Community Development Financial Institutions: On the Front Lines

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- Atlanta Fed President and CEO Dennis Lockhart, in an October 25, 2016, speech to the Opportunity Finance Network Conference in Atlanta, presents his views on financing community development.
- Lockhart says despite economic progress achieved, the circumstances of many urban and rural low-income communities remain very difficult. He believes community development financial institutions—CDFIs—are well positioned to play a pivotal role.
- Lockhart notes that CDFIs operate in a fragmented industry community with more than 1,000 individual entities.
- In his opinion, CDFIs should get to scale in good time or combine with others, and they must adapt to changes in the landscape of financial technology.
- Lockhart says we can't assume a community has the capacity to absorb development capital in ways that move a distressed place and its residents ahead.
- In Lockhart's view, a set of circumstances is coalescing in the nation's economy that will put CDFIs on the front lines of efforts to address troubling, perhaps even dangerous, distributional imbalances.

I'd like to begin by welcoming OFN to Atlanta. This city is an apt venue for engaging the issues at the heart of this conference.

Last week I visited Detroit and spoke to some civic leaders who also participate on the board of directors of the Federal Reserve facility there. One director called the experience in Detroit a "tale of two cities." I understood him to mean that for years the experience of the professional and relatively affluent class in Detroit has been radically different from the living experience of the working poor.

Atlanta's circumstances are not as extreme, but sharp contrasts are evident here as well. Atlanta is one of the fastest-growing urban regions in the country, yet Atlanta is one of the worst for economic mobility. This community continues to attract new residents, to attract business operations relocating from elsewhere, and to attract new investment. Yet real per capita income today is lower than it was in 2000, and we have pockets of entrenched poverty and disinvestment.

This conference is about community development finance and especially the role of community development financial institutions, or CDFIs. And the theme of this conference is "rethink."

Quite frankly, I don't consider it necessary to do a comprehensive, top-to-bottom rethink of the role, business model, and operating methods of CDFIs. I am a fan of CDFIs. I like your dedicated focus on funding mostly unbankable entities, providing technical assistance, and operating with intimate knowledge of your community's dynamics and your borrowers' daily business details.

Before joining the Federal Reserve, I worked as a banker and investor up and down the borrower quality continuum. I had a lot of experience with high-risk, relatively immature businesses. I oversaw a number of small business finance companies. I also chaired an investment group called the Small Enterprise Investment Funds that made equity investments in the equivalent of underserved communities in emerging markets around the world. To generalize from my experience, lending to and investing in relatively young, undercapitalized, entrepreneur-led enterprises is hard. That said, there is often a difference between perceived risk and actual risk, and skilled lenders and investors can exploit that distinction. CDFIs inhabit such a market space and do it quite effectively.

So, while I might question the need for a complete rethink of what you're doing, I do accept that it's healthy to revisit and refresh assumptions from time to time. This is what I intend to do today. I consider this an opportune time because, although we're in the eighth year of recovery following the Great Recession, progress has been uneven. You confront that reality daily.

I must mention here that Federal Reserve officials who participate in the Federal Open Market Committee (FOMC)—the body that makes monetary policy—are now in a quiet period as regards public remarks. There is a meeting of the FOMC next week, so I cannot address current issues influencing monetary policy. This frees me to focus on the topic at hand—financing community development.

You may ask why your central bank—an institution appropriately concerned with macroeconomic conditions and interest-rate policy—in short, the big picture—is involved in community development and community development finance.

The Fed's community and economic development work is rooted in our bank supervisory responsibility for enforcement of the Community Reinvestment Act (CRA). We continue to oversee the banking industry's performance about their CRA responsibilities, but we have built on that experience by devoting some resources directly to **micro**economic issues of communities, especially low- and moderate-income communities. Our Community and Economic Development team spearheads that activity.

Each Federal Reserve Bank adapts its program to its own geography. Five Federal Reserve banks as well as the Board of Governors in Washington are represented at this meeting. Colleagues from Reserve Banks in Chicago, Minneapolis, Richmond, and St. Louis are here to engage in this discussion. As I said, each has its own unique program.

In our district, which encompasses much of the Southeast, we are specializing in four interconnected areas—workforce development, housing and neighborhood revitalization, small business, and community development finance.

Our resources for this work are limited, so we've put emphasis on research that can be useful to practitioners along with partnership efforts conducted in various ways. Let me drop some names. We're partnering with leaders in community development finance like Donna Gambrell (we're lucky to have Donna as a visiting scholar at the Atlanta Fed); Bill Bynum with HOPE Credit Union in Mississippi; Ignacio Esteban with the Florida Community Loan Fund; Grace Fricks with ACE; and Clint Gwin from Pathway Lending. They have been helping us understand the ground-level challenges facing the communities and enterprises served by CDFIs.

In spite of the economic progress achieved, the circumstances of many urban and rural low-income communities remain very difficult. Everyone here is all too familiar with the human and community face of income inequality, concentrated poverty, and economic exclusion. Demands for redress are growing louder, in my opinion.

If, in the coming years, American society pulls together to address these problems in a more aggressive way, I believe CDFIs are well positioned to play a pivotal role. You specialize in serving underserved markets. You grasp the complex dynamics at play in distressed areas. And you invest with an eye on both financial and social returns.

So, it seems to me that a front-and-center question is…are you ready? Let me flesh out that question. Are CDFIs ready to be the vehicle of choice to confront the challenges of inequality, economic and financial exclusion, and the deficit of, and the underfunding of, entrepreneurial ventures in low- and moderate-income communities?

I certainly hope this conference will bring forth perspectives on the question. Let me offer some tentative views—views that are informed by my organization's contacts with knowledgeable figures in your industry.

First, CDFIs operate in a fragmented industry community. Since the U.S. Treasury started certifying CDFIs in the late ‘90s, the population of CDFIs has expanded to more than a thousand individual entities. The industry includes both regulated depositories and unregulated loan funds. Most are relatively small.

It’s my impression that a large number of the thousand or so certified CDFIs have not reached operational sustainability. Given their mission, this is not an indictment. Rather, it’s an attempt to point out obvious implications—get to scale in good time or combine with others.

I think a period of consolidation can be anticipated. Sustainability pressures may call for leaders of CDFIs who can identify partnering opportunities that bring efficiency benefits while preserving the market knowledge of smaller, place-based organizations.

A second observation is CDFIs must adapt to changes in the landscape of financial technology. We’re in a period of significant industry disruption in banking, small enterprise finance, and personal finance. Innovative business models and methods are exposing costly and inefficient business practices in areas such as payments, borrower identification and loan origination, loan processing, and customer interface. Jeremy Nowack pointed to this challenge in a provocative paper published by OFN earlier this year. He said, “FinTech should be considered a wake-up call for CDFIs.”

My third and last point relates to capacity constraints—not of CDFIs narrowly, but of distressed communities where CDFIs attempt to operate. Perhaps it’s a tautology, but capacity constraints are most prevalent where challenges are greatest. We cannot facilely assume a community has the capacity to absorb development capital in ways that move a distressed place and its residents ahead.

I’ve come to understand that the challenges you all confront in your lending and technical assistance activities are often most intractable where there are few institutional partners to work with. Whether you are financing a charter school, financing development of affordable housing, financing the building of a health clinic, or financing a small business of some kind, you need partners who can execute.

Unfortunately, those partners don't exist everywhere. New research performed by Fed community development teams in Atlanta and Philadelphia looked at philanthropic grants for community economic development. The research assessed the local factors that make a place more or less likely to attract funding from larger foundations. Our researchers found a statistical relationship between population and grant dollars received per capita. They also found that places with a greater density of nongovernmental organizations (NGOs) operating locally are more likely to attract funding. Perhaps this too is an obvious finding. Places with more capacity—a more built-out institutional landscape—attract greater amounts of philanthropic funding from large foundations.

My team here developed an online tool called "Following the Money" that can be used to visualize the flow of foundation grants and the capacity constraints that limit such flows.

Other research work on the capital absorption capacity of communities suggests they struggle to absorb double or triple bottom-line investments. This is not because the supply of social impact capital is constrained, but because development projects are disconnected. They are often not clearly aligned with a set of visible local priorities. They may be siloed in one department or agency. This work leads us to urge communities seeking investment to organize their demand for capital into an agreed set of priorities yielding a pipeline of investable opportunities. This is true, it seems, even in larger communities with a dense network of NGOs.

Whether it involves a small metro area or a large urban region, agreement on community priorities does not come easily or automatically, I know. Lately, I've been musing about the role of volunteer civic leadership in communities of all sizes. It seems to me there is an element of serendipity in the fortune of communities. Some are blessed with the right mix of committed, talented leaders at a community's time of need. Some communities may not be so blessed. You might call this the "hero theory of community progress." In Detroit last week, I heard the uplifting story of civic leaders stepping up when the city had its back to the wall.

I'll be retiring from the Federal Reserve next February. I have served in my position over a momentous 10-year period that spans the financial crisis, a deep recession, and a protracted recovery. The country has come a long way since 2008 and 2009, but there is more to do. In my view, a set of circumstances is coalescing in the nation's economy that will put CDFIs on the front lines of efforts to address troubling, perhaps even dangerous, distributional imbalances. I'll repeat the important question: are you ready? I do hope this conference will bring forth a response to the readiness question in a way that inspires and empowers your organizations.

As I said, I am a fan of CDFIs, and my Reserve Bank is deeply engaged with the CDFI community in our region. We look forward to continuing our work with your community. Thank you for what you do.