income individuals.

National banks can make direct investments in CDCs subject to the satisfaction of several conditions specified by the Comptroller of the Currency.[2] Any national bank may invest in a CDC provided that (1) the project is of a predominantly civic, community, or public nature and not merely private or entrepreneurial; (2) the bank's investment in any one project does not exceed 2 percent of its capital and surplus, with the aggregate investment in such projects not exceeding 5 percent of its capital and surplus; and (3) the investments appear on the bank's books under "other assets."[3] In addition, the Comptroller of the Currency requires all CDCs to include a majority of community-at-large representatives on their boards of directors. Although the CDC can be set up as a profit corporation, dividends cannot be remitted to the parent bank for at least three years after the CDC's formation. A CDC approved for national-bank investment may acquire, own, rehabilitate, construct, or sell real estate in a targeted area; extend loans or grants to promote projects related to a CDC's activities; serve as an information clearinghouse between the bank and the community; provide technical assistance in planning, financing, and implementing related activities; and conduct or contract for research and studies related to community development activities. A CDC may be owned wholly or jointly by two or more banks or by a bank and a community organization.

CDCs formed under the Comptroller of the Currency or the Federal Reserve Board's rulings may be set up as either for-profit or not-for-profit entities. The choice of structure will determine the resources that the CDC is eligible to receive and the recipients of revenues from projects. A not-for-profit CDC can receive foundation grants, while a for-profit CDC cannot. Moreover, if the CDC obtains a federal tax exemption as a charitable corporation, it can attract charitable donations. Any "profits" earned by the CDC, under certain conditions, can be nontaxable and eligible for reinvestment in the community. A for-profit CDC, on the other hand, can attract private investment (as opposed to grants and donations) and can distribute its profits in the form of dividends. In addition, a for-profit CDC can receive Small Business Administration (SBA) loans, while a not-for-profit CDC cannot. A for-profit CDC also can pool the profits

1. See Published Interpretations of the Board of Governors of the Federal Reserve System, Paragraph 7377, Investments in Community Welfare Projects, June 1972.

2. State member and nonmember banks must abide by state banking laws regarding the formation of CDCs. To date, no state banks have formed CDCs, perhaps because most state laws pertaining to the formation of CDCs have been confusing and difficult to interpret.

3. See Comptroller of the Currency, Interpretive Ruling 7.7480, *Investment in Community Development Projects* [12 U.S.C. 24 (a)(8)], 1978.

and losses of its subsidiaries to reduce its overall tax liability. To maximize the funds at its disposal, a for-profit CDC can form a not-for-profit arm to take advantage of foundation grants and charitable donations.

Bank holding companies have been authorized to form CDCs since 1970. The Board of Governors of the Federal Reserve System has approved eleven applications by bank holding companies to form CDC subsidiaries (see box). The Comptroller of the Currency has approved six applications by national banks to form CDCs since 1978.

One factor that may stimulate interest in CDCs is the Community Reinvestment Act of 1977 (CRA). The CRA requires financial institutions to demonstrate that their deposit- and credit-granting facilities serve the credit needs of the communities in which they are chartered. The CRA also requires federal regulatory agencies to encourage a financial institution to ascertain and meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound lending practices. The regulatory agencies must consider the CRA record of the financial institution when evaluating an application for merger, acquisition, branch office, or other structural change. In effect, the CRA may be viewed as an effort to strengthen the link between the activities of financial institutions and local housing or community development. When assessing an institution's record of meeting the credit needs of its local community, the regulatory agency considers the institution's participation in community development programs.

Through participation in a CDC, a financial institution can assume a more active role in initiating community development projects. As outlined earlier, a CDC enables a bank to initiate a variety of projects and to raise venture capital for these projects. In addition, a CDC allows a bank or bank holding company to own or rehabilitate real property, an activity otherwise prohibited. Thus, a CDC permits a financial institution to participate in activities that would otherwise be prohibited.

CDC Investment Activities

Although the investment activities of CDCs are as diverse as the problems they face, several characteristics have emerged as common to successful CDCs. These include (1) strong commitment on the part of the participating financial institution and willingness to assume a leadership/initiator role; (2) targeting of projects to specific, well-defined neighborhoods; (3) support of residents in the community; and (4) leveraging of funds. The following examples illustrate the importance of these factors to a CDC's success.

The decision to form a CDC implies strong commitment on the part of a financial institution to participate in a community's revitalization. Nevertheless, the success of any individual project depends overwhelmingly on the willingness of the financial institution to assume an active role in transforming development ideas into viable projects. One example of a financial institution's assuming a leadership role in urban redevelopment is the South Shore Bank of Chicago, the banking subsidiary of the Illinois Neighborhood Development Corporation (INDC). INDC's other subsidiaries are City Lands Corporation, a for-profit CDC formed to acquire, rehabilitate, and sell residential and commercial properties in South Shore; the Neighborhood Fund, a minority small business investment corporation licensed by the Small Business Administration to invest venture and development capital in minority businesses; and the Neighborhood Institute, a not-for-profit CDC that engages in social and economic development activities.

INDC acquired controlling interest in the South Shore National Bank in 1973, following a denial by the Comptroller of the Currency of the bank's application to relocate to a downtown site. INDC's primary goal has been to promote neighborhood revitalization through the activities of the bank and its affiliates. The bank has focused its activities on development lending, loaning over $30 million for development projects since 1973. Over 20 percent of the bank's loan portfolio consists of mortgage and rehabilitation loans

Active Community Development Corporations

Bank holding company/national bank	CDC subsidiary	Permit date	Initial capitalization	Major activities
J.P. Morgan & Co., Inc. New York, NY	Morgan Community Development Corp.	11-9-71	$1 million	Rehabilitate low- and moderate-income housing; undertake economic development of low-income neighborhoods
Citicorp New York, NY	Citicorp Community Development, Inc.	1-20-72	$10 million	Rehabilitate and/or construct low- and moderate-income housing
Marine Midland Banks, Inc. Buffalo, NY	Marine Midland Realty Credit Corp.	1-15-72	$200,000	Lend on interim basis for construction of commercial properties and housing developments
First Bank System, Inc. Minneapolis, MN	First Building Corp.	11-5-73	$250,000	Construct and lease grocery store in minority neighborhood
Pyramidwest Development Corporation Chicago, IL	1. Pyramidwest Realty and Management, Inc. 2. California Health Care, Inc.	6-16-77	$2 million	Manage existing commercial and industrial developments and existing HUD properties; arrange financing for housing developments
Illinois Neighborhood Development Corp. Chicago, IL	1. City Lands Corp. 2. The Neighborhood Institute	12-19-77	$100,000	Rehabilitate low-income housing; revitalize commercial areas
The First Bancorporation Chelmsford, MA	First Bancommunity Development Co.	4-28-78	$100,000	Rehabilitate low-income housing for elderly
Rainier Bancorporation Seattle, WA	Rainier Community Service Corp.	5-26-78	$500,000	Construct and sell housing
The First National Bank of Chicago Chicago, IL	First Chicago Neighborhood Development Corp.	3-9-79	$1 million	Rehabilitate low-income housing; revitalize commercial and industrial areas
North Carolina National Bank Charlotte, NC	NCNB Community Development Corp.	3-29-78	$250,000	Rehabilitate and/or construct middle-income housing
First National Bank and Trust Company of Rockford Rockford, IL	First Rockford Community Development Corporation	6-15-79	$100,000	Rehabilitate low-income housing; revitalize commercial areas
Mercantile Trust Company, N.A. St. Louis, MO	Mercantile Community Development Corporation	7-29-80	$500,000	Rehabilitate housing in low- and moderate-income neighborhoods
First National Bank of Fayetteville Fayetteville, AR	First National Bank of Fayetteville Community Development Corp.	2-12-81	$200,000	Redevelop commercial areas
First National Bank of Waseca Waseca, MN	First National Bank of Waseca Community Development Corp.	3-11-81	$25,000-$40,000	Develop housing and commercial area in rural community

for South Shore housing. The bank's Parkside Banker program, which examined the housing problems of South Shore's most blighted areas, was the impetus to the Parkways project of City Lands.

Two of the bank's affiliates—City Lands Corporation and the Neighborhood Institute—have complemented the bank's efforts in neighborhood revitalization. City Lands' most ambitious project has been the Parkways, the largest multi-family rehabilitation project currently under way in the country. The project will produce 446 units of rehabilitated housing partly at market rates and partly subsidized by Section 8 rent supplements, at a cost of roughly $20 million. This project is a joint venture with First Chicago Neighborhood Development Corporation (a subsidiary of First Chicago Corporation) and RESCORP (a real estate service corporation owned by 55 Chicago savings and loan associations).

In addition to demonstrating a strong commitment to a specific project, most successful CDCs have targeted their efforts to a single, well-defined neighborhood, thereby increasing their visibility and the likelihood of generating additional investment for other projects. Within the context of targeting, some CDCs have adopted the strategy of pursuing small, short-term projects, while others have chosen the route of large-scale land development. Generally, small projects entail less risk than large-scale, long-range developments, and the failure of a small project is less catastrophic than that of a larger involvement. The small-project strategy was adopted by First Bank System of Minneapolis, which built and financed one grocery store in a minority neighborhood. This project, in turn, generated additional investment in a small shopping center in the same neighborhood.

One notable example of the broad-based approach is the Pyramidwest Development Corporation (formerly the North Lawndale Economic Development Corporation), which is located in the North Lawndale community on Chicago's west side. Pyramidwest was a CDC that became a bank holding company by acquiring the Community Bank of Lawndale. Its two other subsidiaries are Pyramidwest Realty and Management, Inc., and California Health Care, Inc. Although the founders of Pyramidwest recognized the risk inherent in a large-scale land development strategy, they undertook this approach to have a measurable impact on the community and to enlist the support of neighborhood residents. Because land development projects are more complex and require more time for completion, the CDC often foregoes the rewards provided by small projects offering quick successes. In addition, large-scale land acquisition involves extensive dealing with all levels of government as well as property owners.

Another factor critical to a CDC's success is the financial institution's ability to elicit the participation of community residents who will be directly affected by the project. The effectiveness of its development efforts depends on acceptance and cooperation by community residents who must live with the consequences of any project. By eliciting resident input, the CDC will be better able to show community residents that their interests are being served.

Finally, CDCs must take advantage of the variety of funding sources available for development projects and package their projects to attract private as well as public funding. While private-sector commitment is essential for community development projects, direct government support of redevelopment efforts is also available. There are numerous programs available that use public funds as an incentive to attract private-sector investment. Programs such as the urban development action grant (UDAG), administered by the Department of Housing and Urban Development, require an up-front, private-sector commitment before approval of an application. The Warren-Sherman area in Toledo is an example of a major development effort that utilized both public and private financing. Toledo's largest bank and largest corporation, Toledo Trust Company and Owens-Illinois, respectively, prepared a plan to revitalize Toledo's distressed downtown. In addition, a commitment was obtained from the city of Toledo to support the effort with public improvements that would complement the private investments. The city of Toledo responded by obtaining a $12-million UDAG to fund various improvements and projects in the adjacent areas.

Section 8 rent supplements also have been used extensively to counter the adverse effects of displacement that often occur in rehabilitated neighborhoods. The Parkways project, described earlier, utilized Section 8 rent supplements to ensure that rehabilitated properties would benefit low- and moderate-income families. The CDC obtained a federal commitment of rent subsidies as well as below-market financing from the state housing finance agency. Federal grants also have been used to establish investment companies that finance small, young companies as well as loan-guarantee programs to protect loans extended by commercial banks.

Conclusion

Although the activities of CDCs are broad in scope, all face the challenge of going beyond the normal mode of bank evaluation and participation in investment projects. In particular, CDCs are risk-oriented, and their investments, that is, development loans, are usually riskier than the ordinary loans of commercial banks.

CDCs have the potential to enhance the role played by local financial institutions in community development and revitalization. In this capacity they face the same problems confronting any private effort to rejuvenate older, urban areas. Specifically, to make rehabilitation efforts economically feasible, large government subsidies have been used to attract private investments. The pervasive role that federal funding has played in CDC projects raises the issue of their viability if such funding for urban development is severely reduced. Should this occur, financial institutions would be faced with an even greater challenge to devise creative approaches to solving urban redevelopment problems. To be successful in this new financial environment, CDCs and other elements of an institution's urban program should be integrated into an institution's long-term objectives.

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