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COMMUNITY DEVELOPMENT STUDIES & EDUCATION

CDFIs Innovate on Small Consumer Loans*

By Noelle S. Baldini, Community Engagement Associate

Fair and impartial access to credit is a core component of building household financial stability. It is essential, however, that available credit products meet the needs of consumers and contribute to their overall financial well-being. This article examines the business models of two community development financial institutions (CDFIs) that offer small credit-building products, as well as describes other developments in the field.

The Need for Small Consumer Loans

Nearly two out of three Americans do not have sufficient savings to cover an unexpected expense of $500.[1] Further, income uncertainty and volatility cause many families to experience spikes and dips in their monthly budgets, often leaving insufficient capital to cover expenses. With limited access to traditional lines of credit, many consumers turn to small loan products to weather a financial shock or to smooth their income fluctuations. While predatory, expensive products can lead consumers into a cycle of repeated usage and mounting debt, consumer-friendly products can provide the opportunity to build credit and improve financial capability.

Small-dollar lending is a priority for the Consumer Financial Protection Bureau (CFPB). There are currently no comprehensive federal rules regulating nonbank providers in this marketplace, and state laws vary greatly. The CFPB released an outline of its small-dollar lending proposal[2] in March 2015 and expects to release a formal proposal in the first quarter of 2016.[3] One section of the CFPB proposal would require lenders to verify income and expenses of the borrower, but does not limit loan duration or payment size. Since the CFPB lacks authority to limit interest rates, payday loans — one popular type of small consumer loan product in which borrowers are charged average annual percentage rates of 400 percent[4] — may continue to exist under this section of the proposal. Though verifying consumers' ability to repay is an important step, consumers may also find relief on the price side under the longer-term alternatives section of the proposal. The CFPB proposes to make loans more affordable by requiring less underwriting and documentation if the lender agrees to limit the loan term to six months and to cap monthly payments at 5 percent of the borrower's monthly income.

The goal of making small-dollar lending more responsible and affordable is one way the CFPB aims to protect consumers and promote financial capability. CFPB defines financial capability as feeling in control of one's day-to-day finances, having the capacity to absorb a financial shock, being on track to meet financial goals, and having the financial freedom to make choices and enjoy life.

The Center for Financial Services Innovation (CFSI) is also committed to building financial capability. Its mission is to improve the financial health of Americans, especially the underserved, by shaping an innovative financial services marketplace with increased access to high-quality products and services. To further that mission, CFSI developed its Compass Principles as "aspirational guidelines to assure quality innovation and execution in financial services — services that enable people to transact, borrow, save and plan in ways that are beneficial to the consumer and profitable to the industry."[5] The CFSI Compass Guide describes a high-quality small-dollar loan as one that is made with confidence in the borrower's ability to repay; is structured to support repayment; is priced to be profitable for the provider and

* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.
[1] Kristin Wong, "Most Americans Lack Reserve Cash to Cover $500 Emergency: Survey," NBC News, January 8, 2016, available at http://ow.ly/YNTXJ.
[2] "CFPB Considers Proposal to End Payday Debt Traps," March 26, 2015, available at www.consumerfinance.gov/newsroom/cfpb-considers-proposal-to-end-payday-debt-traps.
[3] Rachel Witkowski, "Nonbanks to Feel Brunt of CFPB Rules in 2016," *American Banker*, January 6, 2016, available at http://ow.ly/YSRxX.
[4] Nick Bourke, "Regulators Should Let Banks Get Back to Small-Dollar Loans," Pew Charitable Trusts, January 7, 2016, available at http://ow.ly/YNWTe.
[5] Beth Brockland, "Compass Principles: The Compass Guide to Small-Dollar Credit," Center for Financial Services Innovation, 2014, available at www.cfsinnovation.com/Document-Library/The-Compass-Guide-to-Small-Dollar-Credit.

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successful for the borrower; creates opportunities for upward mobility and greater financial health; has transparent marketing, communication, and disclosures; is accessible and convenient; and provides support and rights for borrowers.

Business Model Case Study: Capital Good Fund

Some companies and nonprofit organizations are beginning to see a market opportunity to provide small consumer loans that embrace the Compass Guide principles. Andy Posner, founder and chief executive officer of Capital Good Fund, a CDFI based in Rhode Island with a mission of providing equitable financial services that create pathways out of poverty, said: "On the one hand, banks seem to have given up on serving the small-dollar loan market. On the other hand, you have the payday lenders, rent-to-own, auto title, subprime auto, etc. — a $100 billion industry — that is all-too-eager to prey on the economically vulnerable. Unfortunately, there is nothing in the middle in terms of companies whose sole mission is to do small personal loans equitably." Posner pointed out that there is extremely high demand with no competitors meeting the true needs of the customers.

This demand is reflected in the fact that, although Capital Good Fund has no marketing and advertising budget, the organization needs to raise ongoing operating capital to meet the growing demand for its products. Its recent capitalization effort is an example of innovation within the organization. In 2015, Capital Good Fund launched a Direct Public Offering, which allows the organization to raise capital in increments of $1,000 from unaccredited and accredited investors in 15 states.[6,7]

With the capital raised, Capital Good Fund plans to expand into states beyond Rhode Island, including Delaware. The products available in Delaware would be similar to those currently offered by Capital Good Fund, as described in the table at the bottom of the page.[8]

Capital Good Fund has provided more than 1,000 loans totaling more than $1 million since it was founded in 2009 and has had a repayment rate of 90 percent. Unlike most lenders, who would view a high repayment rate as a sign of success, Posner said that the high repayment rate is a signal that Capital Good Fund has the potential to take on more risk and make credit available to more traditionally underserved customers. Posner explained that Capital Good Fund's underwriting and risk management policies are based on close relationships with customers and sound underwriting standards, rather than a reliance on big data or what he terms "magic algorithms." Loan payments made by Capital Good Fund's borrowers are submitted to the three main credit bureaus, enabling its customers to build credit. The CDFI also offers financial coaching to both customers and noncustomers for a fee of $180. This fee is broken down into monthly payments of $15 and is booked as a loan with zero percent interest that is also submitted to credit bureaus, providing yet another opportunity for positive credit building.

Products Offered by Capital Good Fund

	Emergency Loans	All Other Consumer Loans	Weatherization (Energy Efficiency) Loans	Car Loans
Minimum Loan Amount	$300	$700	$500	$8,000
Maximum Loan Amount	$500	$2,000	$10,000	$13,500
Interest Rate	36%	24%	0%	9% to 15%
Closing Fee	None	None	None	$850 (rolled into loan)
Down Payment	$0	$0	$0	$500
Repayment Period	12 months	24 months	2–5 years	60 months
Typical Uses	Debt repayment, payment of past due bills, utilities, unforeseen expenses	Immigration costs, security deposits, auto repairs, computer purchase	Insulating walls, replacing light bulbs, sealing ducts	Vehicle purchase

Source: www.capitalgoodfund.org

[6] For more information about Capital Good Fund's direct public offering, see www.socialcapitalfund.org.
[7] Rule 501 of the U.S. Securities and Exchange Commission's Regulation D defines an accredited investor as a person who earns an individual income of more than $200,000 per year, or a joint income of $300,000, in each of the last two years and expects to reasonably maintain the same level of income; has a net worth exceeding $1 million, either individually or jointly with his or her spouse; or is a general partner, executive officer, director, or a related combination thereof for the issuer of a security being offered. See http://ow.ly/YSSAG.
[8] More information on this CDFI's loan products is available at www.capitalgoodfund.org.

Business Model Case Study: Oportun

Another CDFI that offers small consumer loans is Oportun,[9] a for-profit CDFI based in Redwood City, CA. Oportun offers "starter loans" at a minimum of $300 and larger loans up to $6,000 for returning customers. Most of Oportun's customers are Hispanic, and nearly 90 percent live in low- to moderate-income neighborhoods in California, Illinois, Nevada, Texas, and Utah.

Raul Vazquez,[10] Oportun's chief executive officer, said: "We estimate that there are approximately 25 million U.S. Hispanics who are outside the financial mainstream because traditional banks don't have financial products that suit their needs or because they don't have the necessary credit history to access traditional credit." Oportun has made 1.3 million loans totaling more than $2.2 billion to more than 680,000 customers since it started lending in 2006.

Unlike traditional financial institutions, which deem individuals with limited credit history as "unscorable," Oportun uses a proprietary system that leverages advanced data analytics and nine years of insights gained from serving customers to determine a loan applicant's ability to repay, approving loans to those applicants Oportun believes are likely to repay on time. Oportun's underwriting also includes verifying income for all loan applicants. It uses data analytics to determine loan amounts and terms that fit individual budgets to increase the likelihood of repayment. Oportun aligns loan payments with customers' pay periods with terms of six to 35 months and avoids balloon payments. Additionally, Oportun does not charge any prepayment fees.

Sherlie Martinez received a loan from Capital Good Fund to purchase a car for her and her daughter. Photo: Capital Good Fund

Oportun's loans are affordable compared with the alternatives typically available to people with little or no credit history in the geographic areas it serves. According to a study conducted for Oportun by CFSI, those alternatives are on average more than three times more expensive than Oportun's loans but can be up to seven times more expensive. Vazquez said that the CFSI study "estimated that Oportun saved our customers a cumulative total of $345 million."

Oportun reports customer accounts to credit bureaus to help borrowers establish a credit history. Vazquez added: "Credit scores are not just used for access to financial services, but they are also used increasingly for being able to rent an apartment and to get a job, so we feel that from a mission perspective, we help to create a very valuable asset for our customers." Credit reporting is an essential part of promoting financial well-being among Oportun's customers, as approximately 48 percent of all Oportun customers had no credit score when they first applied.

Oportun also supports customers by educating them on the basics of credit at the time the loan is deployed as well as sending text message reminders about upcoming payment due dates. Vazquez explained that "Our business model is based on our customers successfully paying back their loans, so our interests are aligned with theirs. Their success is our success."

Vazquez also credits Oportun's success to its for-profit business model. Though Oportun has a mission similar to that of many nonprofits, its for-profit status has allowed the company to expand and meet the needs of many customers. Oportun has raised equity from social venture capitalists, received loans from large banks, and issued bonds. Oportun seeks to expand to one or two additional states each year through its access to low-cost capital. The other secret to this growth, Vazquez said, is "a large team of more than a hundred engineers, mathematicians, and data scientists on payroll to help develop our risk engine and build web-based workflows that allow us to be efficient by embracing technology."

CDFI Industry Potential

Capital Good Fund and Oportun are not the only CDFIs involved in consumer finance. In addition to approximately 25 CDFI loan funds that make consumer loans, CDFI-certified banks and credit unions are also increasingly

[9] Formerly Progreso Financiero, Oportun changed its name in 2015. Derived from the Spanish word *oportunidad*, which means opportunity, Oportun became the new name of the growing organization. For more information about Oportun's loan services, see www.oportun.com.

[10] Raul Vazquez was appointed in 2015 to serve on the newly created Federal Reserve Board of Governors Community Advisory Council. For information, go to www.federalreserve.gov/newsevents/press/other/20150922a.htm.

meeting the credit needs of low- and moderate-income consumers or those who have been underserved by traditional financial institutions.[11] In early 2016, the National Credit Union Administration and the U.S. Treasury Department's Community Development Financial Institutions Fund signed an agreement that will streamline the application process for low-income credit unions to become certified as CDFIs.[12]

Also in early 2016, Senator Sherrod Brown (D-OH) called for the Obama administration to prioritize funding in fiscal year 2017 for the programs under Title XII of the Dodd–Frank Wall Street Reform and Consumer Protection Act. Title XII — Improving Access to Mainstream Financial Institutions[13] was a key economic empowerment provision in the act, but no part of Title XII has been implemented since the law was passed in 2010. Under sections 1205 and 1206 of Title XII, CDFIs may establish partnerships to provide low-cost, small consumer loans with reasonable terms, and the CDFI Fund would help CDFIs defray the costs of operating small consumer loan programs.[14]

The Wells Fargo NEXT Awards for Opportunity Finance in partnership with the Opportunity Finance Network (OFN) recognize innovation by leading CDFIs. The awards were solely dedicated to consumer finance in 2015 and will continue this theme in 2016.[15] Beth Lipson, executive vice president of strategic initiatives at OFN, said: "With 57 percent[16] of Americans struggling with financial health, and a growing number of households turning to high-cost alternative financial products and services, CDFIs are needed more than ever to expand their role and provide this market with affordable and responsible products." OFN is offering a webinar series for CDFIs in 2016 on consumer financial services.[17]

As CDFIs begin to offer a variety of products and services to meet consumer financial needs, they will be well-suited to deliver small loans that will help consumers improve their overall financial capability.

Additional Resources

- Thea Garon and Beth Brockland, "Designing High-Quality, Small-Dollar Credit: Insights from CFSI's Test & Learn Working Group," Center for Financial Services Innovation, 2015, available at www.cfsinnovation.com/Document-Library/Designing-High-Quality,-Small-Dollar-Credit-Insig.
- Joe Valenti, Sarah Edelman, and Julia Gordon, "Lending for Success," Center for American Progress, July 2015, available at https://cdn.americanprogress.org/wp-content/uploads/2015/07/LendingForSuccess-report.pdf.
- "Small Dollar Consumer Loans: Nonprofit Lenders Making a Difference," Credit Builders Alliance, 2013, available at http://ow.ly/Z5amI.

For more information, contact Andy Posner at andy@capitalgoodfund.org, www.capitalgoodfund.org; Raul Vazquez at raul.vazquez@progressfin.com, www.oportun.com; and Noelle Baldini at Noelle.Baldini@phil.frb.org.

[11] According to Opportunity Finance Network.
[12] Information on the agreement is available at http://ow.ly/YSWxq.
[13] See www.sec.gov/about/laws/wallstreetreform-cpa.pdf, page 754.
[14] See http://ow.ly/YSX16.
[15] More information on the NEXT Awards for Opportunity Finance is available at http://nextawards.org.
[16] Aliza Gutman, Thea Garon, Jeanne Hogarth, and Rachel Schneider, "Understanding and Improving Consumer Financial Health in America," Center for Financial Services Innovation, March 24, 2015, available at www.cfsinnovation.com/Document-Library/Understanding-Consumer-Financial-Health.
[17] For webinar recordings or to register for upcoming webinars, visit http://nextawards.org/webinars.

Read the entire issue of *Cascade* at www.philadelphiafed.org/cascade.

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Online Lenders Disrupt Small Business Lending*

By Karen Gordon Mills

***Karen Gordon Mills** served from 2009 to 2013 as the administrator of the U.S. Small Business Administration (SBA), which manages a portfolio of almost $100 billion in government-guaranteed small business loans. She is currently a senior fellow at the Harvard Business School (HBS) and at the Harvard Kennedy School, where she focuses on U.S. competitiveness, entrepreneurship, and innovation.*

Mills and Brayden McCarthy are the authors of "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game,"[1] a working paper published in July 2014 by HBS. The paper analyzes cyclical and structural problems in bank lending to small businesses as well as the growth of online small business lending. McCarthy is currently earning his M.B.A. at HBS and is also the head of policy and advocacy for Fundera, an online marketplace that connects small business owners with funding providers.

Karen Gordon Mills

Keith Rolland recently asked Karen Mills several questions in a Cascade *interview about online and bank small business lending trends. Her answers appear here.*

- **What are the strengths, limitations, and potential of online small business lending?**

It's important to first look at why it is that we worry about access to capital for small businesses.[2] In the United States, there are more than 28 million small businesses — ranging from sole proprietorships to firms that employ workers producing goods or services in supply chains or serving customers on Main Street.[3] Historically, small businesses have been responsible for nearly two-thirds of the net new jobs created in the United States. That rate, however, has declined since the recession, which took a significant toll on small businesses. Between 2007 and 2012, small businesses' share of the total net job *loss* was about 60 percent. This impact is consistent with economic literature that tells us small businesses are always hit harder during a financial crisis because they are more dependent on bank capital to fund their growth.[4]

Bank credit is a vital lifeline for small businesses, and often ranks as high as equity from the business owner or friends and family. In fact, in 2012, more than 85 percent of small businesses reported to the National Federation of Independent Businesses (NFIB) that their primary financial institution was either a large or community bank.[5] Yet, during and in the years following the financial crisis, bank loans to small businesses fell 18 percent and have only recently started to grow again (Figure 1).[6]

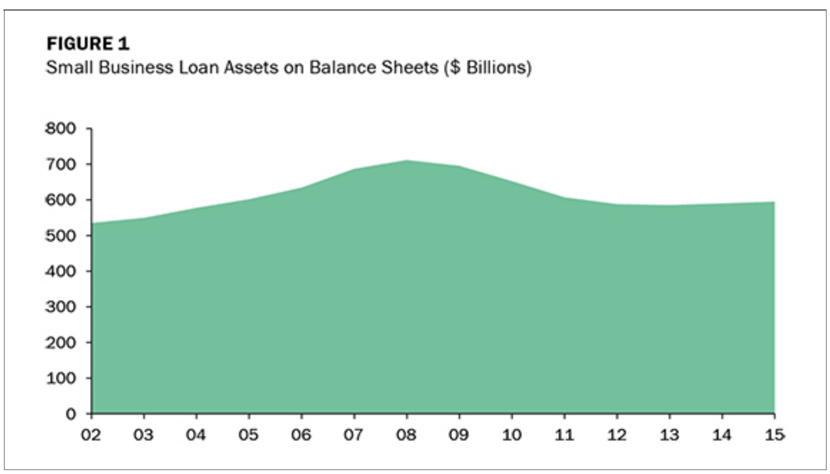

Figure 1. Bank loans to small businesses in the U.S. fell dramatically. Graph courtesy of Karen Mills.
Source: Federal Deposit Insurance Corporation, Call Report Data, as of January 2015.

With bank lending to small businesses slow to recover in the post-recession years, we saw a rise in the number of online lenders stepping into — or some would say disrupting — the small business market. These online lenders emerged along three models:

- **Peer-to-Peer Marketplaces:** Connect prime and subprime small business borrowers with capital from consumers and institutional investors that are looking for a return on their investment (e.g., Lending Club, Prosper);
- **Borrower-Driven Broker Marketplaces:** Connect borrowers with a range of traditional and alternative financing sources, ranging from banks and SBA-backed loans, to new online lenders (e.g., Fundera, Biz2Credit); and
- **Balance Sheet Lenders:** Leverage capital they hold on their own balance sheet provided by institutional investors to make loan decisions based on proprietary risk-scoring algorithms that rely largely on cash flow data (e.g., Kabbage, OnDeck).

Strengths of these online lending platforms include the ease of use by small businesses and the quick turnaround on loan decisions. Innovative applications of technology have made it possible for these new entrants to small business lending to collect application information and make loan approval decisions, based on proprietary risk algorithms, more quickly than applicants typically experience at banks. Yet, while online lenders may have an edge when it comes to customer service, they don't have the existing customer bases that banks do. As a result, online lenders commit significant resources to finding customers and building their loan portfolios.

This does not mean, however, that online lenders won't continue to increase their share of the small business market. In fact, Morgan Stanley estimates that lending by online lenders to small businesses will grow from 3 percent of the market today to 16 percent ($47 billion) in 2020.[7] As a result, the real winners will most likely be the small business owners. Online lending continues to transform how small business owners access capital as well as how banks approach the small business lending market. (The projected growth in online lending is shown in Figure 2.)

- **Can banks compete with online lenders for small business loans? What are banks' competitive advantages? Is there collaboration in small business lending between banks and online lenders?**

Yes, banks can compete simply because their portfolios already include their existing small business customers, and they have large amounts of data about those customers. Additionally, banks don't have to raise high-cost capital to compete because of their ability to make loans against their depository assets. Meanwhile, online lenders are devoting significant resources, in the form of investor dollars, to finding small business customers. This is the very reason why there is an opportunity for collaborations between banks and online lenders, and we are starting to see those partnerships form. Notably, JPMorgan Chase & Co., one of the nation's largest banks, is partnering with OnDeck, one of the early entrants to the online lending market, to offer loans to its approximately 4 million small business customers through the online lender's platform.[8] In fact, banks are experimenting in a wide variety of ways with online lending, including everything from referring their smallest loans or loan declines to external online lenders, to participating in online marketplaces like Fundera and Lendio, to building their own in-house capabilities.

- **How can both banks and online lenders better serve minority- and women-owned small businesses? Do either or both sectors currently have any initiatives targeted to such businesses?**

The persistent market gaps in small-dollar loans — the loans of $250,000 or less that are most needed by small businesses[9] — disproportionately affect underserved segments of the small business community. This is why the SBA has launched a number of initiatives since the recession that are focused on small businesses in underserved communities. One such initiative is the current elimination of its fees on loans below $150,000.[10] (See Figure 3 for survey findings about the importance of small loans.)

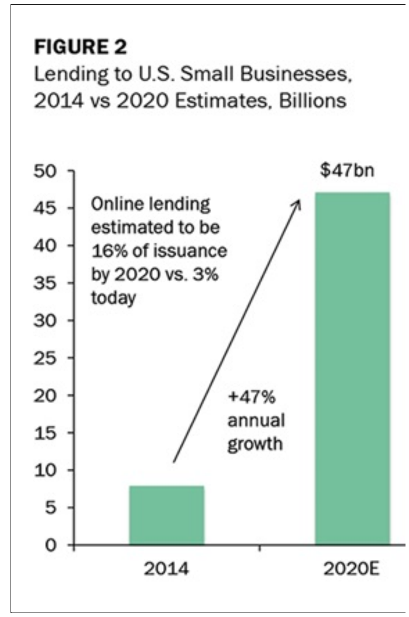

Figure 2. Online lending in the U.S. is growing rapidly. Graph courtesy of Karen Mills.
Source: Company data, Morgan Stanley research estimates.

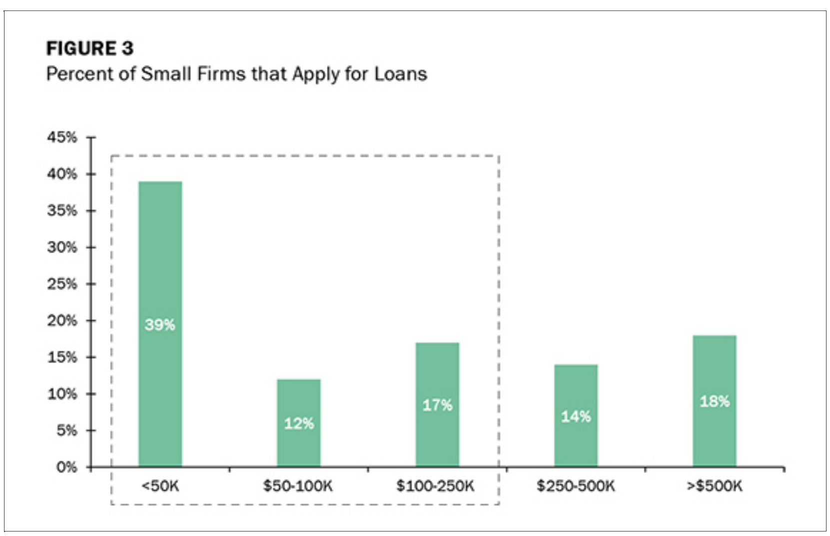

Figure 3. Firms want small loans, which aren't profitable for banks. Graph courtesy of Karen Mills.
Source: Federal Reserve Bank of New York, "Small Business Credit Survey," Fall 2013.

Yet, a number of these market gaps and the reasons for them have not been fully identified. Nonetheless, it is possible that online lending may provide greater access for creditworthy borrowers in underserved areas — including among women-, veteran-, and minority-owned small businesses — by providing more transparent and accessible loan opportunities. In one example, Opportunity Fund, a nonprofit CDFI [community development financial institution] in California, formed a pilot program with the Lending Club to provide up to $10 million in loans to small businesses in underserved areas of California.[11] We also have seen the emergence of some online lenders that specifically target underserved sectors of the small business community. One such lender is StreetShares, which targets veteran-owned small businesses with its peer-to-peer, auction-based platform.[12] Additionally, an interesting approach that is worth considering is using Community Reinvestment Act (CRA)-motivated funds to provide the opportunity for community lenders to partner with online lenders in developing algorithms and channeling creditworthy borrowers to these new lending platforms.

- **How can the financial literacy and financial management skills of small business borrowers strengthen?**

Financial literacy and financial management skills are critical. In recent years, there has been an expansion in the sources of capital available to small businesses. But far too often, small business owners don't understand their cash flow cycles and when to borrow in order to have the greatest impact on the businesses' growth. They understandably are focused on running their businesses and it's often hard for them to know what loan product they need at a particular point in the business cycle, and what terms and rates they should take on that loan. In the past, small businesses often had local bank advisors who helped the businesses think about what their actual need might be. However, with the substantial decline in the number of community banks, those local resources are less available.

As we look at the landscape of small business lending today, the customer-product fit is critical. A small business needs to find a loan with the size, duration, and cost that matches the needs of the business and its cash flow. In the absence of the local bank advisor who had a long-term relationship with a small business owner, it will be interesting to see if the new online lenders — as well as the big banks — can provide the advice and service required to ensure that small business owners get the loans that are right for them.

- **Do regulatory burdens currently have a negative impact on small business lending on the part of banks?**

There are a couple of key considerations that will continue to drive the regulatory conversation: First, what is the right balance of regulation as it relates to large and small banks? Small banks don't have the same level of resources as their large counterparts do. With the addition of new regulations and a new regulator, compliance time for small banks has increased.[13] To keep capital flowing from these banks to small businesses, regulatory guidance that is clear and not conflicting or ambiguous is critical.

Second, what oversight of online lenders should be put into place? Some feel there is an urgency to curb risk and potential bad actors, while others caution that stepping in too soon could stifle the innovation that is expanding access to capital for small businesses. An important initial set of guidelines called the Small Business Borrowers' Bill of Rights was suggested by a number of industry participants last summer.[14] This may provide an important framework for regulatory thinking going forward.

- **What are the challenges and opportunities of online small business lending for regulators and policymakers?**

There's an important conversation to be had around the regulatory approach. The United Kingdom, for example, offers an interesting model in the form of principles-based oversight in which investor and borrower protections are established and govern industry practices. In the United States, the situation is more complicated because it is unclear which regulator or regulators have authority over the online lenders.

In general, it will be important to provide protections to ensure that small business owners are not exploited by the high interest rates that some online lenders charge. A positive first step involves transparency so that small business are able to clearly understand the terms of the loan and any additional expenses and fees or arrangements a lender is offering in a clear and transparent way.

Further data collection on the small business market, as mandated in Section 1071 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, also will go a long way to highlight the needs and activity in this critical sector. Section 1071 includes provisions for collecting data on loans to underserved segments of the small business market. The Consumer Financial Protection Bureau should make it a priority to implement these provisions.

Online lenders are disrupting the small business lending sector. Their innovative application of technology and data is making it possible for small businesses to access credit through a more streamlined application process and in much quicker timeframes. The questions around transparency and regulatory oversight are certainly ones that need to be asked. But no matter the outcome of those discussions, what is clear is that the real winners will be the small businesses owners themselves, who will continue to see a growth in the sources from which they can access capital and more streamlined processes for doing so.

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* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

1 Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Working Paper 15-004, Harvard Business School, July 22, 2014, available at http://ow.ly/YZxEz.

2 Small businesses are defined for purposes of this article as firms with fewer than 500 employees.

3 U.S. Census Bureau.

4 Randall S. Kroszner, Luc Laeven, and Daniela Klingebiel, "Banking crises, financial dependence, and growth," *Journal of Financial Economics*, 84 (2007), pp. 187–228.

5 NFIB Research Foundation, "Small Business, Credit Access, and a Lingering Recession," January 2012, available at http://ow.ly/YZA05.

6 FDIC Call Report data, as of January 2015.

7 Morgan Stanley Research, "Global Marketplace Lending: Disruptive Innovation in Financials," Blue Paper, May 19, 2015.

8 Ben McLannahan, "JPMorgan Plans Lending Venture with OnDeck Capital," *Financial Times*, December 1, 2015.

9 Federal Reserve Bank of New York, "Small Business Credit Survey, Fall 2013," 2013, available at www.newyorkfed.org/medialibrary/interactives/fall2013/fall2013/files/full-report.pdf.

10 U.S. Small Business Administration. "7(a) Loan Amounts, Fees and Interest Rates," available at www.sba.gov/content/7a-loan-amounts-fees-interest-rates.

11 The partnership was developed as part of a Clinton Foundation initiative. See http://ow.ly/YZJhs.

12 Samantha Hurst, "Peer-to-Peer Marketplace StreetShares Captures $200M for Veteran-Owned Small Businesses," *Crowdfund Insider*, March 11, 2015, available at http://ow.ly/YZJAc.

13 See Marshall Lux and Robert Greene, "The State and Fate of Community Banking," M-RCBG Associate Working Paper Series 37, Harvard Kennedy School, February 9, 2015, available at http://ow.ly/YZW2S, and Mills and McCarthy, 2014, available at http://ow.ly/YZxEz.

14 See Small Business Borrowers' Bill of Rights at www.responsiblebusinesslending.org/.

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Bank Partnership Helps Ex-Offenders*

By Sydney Diavua, Community Engagement Associate

In an effort to support community stabilization in Monroe County, PA, a local community bank last year entered into a unique partnership with a community college, a health-care system, and a district court to help ex-offenders reintegrate into their communities. ESSA Bank & Trust,[1] located in Stroudsburg, PA, provides financial education and loans to ex-offenders who are leaving the federal corrections system and transitioning back into the community. Bank president and chief executive officer Gary S. Olson notes: “We [ESSA Bank & Trust] were looking for ways to strengthen our ties and impact in the community and this partnership provides that opportunity.” Through this program, ESSA Bank & Trust and its partners seek to reduce the rate of recidivism and improve outcomes for individuals and families.

Community Supervision

According to the U.S. Department of Justice, about 4.7 million people, or one of every 52 individuals, were under community supervision as of December 2014.[2] In Pennsylvania, about 2,700 of every 100,000 residents are under community supervision.[3] Community supervision, also known as community corrections, is the supervision of former criminal offenders in the resident population.[4] Around the nation, community supervision programs emphasize rehabilitation through supportive services that help offenders identify and address their problems and needs. These programs fill the critical gap between the prison and jail systems and full community reintegration with the goals of reducing recidivism, improving public safety, and contributing to community stabilization. According to a Congressional Research Service report, “Compared with the average American, ex-offenders are less educated, less likely to be gainfully employed, and more likely to have a history of mental illness or substance abuse — all of which have been shown to be risk factors for recidivism.”[5]

For the past seven years, the Court-Assisted Re-Entry Program (CARE)[6] of the United States District Court for the Middle District of Pennsylvania has been providing supportive release for ex-offenders under community supervision. Through this program, returning offenders voluntarily work with a collaborative team consisting of a CARE judge, an assistant U.S. attorney, an assistant federal public defender, and probation officers to ensure that the terms of the release are satisfied, and that the chances of re-offense are lowered. Criminal justice professionals encourage and assist participants to seek education, employment, health services, counseling, and other opportunities. Eligibility for the program varies with a potential participant’s calculated risk score for re-offense; however, ex-offenders convicted of a violent crime or sexual offense are ineligible. The CARE program currently operates in the court’s Harrisburg, Scranton, and Williamsport venues.

Development of the Partnership

Building a partnership between ESSA Bank & Trust and the Middle District court was an organic process that depended heavily on existing relationships between Olson and a local attorney, Albert Murray, who introduced Olson to the judge leading the CARE program. Olson visited the Honorable Thomas Vanaskie, United States Court of Appeals for the Third Circuit, to observe the CARE program’s court proceedings. During one probationer’s hearing, in which the probationer was having trouble financing a vehicle to transport him to work, Vanaskie appealed to Olson by asking, “How can you help?” Olson was further informed of the challenges that CARE program participants encountered when opening checking accounts, securing car loans, or obtaining housing — all factors that affect successful completion of the program’s terms and integration into meaningful work or education. Until that point in time the program was funded by grants through the Second Chance Act of 2007; however, funding levels have fluctuated over the years.[7]

In the summer of 2015, the CARE program partnered with ESSA Bank & Trust, Northampton Community College, and Pyramid Healthcare to provide Cooperatively Arranged Re-Entry Services (CARES). CARES providers offer financial literacy courses, educational and vocational training, financial support, and level of care assessments for behavioral and mental health services.

ESSA Bank & Trust provides participants with financial literacy training and loans up to a maximum of $15,000 for a term of up to five years for housing, transportation, or education and training courses. All program participants enter financial education courses conducted by ESSA Bank staff utilizing the Money Smart training module from the Federal Deposit Insurance Corporation (FDIC).[8] ESSA Bank’s corporate secretary Suzie Farley leads the courses, which are held at the bank’s headquarters or are conducted via web conferencing to better accommodate participants in distant locations. After successful completion of the coursework, participants are eligible to secure a loan from the bank. The bank plans to provide up to $250,000 in loan funds to eligible CARE program participants over the course of the partnership. Since the beginning of the loan program in July 2015, two participants have received loans, and another is currently going through the process. One participant received a loan for $13,750 to purchase a car to use as transportation to work, while the other received a loan to finance training and licensing to become a commercial truck driver.

Participants in the CARE program also receive a level of care assessment from Pyramid Healthcare to determine any behavioral or rehabilitation needs, as well as an assessment from Northampton Community College to identify their educational and training needs. General educational development (GED) and adult-level basic education courses are free to all participants through Northampton Community College. Participants seeking associate degree opportunities are encouraged to do so, and are given assistance with applying for federal and state financial aid. Participants remain eligible for services from CARES providers after their term of community supervision ends. Judge Vanaskie notes that the benefit is extended to all current and past participants so as to "create a safety net for these participants," and that "with each successful participant, we're [CARES providers] making the community stronger."

The CARE/CARES program partnership does not come without challenges. Program eligibility and program jurisdiction is a persistent challenge to participant recruitment. The program is administered through a federal level court, so only individuals within the court's jurisdiction are eligible. ESSA Bank & Trust has received interest from individuals who satisfy the bank's conditions for the program but who are under the supervision of state or local justice systems, thus making them ineligible. To address this challenge, partners are working on a case-by-case basis to refer ineligible individuals to other services; however, this method does not have long-term sustainability. Coordinators state a need for deeper collaboration with re-entry efforts on the state and local corrections levels to address this barrier.

The Partnership's Future

CARES partners acknowledged a need for additional CARES providers to increase the number of people served in the Middle District and other areas of Pennsylvania. The jurisdiction of the United States District Court for the Middle District of Pennsylvania covers approximately half of eastern and middle Pennsylvania, not including Philadelphia County; however, CARES providers are limited in their scope. Currently, the CARES providers are in preliminary discussions with additional judges in the re-entry program to expand the program benefits to Philadelphia.

The CARES providers are also working to develop a nonprofit intermediary that can coordinate the delivery of services, since the current service delivery model relies on volunteers. In addition, the nonprofit's staff may be able to provide additional one-on-one assistance to program participants.

For Olson, the work as a CARES provider is just beginning, but he has already seen tangible impacts on the lives of current participants. He hopes that through ESSA Bank & Trust's participation there will be a reduction in recidivism among ex-offenders and that the ex-offenders will receive the assistance they need to address any mental and behavioral health problems. Olson also hopes that the program will help stabilize the local neighborhoods and households that comprise the bank's service area.

To learn more about the CARE program and CARES providers, visit the following resources:

- Michael Rubinkam, "ESSA, NCC help felons get back on their feet," *Pocono Record*, February 15, 2016, available at www.poconorecord.com/article/20160215/NEWS/160219694
- "Smart on Crime, Reentry, CARE and CARES," United States Attorney's Office, Middle District of Pennsylvania, updated December 24, 2015, available at www.justice.gov/usao-mdpa/smartoncrime
- "New Smart on Crime Program Aids Recently Released Offenders to Reenter the Community," United States Department of Justice, August 18, 2015, available at www.justice.gov/opa/pr/new-smart-crime-program-aids-recently-released-offenders-reenter-community

For additional information contact, Gary Olson, president and CEO, ESSA Bank & Trust, at golson@essabank.com.

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* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

1 ESSA Bank's service area includes the Lehigh Valley and Pocono regions.

2 From Danielle Kaeble, Laura M. Maruschak, and Thomas P. Bonczar, "Probation and Parole in the United States, 2014," U.S. Department of Justice, Bureau of Justice Statistics, November 2015, available at www.bjs.gov/content/pub/pdf/ppus14.pdf.

3 According to Kaeble et al., 2,783 out of every 100,000 Pennsylvania residents are under community supervision.

4 The main types of community supervision are probation and parole. For more on this topic, see http://www.bjs.gov/index.cfm?ty=tdtp&tid=1.

5 Nathan James, "Offender Reentry: Correctional Statistics, Reintegration into the Community, and Recidivism," Congressional Research Service, January 2015, summary page.

6 The United States District Court for the Middle District of Pennsylvania has jurisdiction over one-half of Pennsylvania, including eastern and central portions of the state.

7 The Second Chance Act of 2007 was enacted by Congress to break the cycle of criminal recidivism; improve public safety; and help state, local, and tribal government agencies and community organizations respond to the growing number of formerly incarcerated people who were returning to their communities. For more information, visit www.bja.gov/ProgramDetails.aspx?Program_ID=90.

8 See www.fdic.gov/consumers/consumer/moneysmart/mscbi/mscbi.html.

CASCADE: NO. 91, SPRING 2016

Spotlight on Research: Down Payment Assistance Plays Critical Role in Affordable Homeownership*

By Marvin M. Smith, Ph.D., Senior Community Development Economic Advisor

In the aftermath of the recent Great Recession, there has been a tightening in mortgage lending practices. This cautious atmosphere has been prompted in large part by the rash of foreclosures in the housing market that accompanied the financial crisis. One potential safeguard is the existence of a down payment requirement that must be met by prospective homebuyers as a condition of securing a mortgage. The rationale is that when individuals invest their own money in the form of a down payment, the potential homebuyers will be more motivated to maintain their mortgage obligations. For those potential homeowners who need help in complying with the down payment requirement, there is down payment assistance. Down payment assistance plays a crucial role for some low- and moderate-income (LMI) individuals in achieving their goal of homeownership. A concern has arisen, however, that the availability of down payment assistance might diminish the influence of using personal funds as a motivating factor to follow through on mortgage responsibilities. Allison Freeman and Jeffrey Harden examine the factors that underscore the need by LMI homeowners for down payment assistance and the impact of down payment assistance on mortgage performance.[1] The following is a summary of their study.

Background

Marvin M. Smith, Ph.D.

The financial crisis that began in 2008 had a profound impact on mortgage policies and practices. A repercussion of the crisis has been the stiffening of the qualifications necessary to obtain a mortgage. "One hotly debated issue concerns the establishment of down payment requirements that would give borrowers sufficient 'skin in the game' to deter them from defaulting on their home loans."[2] Although increasing down payment requirements might strengthen the resolve of homeowners to make good on their mortgage payments, it will shrink the pool of those who might be eligible for mortgages if borrowers are unable to obtain the additional funds to cover the down payment costs. LMI individuals are particularly at a disadvantage in accumulating the full amount for a down payment. One research effort indicated that down payment assistance programs that "provide even modest amounts of assistance can have a significant impact on the number of low-income and minority households that buy homes."[3]

But what are the influences that underlie the access to outside assistance for the down payment? Of particular concern is the experience of black and white aspiring homeowners. Freeman and Harden reviewed the literature and found that "the primary factors in the gap between White and Black transitions to homeownership were differences in income, differences in family structure, and differences in the ability and willingness of parents to provide down payment assistance."

The authors noted that "even less has been written on the relation between the use of down payment assistance and mortgage performance." One study on the topic has been viewed with some skepticism. The study involved loans insured by the Federal Housing Administration (FHA). More specifically, the study compared the loan performance of FHA-insured loans with down payment assistance provided by seller-funded nonprofits with loans without such assistance.[4] The finding was that the loans with down payment assistance performed more poorly than the loans without assistance. Freeman and Harden pointed out that the results should be regarded with some apprehension. They explained that the FHA had a standard 6 percent contribution limit on funds given directly to a buyer, but no limit on money given indirectly to a buyer through a nonprofit set up for that purpose. Consequently, seller-funded nonprofits were used to circumvent the FHA 6 percent contribution limit. In 2008, the FHA banned the use of funds from these types of programs. The authors sought to provide further insight on the relation between the actual use of down payment assistance and mortgage performance.

Data and Methodology

Freeman and Harden used data from the Community Advantage Panel Survey (CAPS), a longitudinal survey of LMI homeowners and renters in the United States. According to Freeman and Harden, the survey examines the Community Advantage Program (CAP), a secondary mortgage market program that began in 1998 as a collaborative effort between Self-Help, Fannie Mae, and the Ford Foundation. CAP is composed of affordable housing mortgage loans from banks that were purchased by Self-Help and sold to Fannie Mae using a grant of $50 million from the Ford Foundation. More than 46,000 loans made to LMI households between 1998 and 2009 were added to the CAP portfolio. CAP borrowers received a 30-year, fixed-rate loan based on their ability to pay. Because of their financial profiles, it is unlikely that these borrowers would have obtained comparable loans in the private mortgage market.[5] The authors used a subset of the CAP homeowners, namely those whose loans were originated between 1999 and 2003 (before the onset of the housing crisis).

Overall, the CAP loans performed rather well during the housing crisis. The CAP portfolio had a lower default rate than all other mortgages except prime, fixed-rate loans. Moreover, the CAP loans performed better than the subprime loans issued to comparable borrowers.

The authors used the CAP data to investigate two questions: First, what factors affect the use of down payment assistance in their sample of lower-income homeowners? Second, how does the use of down payment assistance affect mortgage performance? They explored these questions by using regression analysis.

Freeman and Harden used statistical estimation models to examine the factors that influence the use of down payment assistance. They considered five sources of assistance: (1) assistance of any kind, (2) assistance from a family member, (3) a second mortgage, (4) a community grant, or (5) assistance from a seller or real estate agent. Thus, the five separate estimating equations had one of these sources of assistance as the dependent variable. The independent (or explanatory) variables included the following: demographic variables (such as owners' race, age, and education); financial literacy variables (such as whether owners' parents had a checking account); and credit-related variables (such as owners' credit scores and debt-to-income ratios).

Results

The statistical analysis of the homeowners in the sample who used extra assistance revealed some noteworthy findings:

- Among Hispanic, black, and white owners, Hispanic owners were least likely to receive down payment and closing costs assistance from the seller or a real estate agent.
- Blacks were least likely to obtain down payment and closing costs assistance from family members or friends.
- Blacks were most likely to report use of a grant for down payment and closing costs assistance.

The authors also analyzed the influence of down payment assistance on mortgage performance. A negative impact on mortgage performance might be due to homeowners having too little "skin in the game," thus weakening their incentive to honor their mortgage obligations.

A positive effect that might result from the use of assistance is the freeing up of homeowners' savings. Homeowners would be able to access their savings as needed to stay current on the mortgage. Using CAPS data from 2003 to 2011, Freeman and Harden relied on regression analysis to investigate this issue. They estimated two regressions with two different dependent variables: (1) if the homeowner's mortgage had ever been 30 to 90 days delinquent and (2) if the mortgage had ever been more than 90 days delinquent or in foreclosure. The independent variables in both equations were the same as those used in the previous equations. The sample included homeowners who used assistance and those who did not.

Freeman and Harden concluded: "The most important finding from our research is the lack of a statistical and substantive difference in mortgage performance between those who do and those who do not use any form of down payment assistance."

The authors recommended that "changes that increase down payment requirements must be coupled with support for programs that assist qualified owners in securing affordable loans." They also cautioned against "imposing highly restrictive down payment requirements that would disproportionately restrict access to mortgage credit for groups of otherwise creditworthy borrowers." Moreover, in the event that down payment requirements are increased, the authors suggest that "legislators and policymakers should also increase their support for community programs to help *all* qualified borrowers make their down payments."

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* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

1 Allison Freeman and Jeffrey J. Harden, "Affordable Homeownership: The Incidence and Effect of Down Payment Assistance," *Housing Policy Debate*, 25(2) (2015), pp. 308–319.

2 Austin Kelly, "Skin in the Game: Zero Down Payment Mortgage Default," *Journal of Housing Research*, 17(2) (2008), pp. 75–99; available at http://ssrn.com/abstract=1330132.

3 Christopher E. Herbert and Winnie Tsen, "The Potential of Downpayment Assistance for Increasing Homeownership Among Minority and Low-Income Households," *Cityscape*, 9(2) (2007), pp. 153–184; available at www.huduser.gov/portal/periodicals/cityscpe/vol9num2/ch5.pdf.

4 U.S. Government Accountability Office, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance,* Report No. GAO-06-24, 2005; available at www.gao.gov/new.items/d0624.pdf.

5 The creditworthiness of those in the data are as follows: 90 percent of the CAP homeowners had either a loan-to-value ratio greater than 90 percent, a debt-to-income ratio greater than 38 percent, or a credit score of 640 or less.

FEDERAL RESERVE BANK OF PHILADELPHIA

CASCADE: NO. 91, SPRING 2016

Low-Income Older Adults Face High Housing Costs and Financial Challenges*

By Richard W. Johnson

Cascade *summarizes a report by Richard W. Johnson, senior fellow in the Income and Benefits Policy Center at the Urban Institute. The report*[1] *was published in July 2015.*

Although the average income of older Americans has grown rapidly over the past few decades, many seniors continue to struggle financially. Based on data from the American Community Survey and the Consumer Expenditure Survey, 14 percent of older adults — 6.5 million people in 2013 — do not have enough income to meet their needs. Most of their income comes from Social Security, and they spend much of it on housing.

Who Receives Inadequate Income at Older Ages?

Older adults have made tremendous financial gains over the past generation. Between 1966 and 2013, the official poverty rate for adults ages 65 and older fell from 29 percent to 10 percent, a nearly two-thirds reduction. Over the same period, the poverty rate increased 27 percent for adults ages 18 to 64 and 11 percent for children younger than 18. Children are now twice as likely as older adults to live in poverty.

The U.S. Census Bureau recently developed the supplemental poverty measure (SPM) that better gauges the number of families with inadequate incomes. Like the official measure, the SPM identifies families whose incomes fall below a specified needs threshold. But it expands the cash income measure to include noncash benefits, such as supplemental nutritional assistance, housing subsidies, and energy assistance. It also subtracts out-of-pocket medical expenses, work expenses, paid child support, and taxes, while adding tax credits, such as the earned income tax credit. In addition, the SPM updates the poverty threshold to better reflect current household spending.

The SPM reduces the 2013 poverty rate for children from 19.9 percent to 16.4 percent; it raises the poverty rate for adults ages 18 to 64 from 13.6 percent to 15.4 percent and for adults ages 65 and older from 9.5 percent to 14.6 percent.

The share of older adults with inadequate incomes varies widely across the older population (Figure 1). More than 25 percent of older Hispanics, African Americans, and adults without high school diplomas did not have enough income in 2013 to meet their needs. The share of older adults with inadequate incomes rises with age, and older adults with disabilities — defined as having difficulty living independently — are more likely to have inadequate incomes than those without disabilities.

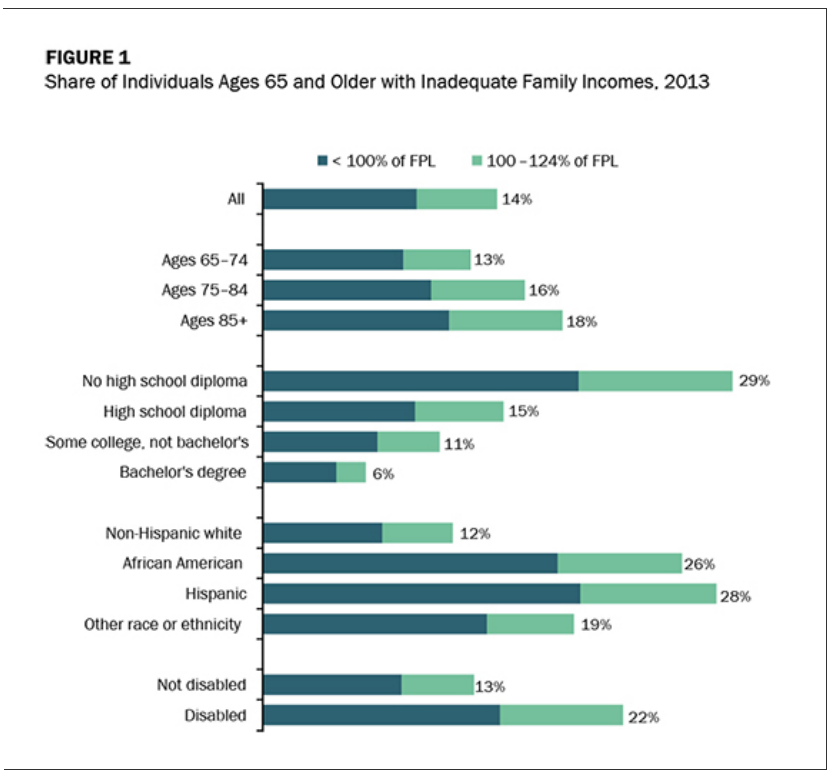

Figure 1. Share of older adults with inadequate incomes varies widely.
Source: Johnson's estimates from the 2013 American Community Survey. Note: FPL = federal poverty level. From Richard W. Johnson, "Housing Costs and Financial Challenges for Low-Income Older Adults," Research Report, Urban Institute, July 2015.

Women ages 65 and older are about 50 percent more likely to have inadequate incomes than their male counterparts. Divorced and widowed women face higher poverty risks in old age than married women because women who become divorced or widowed generally have lower incomes before their marriage ends than those whose marriages remain intact, and because women generally forfeit at least some of their husband's income when the marriage ends.

Income Sources at Older Ages

Social Security is a crucial source of income for low-income older adults. In 2013, it accounted for 72 percent of the family income received by adults ages 65 and older with family incomes below 125 percent of the federal poverty level (FPL) (Figure 2). Supplemental Security Income, a government transfer program for low-income older adults and people with disabilities, accounted for another 9 percent of their income.

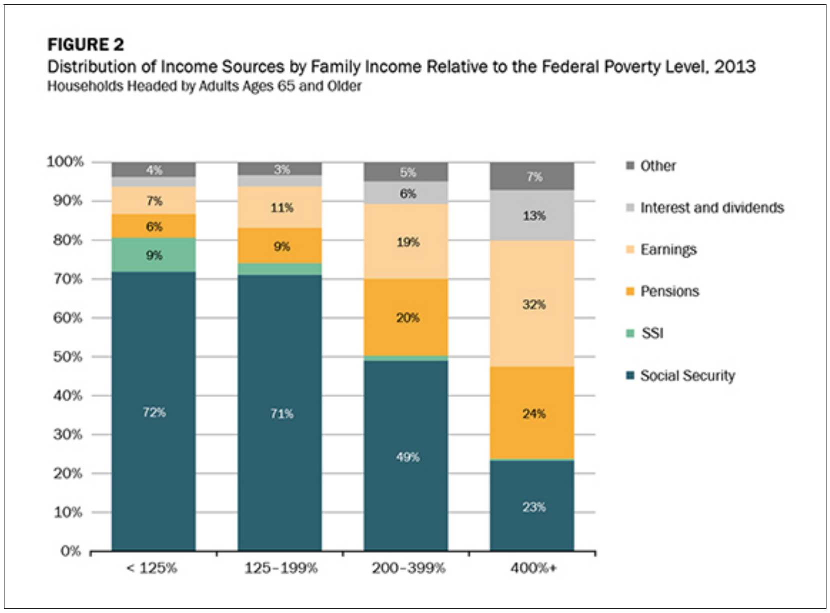

Figure 2. In 2013, Social Security accounted for 72 percent of family income received by adults ages 65 and older.
Source: Johnson's estimates from the 2013 American Community Survey. Note: SSI = Supplemental Security Income. From Richard W. Johnson, "Housing Costs and Financial Challenges for Low-Income Older Adults," Research Report, Urban Institute, July 2015.

Although low-income older adults receive most of their income from Social Security, their benefit amounts are low. Average annual Social Security income amounts to only $8,100 for adults ages 65 and older with family incomes below 125 percent of FPL, compared with $15,300 for those with family incomes between 125 and 199 percent of FPL and $19,600 for those with family incomes between 200 and 399 percent of FPL. Some retirees receive limited Social Security benefits because they collected their benefits early.

Low-income older adults receive little income from employer-sponsored pensions or investments. Few low-wage workers are able to accumulate enough savings to generate substantial interest and dividend income at older ages. In 2014, only 53 percent of workers, including 64 percent of full-time workers and 21 percent of part-time workers, participated in a retirement plan at their workplace, and relatively few workers with a retirement plan earned low wages. Only 33 percent of full-time workers earning less than $25,000 annually in 2010 participated in an employer-sponsored retirement plan, compared with 80 percent of full-time workers earning between $50,000 and $99,000 annually.

Household Spending at Older Ages

Adults use more health-care services at older ages than younger ages. Medicare helps pay for much of the medical care received by adults ages 65 and older, but most beneficiaries must pay substantial premiums for physician services and prescription drug coverage. Medicare also requires beneficiaries to share the cost of most services; does not cap annual out-of-pocket payments; and excludes some important services, such as long-term services and supports and routine dental and vision care.

The single greatest financial risk that older people face is the possibility of developing disabilities and needing long-term services and supports. This care is expensive and there are few financing options. The nationwide median cost of a year-long stay in a nursing home, in a semiprivate room, is $80,000; it is much higher in certain parts of the country. The nationwide median cost for an hour of homemaker services is $20, which translates to about $14,000 a year for someone who receives 60 hours of services a month, the median amount. Medicare does not usually pay for these services, and traditional health insurance doesn't either. Private long-term care insurance usually pays, but only 12 percent of adults ages 65 and older have coverage. As a result, many older people who need long-term services and supports first turn to unpaid family help. When that's not enough, they turn to paid home care and then enter a nursing home.

Although health-care costs attract most of the attention in discussions of older adults' financial security, older people spend much more on housing, which includes shelter (mortgage interest and charges, property taxes, home maintenance and repairs, rent, and homeowners' and renters' insurance) and utilities. In 2013, households headed by adults ages 65 and older devoted 28 percent of their spending to housing — more than twice as much as they spent on health care (Figure 3). Older households also spent more on food and transportation than health care. Housing costs are especially significant for low-income older adults, who devoted 36 percent of their household expenditures to housing in 2013.

FIGURE 3

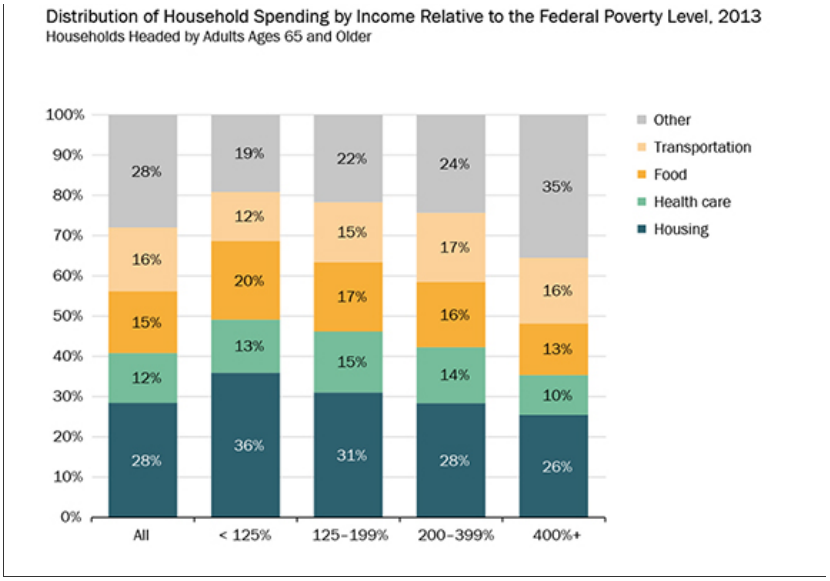

Figure 3. In 2013, households headed by adults ages 65 and older devoted 28 percent of their spending to housing.
Source: Johnson's estimates from the 2013 Consumer Expenditure Survey. From Richard W. Johnson, "Housing Costs and Financial Challenges for Low-Income Older Adults," Research Report, Urban Institute, July 2015.

Housing expenditures as a share of income are also high. Households headed by adults ages 65 and older spent 23 percent of their income on housing in 2013, including 8 percent on utilities (Figure 4). Eighty-one percent of older households own their homes, and 58 percent of older households (72 percent of homeowners) own their homes free and clear. Homeowners with mortgages spend $15,600 on housing costs, nearly twice as much as homeowners without mortgages. Renters spent $10,800 on housing, only about two-thirds as much as homeowners with mortgages. However, renters devote a much larger share of their income to housing than homeowners with mortgages, because, on average, they receive barely half as much income. In 2013, older renters spent 43 percent of their income on housing, substantially more than the 30 percent cutoff commonly used to identify burdensome housing costs.

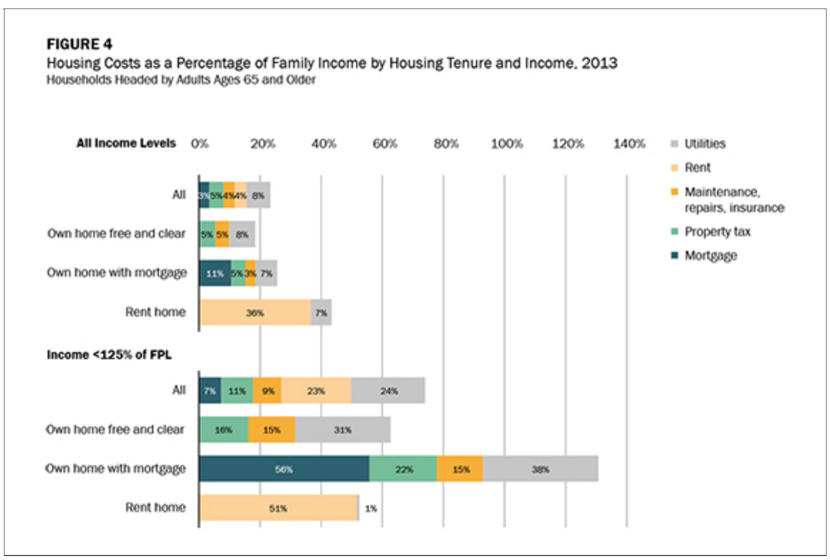

Figure 4. In 2013, households headed by adults ages 65 and older spent 23 percent of their income on housing.
Source: Johnson's estimates from the 2013 Consumer Expenditure Survey. Notes: Family income is measured before taxes. FPL = federal poverty level. From Richard W. Johnson, "Housing Costs and Financial Challenges for Low-Income Older Adults," Research Report, Urban Institute, July 2015.

Older households with incomes below 125 percent of FPL spent 74 percent of their income on housing in 2013. They were twice as likely to rent their home as all older households (38 percent versus 19 percent). Low-income older renters average only about half as much on rent a year as all older renters, but they devote a larger share of their income to housing costs — 52 percent — because their incomes are so much lower. Older low-income homeowners devote even more of their income to housing than older low-income renters. The 50 percent of older low-income households that own their homes free and clear spend 62 percent of their income on housing, and the 12 percent with mortgages spend a staggering 131 percent of their income on housing, forcing many to turn to family members for financial help. Low-income older homeowners with mortgages spend a slightly larger share of their income servicing their mortgage than renters spend on rent. But homeowners must also pay property taxes and maintenance and utilities expenses, which together cost more annually than their mortgage.

Conclusion

Older low-income adults rely mostly on Social Security, receiving little income from savings that they accumulated on their own or in the workplace. They devote much of their income to housing, even when they own their home free and clear, because utilities, maintenance, repairs, insurance, and property taxes cost about as much, on average, as rent. Low-income older households with mortgages spend even more on housing than renters and those who own their homes free and clear.

Housing costs can significantly reduce financial security at older ages. Seniors who spend more than half their income on housing spend significantly less on food and health care than their counterparts with lower housing expenses. The onset of mobility-limiting health problems at older ages creates additional housing-related financial concerns. To remain in their homes, seniors may need to make expensive home modifications, such as widening doorways or adding ramps to accommodate a wheelchair. Raising federal funding for housing with supportive services or expanding federal rental assistance, which now helps only one in four low-income renter households, could benefit many low-income older adults.

Policy initiatives aimed at helping families cover health-care expenses could also improve financial security at older ages. Although health-care costs consume only a modest share of older households' income on average, some older adults with high medical or long-term care needs experience catastrophic costs. Policy options, such as capping out-of-pocket expenses for Medicare beneficiaries or creating a public insurance program to cover long-term services and supports, could protect older adults from these financial risks.

Other policy initiatives could boost retirement incomes. Because retirement incomes depend on earnings earlier in life, expanding employment opportunities for low-skilled workers, perhaps through better federally funded workforce development programs, could improve financial security at older ages. Efforts to promote savings, especially for workers without access to employer-sponsored retirement plans, might have long-term payoffs. The Obama administration recently created the myRA program, which allows workers without access to an employer retirement plan to contribute to a retirement account through automatic payroll deductions. Since 2012, 17 states have introduced or considered legislation that would mandate employer retirement plans, including automatic IRAs, for private-sector workers. Expanding the saver's tax credit could also boost savings for people with limited resources. This federal program matches up to 50 percent of the first $2,000 in retirement savings by low-income adults. The government contribution, however, comes as a nonrefundable federal income tax credit and thus does not benefit savers who do not earn enough to pay federal taxes. Providing a refundable tax credit would provide additional savings incentives.

Probably the most important step that Congress could take to improve financial security at older ages is to shore up Social Security's long-term finances, given the vital importance of the program to low-income seniors. Current projections indicate that, beginning in 2033, Social Security will not collect enough revenue to make full payments to beneficiaries. Instead, taxes would be sufficient to pay only about three-quarters of scheduled benefits. Congress could close the financing gap with higher taxes and trimmed benefits. However, it is important to protect the benefits of low-income beneficiaries. In fact, Congress might consider raising benefits for retirees with limited lifetime earnings, such as by instituting a meaningful minimum benefit in Social Security or expanding Supplemental Security Income.

For further information, contact Richard W. Johnson at rjohnson@urban.org.

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* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

1 Richard W. Johnson, "Housing Costs and Financial Challenges for Low-Income Older Adults," Research Report, Urban Institute, July 2015, available at www.urban.org/research/publication/housing-costs-and-financial-challenges-low-income-older-adults/.

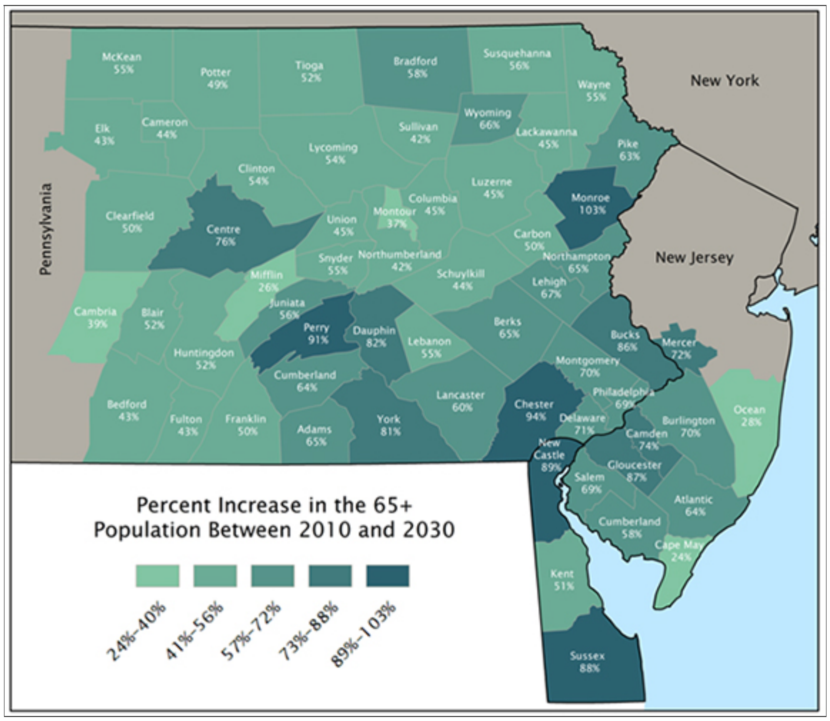
CASCADE: NO. 91, SPRING 2016

Mapping Our Community: Older Adult Population Projected to Grow by Two-Thirds by 2030*

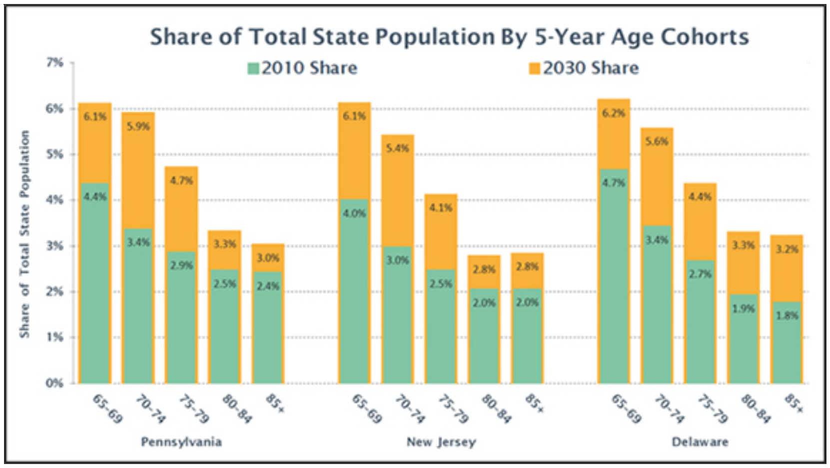
By Kyle DeMaria, Community Development Senior Research Assistant

Download a PDF of this column.

Older adults — defined as persons 65 years or older — represent a significant segment of the population in Pennsylvania, New Jersey, and Delaware. In fact, among all the states, Pennsylvania has the fifth highest share of its population in this age group, and Delaware has the seventh highest share. New Jersey ranks 28th on this measure.[1] Between 2010 and 2030, the number of older adults in the tristate area is expected to grow from 3.3 million to 5.4 million, reflecting an increase of nearly two-thirds over the period. Viewed another way, older adults will represent a much greater share of the tristate area population in 2030 (22 percent) than in 2010 (15 percent).



The map presents projected population growth rates between 2010 and 2030 for 60 counties in the tristate area. The population of older adults is predicted to increase by at least 24 percent in each county and more than double in Monroe County, PA. The chart depicts the share of older adults in Pennsylvania, New Jersey, and Delaware by 5-year age cohorts in 2010 and 2030. For each cohort, the share is expected to increase, with the greatest increase predicted for the 70 to 74 age cohort.



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Data sources: Author's calculations using unrevised 2010 U.S. Decennial Census population counts and 2030 official state population projections for Pennsylvania (available at http://ow.ly/XZJYC), New Jersey (available at http://ow.ly/XZKGD), and Delaware (available at http://ow.ly/XZKRE).

Map source: U.S. Census Bureau.

1 The percentages are highest in Florida (19 percent), Maine (18 percent), and West Virginia (18 percent), according to 2014 American Community Survey one-year data estimates.

FEDERAL RESERVE BANK OF PHILADELPHIA

CASCADE: NO. 91, SPRING 2016

Small Businesses Report Better Financing Outcomes*

By Nathaniel Borek, Outreach and Administrative Analyst

Background

Small businesses provide substantial employment and services and are an important part of the U.S. economy. One measure of small business conditions is the findings of the *2015 Small Business Credit Survey*[1] (SBCS). The survey, which is a collaborative effort of the community development departments of the Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, includes responses from small businesses operating in 26 states.[2] This article summarizes highlights of the 2015 SBCS.

The SBCS is an annual, online survey that has been conducted since 2010 among small businesses with 500 or fewer employees.[3] The survey is distributed by small business development centers, professional small business associations, and chambers of commerce. Since the sample is not random, the data are weighted by industry, age, and employment size so that the distribution of firms in the survey more closely matches the distribution of the small business population in the survey coverage area.

2015 SBCS

Results

The SBCS was completed by 3,459 businesses from September to November 2015. Seven main highlights from the survey are outlined here.

1. **Profitability, revenues, and employment improved.**

Business performance showed improvement from 2014 to 2015, as is reflected in profitability, revenues, and hiring. Respondents expected continued improvement in revenues and hiring in 2016 (Figure 1).

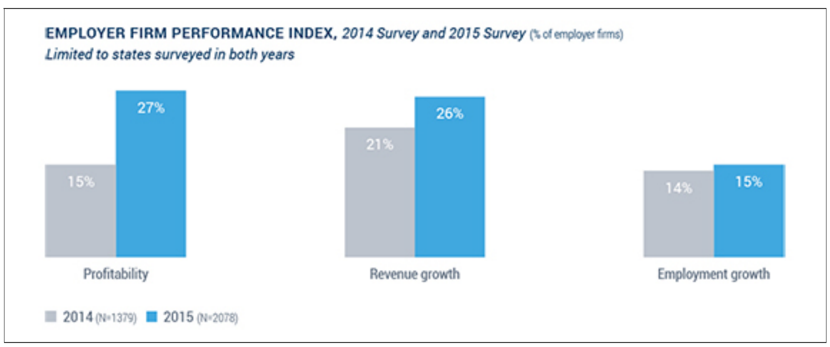

Figure 1. Employer firm performance index.
Source: *2015 Small Business Credit Survey: Report on Employer Firms*, Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, March 2016

2. **Financing outcomes improved.**

The number of small businesses that reported receiving all of the financing for which they applied rose from roughly 38 percent in 2014 to 45 percent in 2015. Likewise, the number of small businesses that received none of the financing for which they applied fell from 35 percent in 2014 to 20 percent in 2015 (Figure 2). The main intended uses of the financing were, first, expanding operations and, second, meeting operating expenses.

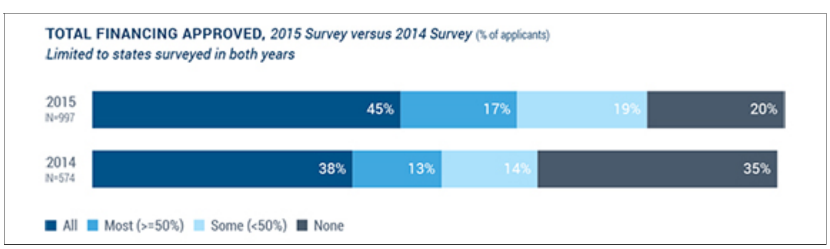

Figure 2. Total financing approved.
Source: *2015 Small Business Credit Survey: Report on Employer Firms*, Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, March 2016

3. **Customer satisfaction was highest with small banks.**

Claire Kramer Mills, assistant vice president in the Communications and Outreach Group of the Federal Reserve Bank of New York, noted that small banks[4] ranked highest among lenders in borrower satisfaction.[5] In the 2015 SBCS results, credit unions, large banks, and online lenders were ranked second, third, and fourth, respectively, in borrower satisfaction.

4. **Relationship with the lender was the most important factor in application decision.**

The results of the 2015 survey indicate that the most important factors affecting the decision to apply for credit were, first, the relationship with the lender and, second, the cost of funding.

5. **Personal assets were the most common type of collateral.**

Personal assets were the most common collateral pledged to secure credit, regardless of the age of the business. In other words, similar percentages of businesses of all ages used personal assets to secure debt.

6. **Small businesses are interested in obtaining financing from online lenders.**[6]

Kramer Mills said that a consistent finding in the yearly surveys is interest in online lenders. In 2015, roughly 20 percent of survey respondents applied for credit through online lenders.

7. **Approval rates for credit applications were highest from small banks.**

The majority of applicant firms sought traditional loans or lines of credit from banks. However, approval rates were much higher from small banks than from large banks (Figure 3). This approval pattern held across all revenue sizes of firms. Overall, microbusinesses and firms with $100,000 to $1 million in annual revenues were much less likely to be approved by both small banks and large banks than their larger counterparts.

APPROVAL RATE BY SELECT SOURCE AND TYPE OF LOAN/LINE OF CREDIT N=48–869
(% applicants receiving at least some credit)

TOP PERCENTILE | MIDDLE PERCENTILE | BOTTOM PERCENTILE

		All Firms	Micro (<$100K)	$100K–$1M	$1M–$10M	>$10M
Source	Large bank	58%	33%	49%	72%	88%
	Small bank	76%	60%	69%	88%	96%
Type	Business loan	69%	54%	65%	81%	92%
	Line of credit	71%	55%	65%	82%	91%

Figure 3. Approval rates by select source and type of loan or line of credit for both large banks and small banks. Small banks are defined as community or smaller regional banks. Large banks are defined as national or larger regional banks.
Source: *2015 Small Business Credit Survey: Report on Employer Firms*, Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, March 2016

Conclusion

Overall, small business respondents to the 2015 SBCS survey reported positive trends in business performance and access to credit. Small banks played a vital role in providing credit to this market. Small businesses reported continued interest in online lending.

For more information, contact Claire Kramer Mills at claire.kramer@ny.frb.org or visit the Federal Reserve Bank of New York's web page on the topic of small businesses at www.newyorkfed.org/smallbusiness.

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1 *2015 Small Business Credit Survey: Report on Employer Firms*, Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, March 2016, available at www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf.

2 About 7 percent of respondents were located in Pennsylvania and New Jersey. There were no respondents in Delaware.

3 The businesses reported on here had at least one paid employee and no more than 500 paid employees. There will be a separate report released later this year on firms that have no paid employees.

4 Small banks are defined as community or smaller regional banks. Large banks are defined as national or larger regional banks

5 Only successful applicants were asked this question in order to factor out any negative experiences stemming from a denied application.

6 The SBCS questionnaire describes online lenders as nonbank online lenders, including alternative and marketplace lenders.

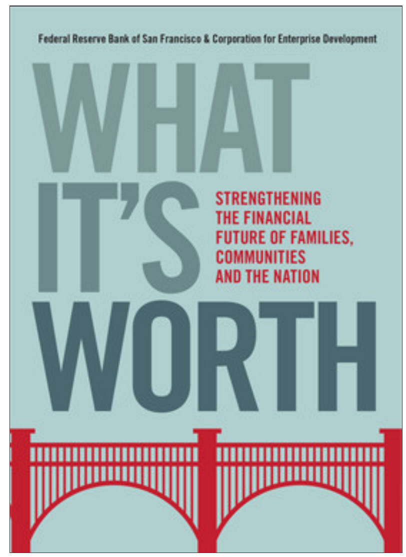
FEDERAL RESERVE BANK OF PHILADELPHIA

CASCADE: NO. 91, SPRING 2016

What It's Worth Reveals New Understanding of Financial Health and Well-Being*

By Laura Choi, Senior Research Associate, Community Development, Federal Reserve Bank of San Francisco

In December 2015, the Federal Reserve Bank of San Francisco and the Corporation for Enterprise Development (CFED) released a new book that examines financial health and well-being from many perspectives, bringing together the voices of long-time champions of financial capability and newcomers from a variety of sectors, such as public health, criminal justice, and business. *What It's Worth: Strengthening the Financial Future of Families, Communities and the Nation*[1] is a compilation of more than 30 essays that present new ideas for helping all Americans gain control over their financial lives and achieve their financial goals. As the book's cover indicates, financial health and well-being form the bridge to a strong financial future, connecting individuals and families to greater opportunity, creating more vibrant communities, and, in turn, strengthening the social and economic fabric of our nation.



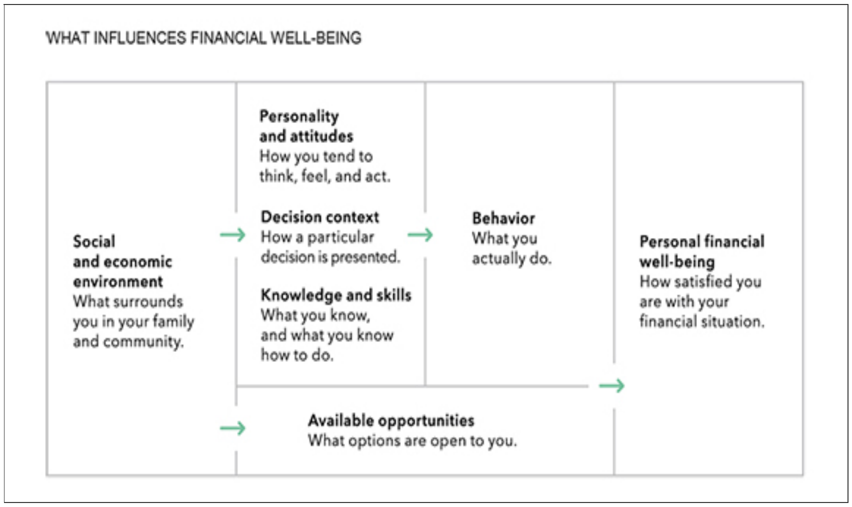
What It's Worth is the third book in a series, following *Investing in What Works for America's Communities: Essays on People, Place & Purpose*[2] and *What Counts: Harnessing Data for America's Communities*.[3] Together, these books explore ideas for the future of community development, highlighting examples of integrated, cross-sector, data-driven approaches from across the country. *What It's Worth* builds on these themes and takes a 360-degree view of the financial problems and challenges millions of American households face, the enormous creativity and innovation already happening to increase financial well-being, and ways to implement proven and emerging solutions. The book also makes clear that addressing these issues requires new partnerships across sectors such as health, education, criminal justice, and workforce development. No single sector or approach can do it alone.

Key Takeaways from *What It's Worth*

1. *A new understanding of financial health and well-being is emerging.*

In the United States, we have traditionally defined financial status by income or wealth, but experts in policy and practice from a range of fields are expanding our focus to better understand what consumers want and need in their financial lives. For example, income and expenses are often unpredictable and mismatched.[4] The traditional concept of a steady biweekly paycheck is becoming a thing of the past, and a significant share of households, even those with higher incomes, experience dramatic swings in their income and expenses. This variability can make it difficult to meet daily needs, plan for the future, and weather unexpected challenges.

A consensus is emerging that satisfaction with one's financial life has elements that are both objective (income, wealth, cash flow) and subjective (financial freedom, on track to meet financial goals). There is no official benchmark for "financial well-being," but the Consumer Financial Protection Bureau (CFPB) defines the term as "financial security and financial freedom of choice in the present and in the future."[5] Financial well-being is determined by a complex array of circumstances and choices. For many people, factors beyond their control determine the financial choices they have. It's important to recognize that the social and economic environment in which people grow up — including their parents' education, when they are born and enter the job market, their race, where they live, or the schools they attend — may limit their opportunities to be financially healthy.



Source: Consumer Financial Protection Bureau, "Financial Well-Being: The Goal of Financial Education," January 2015, p. 46, available at http://files.consumerfinance.gov/f/201501_cfpb_report_financial-well-being.pdf.

2. *We must address the systems that influence financial well-being.*

Creating financial health and well-being is not a just matter of changing individual behaviors. It also requires changing the systems that shape financial opportunities. Where we live, go to school, work each day, and receive health services — along with dozens of other daily actions — shape our financial health and well-being.

There are promising examples of integrated approaches in which new partners are building financial health into their existing approaches. For example, Delaware's Department of Health and Social Services integrates financial coaching strategies[6] into its efforts to promote health and self-sufficiency, and a private employer, Staples Inc., incorporates financial well-being into its suite of workplace benefits.[7] *What It's Worth* also reinforces the importance of place, noting that neighborhood quality plays a significant factor in housing stability, educational and employment opportunities, and health outcomes.

3. *Everyone has a role to play in strengthening the financial future for all.*

Individuals, families, and communities need to reach some threshold of financial well-being in order to achieve long-term goals such as boosting high school graduation rates, improving health, promoting more viable families, or developing better workers for 21st century jobs. Household financial well-being is an important intermediate step and organizing principle that allows different sectors to begin aligning their work. By starting to collectively recognize that financial well-being is often at the root of the myriad challenges that need to be solved over the long term, we can begin unifying around a common understanding of the next step forward. As stated in the book, "The beauty of household financial well-being as a conceptual framework is that it is both a stop on the road and a predictor of future success for so many other important outcomes."[8]

Spreading the Message

In the coming year, the Federal Reserve Bank of San Francisco and CFED will partner with various Federal Reserve Banks across the System to hold regional events that will focus on local solutions and opportunities for building financial well-being. An upcoming event in partnership with the Federal Reserve Bank of Philadelphia on May 5, 2016, which will be held at the Philadelphia Fed, will explore the *What It's Worth* book through the lens of health and income disparities. Researchers from both the public health and community development fields will present research demonstrating the potential to improve health outcomes by addressing nonmedical determinants of health such as financial stress and access to safe and affordable housing. Practitioners will share promising solutions for cross-sector collaboration aimed at improving the financial *and* physical health of families and communities.

In addition, we are excited to see that communities are using the book as a framework for establishing and strengthening their own financial well-being initiatives. For example, we've had requests to use *What It's Worth* as part of strategic planning and staff and board training, as well as for use in college and graduate courses. The entire book is available for download without charge at www.strongfinancialfuture.org. Hard copies of *What It's Worth* can be ordered also without charge at that site. We encourage you to explore the book, share it with your networks, and let us know how we can partner with you to build the financial future of your community.

For further information on the book, contact Laura Choi at laura.choi@sf.frb.org.
For information on the Philadelphia event, contact Noelle Baldini at noelle.baldini@phil.frb.org.

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* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

1 *What It's Worth: Strengthening the Financial Future of Families, Communities and the Nation*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and CFED, 2015, available at www.strongfinancialfuture.org/wp-content/uploads/2015/12/What-its-Worth_Full.pdf.

2 *Investing in What Works for America's Communities: Essays on People, Place & Purpose*. San Francisco: Federal Reserve Bank of San Francisco and Low Income Investment Fund, 2012, available at http://whatworksforamerica.org/pdf/whatworks_fullbook.pdf.

3 *What Counts: Harnessing Data for America's Communities*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and the Urban Institute, 2014, available at www.whatcountsforamerica.org/wp-content/uploads/2014/12/WhatCounts.pdf.

4 Jennifer Tescher and Rachel Schneider, "The Real Financial Lives of Americans," in *What It's Worth: Strengthening the Financial Future of Families, Communities and the Nation*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and CFED, 2015, pp. 53–67, available at www.strongfinancialfuture.org/essays/the-real-financial-lives-of-americans/.

5 Consumer Financial Protection Bureau, “Financial Well-Being: What it Means and How to Help,” January 2015, available at http://files.consumerfinance.gov/f/201501_cfpb_digest_financial-well-being.pdf.

6 Rita Landgraf, “Treating Financial Well-Being as a Public Health Issue: Lessons from Delaware,” in *What It’s Worth: Strengthening the Financial Future of Families, Communities and the Nation*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and CFED, 2015, pp. 173–178, available at www.strongfinancialfuture.org/essays/treating-financial-well-being-as-a-public-health-issue/.

7 Regis Mulot, “Thinking Outside the 401(k): Employer-Sponsored Financial Health Solutions,” in *What It’s Worth: Strengthening the Financial Future of Families, Communities and the Nation*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and CFED, 2015, pp. 143–147, available at www.strongfinancialfuture.org/essays/thinking-outside-the-401k/.

8 Laura Choi and David Erickson, “Toward a New Business Model: Strengthening Families Helps to Strengthen Communities and the Nation,” in *What It’s Worth: Strengthening the Financial Future of Families, Communities and the Nation*. San Francisco/Washington, D.C.: Federal Reserve Bank of San Francisco and CFED, 2015, pp. 371–381, available at www.strongfinancialfuture.org/essays/toward-a-new-business-model/.

CASCADE: NO. 91, SPRING 2016

Message from the Community Affairs Officer

By Theresa Y. Singleton, Ph.D., Vice President and Community Affairs Officer

Theresa Y. Singleton, Ph.D., Vice President and Community Affairs Officer

This issue of *Cascade* focuses on a range of consumer and small business financing needs. Some community development financial institutions (CDFIs) have become active in consumer finance, and the new Capital for Communities column examines how CDFIs are providing small-dollar loans in conjunction with credit-building tools and financial education.

Small business plays an important role in the nation's communities. A contributed article by Karen Gordon Mills, former administrator of the U.S. Small Business Administration, describes significant trends in how online lenders and banks are providing credit to small businesses. In the changing landscape of small business lending, some partnerships have emerged to better serve creditworthy borrowers in underserved areas. Another article highlights findings of a recent survey of small businesses in 26 states conducted by the Federal Reserve Bank of New York and six other Reserve Banks, including the Philadelphia Fed.

Meanwhile, ex-offenders need assistance as they re-enter communities, and one article reports on an unusual partnership by a bank, a community college, and a health-care system that seeks to reduce the rate of recidivism and improve outcomes for individuals and families. The bank, which is based in Stroudsburg, PA, is providing ex-offenders with financial education and loans for housing, transportation, or education and training.

In coverage concerning older people, an Urban Institute report finds that low-income older adults face high housing costs and serious financial challenges. Data provided in the Mapping Our Community feature show that the number of older adults in Pennsylvania, New Jersey, and Delaware is expected to grow from 3.3 million to 5.4 million from 2010 to 2030. Readers may also be interested in viewing materials (agenda with links to speakers' presentations and video) from a conference on Meeting the Financial Needs of Older Adults held March 2 at the Philadelphia Fed.

One article summarizes a research study on the effect of down payment assistance on the performance of affordable housing mortgage loans. There is also coverage of *What It's Worth*, a new book developed by the Federal Reserve Bank of San Francisco and the Corporation for Enterprise Development that examines financial health and well-being from many perspectives. A related event that will feature researchers from the public health and community development fields and explore potential for cross-border collaboration will be held May 5, 2016, at the Philadelphia Fed.