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Remarks by Chairman Ben S. Bernanke
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Community Development Financial Institutions: Promoting Economic Growth and Opportunity

Good afternoon and thank you for inviting me to speak to your annual conference. Since I assumed my new responsibilities earlier this year, as well as during my earlier stint at the Federal Reserve as a member of the Board of Governors, I have met numerous times with community development leaders to discuss both their achievements and the challenges they face. In visiting some underserved communities, I have seen first-hand the effects of various development initiatives. I have also regularly attended the meetings of the Board's Consumer Advisory Council, which brings together community representatives and lenders to discuss a range of consumer and community development issues. These experiences have helped me appreciate the many ways that community development financial institutions (CDFIs) work to strengthen communities and improve the lives of lower-income people.

Ensuring that every American has the chance to improve his or her economic circumstances through hard work, saving, entrepreneurship, and other productive activities is essential for building healthy communities and achieving sustainable economic growth. The Federal Reserve and the CDFI community share a common interest in increasing economic opportunity for all Americans. The Federal Reserve supports local economic development, for example, through its active engagement in financial literacy programs, through its community outreach efforts, through aspects of its role in regulating banking and financial markets, and by its research in regional economics. But the Fed's central mission--to help maintain a financial and macroeconomic environment that fosters price stability and maximum sustainable employment--is of necessity focused on the economic performance of the nation as a whole. Monetary policy is a blunt tool that cannot target industries, population groups, or regions. In contrast, as you know, CDFIs operate primarily at the microeconomic level, community by community. Using techniques such as financial counseling, local market research, and specialized lending, CDFIs work with partners in both the public and the private sectors to help unlock the economic potential of lower-income and underserved communities.

The theme of my remarks today is our shared goal of increasing economic opportunity. I will first discuss some of the progress that has been made in recent years in the economic situations of lower-income households and communities as well as some of the important challenges that remain. I will also offer my perspective on how CDFIs and their partners can help to meet those challenges.

Improvements in Economic Opportunity and Some Challenges

In the past decade or so, U.S. households overall have experienced notable gains in terms of some key indicators of economic opportunity. Three such indicators that I will briefly discuss are access to credit, rates of homeownership, and small business development. Moreover, as measured by these indicators, recent improvements in traditionally underserved markets appear to have been as great as or greater than those in middle- and upper-income households and communities. At the same time, however, the gaps between lower-income households and other households with respect to these measures of opportunity remain wide.

Access to Credit

Access to credit is an important element of economic opportunity and community economic development: It supports homeownership and small-business creation and provides greater financial flexibility for households. In recent years, advances in information and communication technologies, improved methods of risk measurement and risk assessment, the availability of more-comprehensive information about individuals' credit histories, and an increased ability of retail lenders to obtain funds from capital markets have led to what has been called the "democratization" of credit. As the pricing of credit risk has become more sophisticated and more consistent, as scale economies have reduced costs, and as funding sources have increased, lenders have been able to extend credit to households and businesses that might previously have been considered uncreditworthy.

The growth of subprime mortgage lending is one indication of the extent to which access to credit has increased for all households, including those with lower incomes. In 1994, fewer than 5 percent of mortgage originations were in the subprime market, but by 2005 about 20 percent of new mortgage loans were subprime.1 Indeed, the expansion of subprime lending has contributed importantly to the substantial increase in the overall use of mortgage credit. From 1995 to 2004, the share of households with mortgage debt increased 17 percent, and in the lowest income quintile, the share of households with mortgage debt rose 53 percent.2

Although the emergence of risk-based pricing has increased access to credit for all households, it has also raised some concerns and questions, which are magnified in the case of lower-income borrowers. For example, although subprime lending has grown substantially, are prime credit products sufficiently available and do lenders effectively compete in all communities, including historically underserved communities? How well are lower-income borrowers matched with credit products and loan terms that fit their circumstances? Are borrowers aware of the terms and conditions of their loans, and more generally, are consumers sufficiently well informed to be wary of potentially misleading marketing tactics and to shop effectively among lenders? Some evidence, including recent Federal Reserve research on consumers holding adjustable-rate mortgages, suggests that awareness could be improved, particularly among borrowers with lower incomes and education levels.3 This research suggests the need for greater financial literacy and increased access to financial counseling, a point to which I will return.

The release this year and last of mortgage price data gathered under the Home Mortgage Disclosure Act (HMDA) has highlighted a different, but potentially related, concern about access to credit on equal terms. The data show that blacks and Hispanics are considerably more likely than other borrowers to receive higher-priced loans.4 This finding has several possible--and not mutually exclusive--explanations, ranging from illegal discrimination to the effects of legitimate pricing factors not captured in the HMDA data, such as loan-to-value ratios and borrower credit history. Of course, as an agency committed to the rigorous enforcement of the fair lending laws, our job is to distinguish legitimate from illegitimate sources of pricing differentials among the banking institutions we supervise. In our enforcement efforts, we analyze the HMDA price disparities in conjunction with other information, such as the adequacy of the lender's fair lending controls and the presence of business practices that may put lenders at risk for pricing discrimination. For example, a lender might offer its loan officers financial incentives that have the effect of inducing them to charge some applicants higher interest rates or to "steer" them to higher-priced loan products. Lenders at risk for pricing discrimination receive targeted reviews of their pricing to ensure that they are complying with fair lending laws.

Loan price disparities, however, are not just a legal and supervisory issue. They also raise important social and policy concerns. The questions I raised earlier about access to prime products, lender competition, and borrower awareness and financial literacy may well be relevant to understanding the price disparities we observe. Further research to explore these questions and their possible connection to disparities in lending to members of minority groups would be highly worthwhile. In fact, the Federal Reserve's upcoming Community Affairs Research Conference will feature several papers that explore these issues.5

Homeownership

The important issue of loan pricing aside, expanded access to mortgage credit has helped fuel substantial growth in homeownership. The national rate of homeownership increased from 1995 through mid-2006, reaching nearly 69 percent of all households this year.6 All major racial and ethnic groups have made gains in homeownership, but in percentage terms the largest increases have been made by minority households. In particular, since 1995 the homeownership rate has increased 7 percent among white households, 11 percent among black households, and 19 percent among Hispanic households. However, despite the relatively more rapid growth in minority homeownership, significant differences persist: For example, the homeownership rate for blacks and Hispanics remains about two-thirds the rate for non-Hispanic whites.

As for homeownership in lower-income areas, the Federal Reserve's Survey of Consumer Finances indicates that, from 1995 to 2004, census tracts in all income groupings experienced gains in homeownership, with rates in lower-income areas growing somewhat faster than those in higher-income areas.7 But, again, important gaps remain. For example, in 2004, the rate of homeownership in lower-income areas was roughly 47 percent, compared to 72 percent in middle-income areas.

Small Businesses

Another area in which progress has been made both generally and in lower-income communities is small business development. Small businesses are essential to the economic well-being and vibrancy of local communities and of the U.S. economy as a whole. The U.S. Small Business Administration estimates that small businesses account for about half of private-sector output and employ more than half of private-sector workers.8 Moreover, because small businesses sometimes become big ones, small-business ownership can be a significant stepping stone for economic advancement, particularly in traditionally underserved populations. Between 1997 and 2002, the number of businesses owned by Asians, blacks, Hispanics, and women grew more than 20 percent for each group--more than twice the national rate of increase for all businesses.9

Nevertheless, small businesses face continual challenges. Each year, about half a million firms close, in some cases because of difficulties obtaining credit.10 Interestingly, the data do not indicate that experiences in obtaining credit differ greatly across neighborhoods of different income levels. According to the Federal Reserve's Survey of Small Business Finances, for example, the proportions of businesses that were either denied credit or did not apply for fear of being turned down were similar across neighborhood income groups.11

CDFIs as a Solution to Market Failures

Many factors have contributed to the economic gains that I have cited, including broad macroeconomic forces and advances in the delivery of financial services. CDFIs have also played a valuable role by analyzing the economic potential of lower-income markets and developing strategies and marshaling resources to tap that potential.

As CDFI leaders, you are keenly aware of the economic challenges that you work to overcome each day. Economists find it useful to think about these challenges in the context of the economics of market failure. Standard economic analysis tells us that when competitive conditions prevail in a market, the resulting prices induce firms and individuals to allocate resources in a manner that tends to maximize social welfare.12 However, economists also recognize that various deviations from idealized market conditions, termed market failures, can inhibit the efficient allocation of resources.13 In one type of market failure, called a neighborhood externality, the actions of one person affect the well-being or economic welfare of others in the local area, but the individual taking the action neither bears the full costs of nor reaps the full benefits from those actions. Because the individual does not bear the full consequences of the actions taken, he or she may act in a way that is not in the best economic interest of the neighborhood as a whole. For example, the failure of some owners to maintain their properties can lower the value of well-maintained properties in the same neighborhood. Ultimately, such spillover effects from neglected properties can lead to underinvestment in the whole community, potentially harming all neighborhood residents and businesses.

A related type of market failure studied by economists is known as an information externality. An information externality may arise when information about economic opportunities in an area has the potential to benefit many investors but is costly to gather. As a result, no single potential investor may find obtaining the data to be profitable. For example, on average, lower-income areas have fewer owner-occupied homes and record fewer home-purchase loans than higher-income areas do.14 Lower transaction activity makes accurately gauging property values and evaluating credit risks in those areas more difficult, which may inhibit the extension of credit.15 Alternatively, lower-income people may have shorter and more-irregular credit histories, making an evaluation of their individual creditworthiness more difficult and costly. Because a potential investor who bears the costs of obtaining data about underserved neighborhoods may be able to obtain only a portion of the full economic benefits, these data may remain uncollected.16

One purpose of CDFIs is to help overcome these and other market failures that inhibit local economic development. For example, by facilitating larger-scale property development projects, coordinating public and private investment efforts, and working to improve amenities and services in a local area, CDFIs may help to solve collective action problems and reduce neighborhood externalities. CDFIs can counter information externalities by assuming the cost of learning about their local communities and developing specialized financial products and services that better fit local needs. In general, CDFIs provide coordinated development activities and community-specific information that the market may not supply on its own.

Among other benefits, the familiarity with each community that CDFIs develop can help to gauge and control risk.17 For example, the use by CDFIs of appraisers who specialize in evaluating properties in a particular community produces more-reliable estimates of the value of the loan collateral. Likewise, CDFIs structure loans and use public and private credit enhancements both to increase borrowers' ability to qualify for loans and to spread the associated credit risk among a mix of private creditors and other providers of funds.

Although these specialized techniques can reduce credit risk, they are labor-intensive and, consequently, expensive. Most private lending institutions reduce costs by adopting processes that are highly standardized and automated. Such systems are not necessarily compatible with lending to borrowers who require substantial screening, counseling, and monitoring or with acquiring specialized information about community development lending. Part of the explicit mission of CDFIs is to assume the costs of conducting such research and analyses in underserved communities. CDFIs have also developed techniques and strategies--such as flexible underwriting criteria, specialized loan products, and intensive financial education programs--to meet the financial circumstances of their communities. Moreover, in recent years, CDFIs have been working to expand their role as information brokers beyond the local communities they serve. Through national initiatives to collect industry-wide data and to securitize community development loan portfolios, CDFIs are working to expand access to credit and capital in lower-income markets. In short, knowledge and expertise--together with the ability to build new relationships--are the principal contributions that CDFIs bring to the marketplace and to underserved communities.

Is Community Development Lending Profitable?

Can private-market participants profit from community development lending? Data based on Community Reinvestment Act (CRA) examinations tell us much about the volume of such loans but less about their performance and profitability. However, a Federal Reserve survey found that nearly all banks reported that their community development activities were profitable, at least to some degree.18 About two-thirds of the banks also reported receiving some benefit from their lending unrelated to loan profitability, such as an improved image in the community.

Since the Federal Reserve report, studies undertaken by the CDFI Data Project show that, for 2004, charge-off rates for CDFI portfolios were similar to those for the banking industry as a whole.19 These studies and market data suggest that banks and other private organizations may become an increasingly significant source of competition for CDFIs. That is good news, not bad news. Indeed, the surest sign of a CDFI's success is that private investors see viable investment opportunities in the neighborhoods in which the CDFI has been operating.

The Continuing Relevance of CDFIs

Although in some sense the mission of CDFIs is to make themselves unnecessary, I expect that the knowledge and good will that they have accumulated in local communities will continue to make them relevant. For example, I mentioned earlier the loan pricing disadvantages faced by members of minority groups that have appeared in the HMDA data. CDFIs may be able to help reduce those discrepancies by using their local knowledge and financial expertise to offer alternatives to conventional subprime lending. The Opportunity Finance Network, for instance, will be competing with subprime lenders via a mortgage-credit platform that centralizes some CDFI lending processes and directly links counseling and lending services. At the same time, CDFIs continue to expand their ability to attract private investment funds, for example, through increasing transparency and developing the means of providing objective evaluations of their financial and mission-related effectiveness.

These efforts demonstrate the ability of CDFIs to adapt their business strategies to evolving markets, as indeed they have done throughout their thirty-year history. I expect that the local knowledge and specialized financial expertise that CDFIs provide will continue to add significant economic value and complement market forces in the support of community economic development. Thus, CDFIs are likely to contribute to our shared goal of expanding economic opportunity for many years to come.

Footnotes

1. Estimates are based on information from Inside Mortgage Finance Publications (2005 and earlier years), Mortgage Market Statistical Annual (Bethesda, Md.: IMFP), www.imfpubs.com

2. Calculations by Federal Reserve Board staff from the Federal Reserve Board's Survey of Consumer Finances, 1995 and 2004. Further information on the Survey of Consumer Finances is in Arthur B. Kennickell, Martha Starr-McCluer, and Annika E. Sunden (1997), "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 83 (January), pp. 1-24; and Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore (2006), "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," (444 KB PDF) Federal Reserve Bulletin, vol. 91 (Winter), pp. A1-A38, www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf.

3. Brian Bucks and Karen Pence (2006), "Do Homeowners Know Their House Values and Mortgage Terms," Finance and Economics Discussion Series 2006-03 (Washington: Board of Governors of the Federal Reserve System, March).

4. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner (2006), "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin, vol. 92 (September), www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (580 KB PDF).

5. Federal Reserve System Community Affairs Research Conference, "Financing Community Development: Learning from the Past, Looking to the Future", March 29-30, 2007, www.philadelphiafed.org/econ/conf/financingcd/callforpapers-ca-research2007.pdf (489 KB PDF).

6. www.huduser.org/periodicals/ushmc.html

7. Calculations by Federal Reserve Board staff from the Federal Reserve Board's Survey of Consumer Finances, 1995 and 2004, www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

8. U.S. Small Business Administration, Office of Advocacy, www.sba.gov/advo/stats/sbfaq.pdf (91 KB PDF).

9. U.S. Census Bureau, Survey of Business Owners, www.census.gov/csd/sbo/.

10. U.S. Small Business Administration, Office of Advocacy, www.sba.gov/advo/stats/sbfaq.pdf (91 KB PDF).

11. Calculations by Federal Reserve staff from the Federal Reserve Board's 2003 Survey of Small Business Finances. For further information, see www.federalreserve.gov/pubs/bulletin/2006/smallbusiness/smallbusiness.pdf (178 KB PDF).

12. Kenneth J. Arrow (1951), "An Extension of the Basic Theorems of Classical Welfare Economics," in J. Neyman (ed.), Proceedings of the Second Berkeley Symposium on Mathematical Statistics and Probability (Berkeley and Los Angeles: University of California Press), pp. 507-32.

13. Paul Milgrom and John Roberts (1992), Economics, Organization, and Management (Englewood Cliffs, N.J.: Prentice Hall).

14. The decennial census and annual HMDA data indicate, for example, that the average number of owner-occupied properties and home purchase loans in lower-income areas is less than half the average number in higher-income areas.

15. This argument is developed in detail in William W. Lang and Leonard I. Nakamura (1993), "A Model of Redlining," Journal of Urban Economics, vol. 33 (March), pp. 223-34.

16. A detailed model of this phenomenon is in William C. Gruben, Jonathan A. Neuberger, and Ronald H. Schmidt (1990), "Imperfect Information and the Community Reinvestment Act," (2.7 MB PDF) Federal Reserve Bank of San Francisco, Economic Review, vol. 3 (Summer), pp. 27-46.

17. Board of Governors of the Federal Reserve System (1993), Report to the Congress on Community Development Lending by Depository Institutions (Washington: Board of Governors, October).

18. Board of Governors of the Federal Reserve System (2000), The Performance and Profitability of CRA-Related Lending, Report to the Congress submitted pursuant to section 713 of the Gramm-Leach Bliley Act of 1999 (Washington: Board of Governors, July), www.federalreserve.gov/boarddocs/surveys/craloansurvey/default.htm.

19. CDFI Coalition, CDFI Data Project, 2004, www.cdfi.org/cdfiproj.asp#fy; and Elizabeth C. Klee and Gretchen C. Weinbach (2006), "Profit and Balance Sheet Developments at U.S. Commercial Banks in 2005," Federal Reserve Bulletin, vol. 92 (June) www.federalreserve.gov/pubs/bulletin/2006/bankprofits/0606bankprofit.pdf (221 KB PDF).