BY SUREKHA CARPENTER

Expanding Credit Access through Community Development Financial Institutions

Many Americans take access to credit for granted. It's easy for them to underestimate the importance of credit. But without it, a person's economic advancement may become more challenging. For example, in many areas, the inability to secure an auto loan — and thus, a car — could limit employment options, access to healthy food, or medical care.

Different people have disparate experiences in accessing credit. For those who are financially underserved, the market has produced credit alternatives. But many of those alternatives, such as payday lenders, offer unfavorable terms that often make payoff difficult and may leave borrowers falling behind.

One way of addressing such gaps in access lies outside the traditional credit system. Community development financial institutions, or CDFIs, are mission-driven nonprofits and for-profits that deliver a range of financial products, services, and education to underserved individuals and communities. They provide credit where traditional lenders cannot and provide affordable credit where nontraditional — sometimes predatory — lenders do not.

HISTORICAL CHALLENGES

Racial minorities, immigrants of many backgrounds, women, people in rural places, and low-income laborers have long faced considerable challenges obtaining credit. Early in U.S. history, some groups created their own banks and financial resources after being excluded from mainstream institutions. For example, in 1903, Maggie L. Walker became the first Black woman to found a bank — the St. Luke Penny Savings Bank in Richmond. (See "Maggie Lena Walker," p. 12.)

The Great Depression weighed heavily on the banking industry and closed many institutions, including ones that catered to marginalized populations. Beyond bank closures, which dealt a blow to the expansion of financial access, policies and practices put in place to counter the effects of the downturn would also have devastating and lasting effects. To avoid huge numbers of households being foreclosed on, the federal government established the Home Owners Loan Corporation (HOLC). The institution was meant to help refinance mortgages, but as a part of that process, it redlined city neighborhoods that were home to racial minority communities, immigrants, or low-income laborers of all backgrounds. By labeling these places too risky to lend to and "hazardous" for the government to back mortgages in, it became increasingly difficult for these communities to find a source for any type of loan they sought.

Despite its discriminatory effects, redlining was not addressed by Congress for decades. After overt redlining was banned under the Fair Housing Act of 1968, federal laws targeted financial and banking discrimination next. The Equal Credit Opportunity Act of 1974 made it illegal for creditors to discriminate based on race, color, sex, marital status, or religion. Three years later, the Community Reinvestment Act (CRA) was passed to reduce the discriminatory effects of redlining by encouraging banks to meet the credit needs of the communities in which they take deposits — with a particular focus on low- and moderate-income and underserved neighborhoods. (See "Revisiting the Community Reinvestment Act," *Econ Focus*, First Quarter 2022.)

While this was happening in the legislature, the first known CDFI, South Shore Bank, was founded in Chicago in 1973 with an explicit goal of providing financing to low-income communities.

GAPS IN CREDIT ACCESS

The National Community Reinvestment Coalition (NCRC), an association of community-based organizations seeking to increase lending in underserved communities, argues that HOLC's redlined maps from the 1930s and 1940s have led to persistent economic inequality today. NCRC reported that in 2018, almost three-quarters of the neighborhoods that the HOLC graded as high risk were low-to-moderate income (LMI) today and nearly 64 percent were majority minority. This is relevant because recent studies conducted around the United States point to disparate outcomes and experiences in accessing credit for minority and LMI borrowers, among others. This includes finding lenders and being approved for credit.

Brick-and-mortar financial institutions can increase physical access to lending. But there tend to be fewer bank branches in rural areas and in places with large racial minority or low-income populations. Online banking and lending are alternatives to in-person banking, but its limitations affect the same populations. Rural places tend to enjoy less broadband access due to a lack of infrastructure, and in urban areas there is less internet adoption among LMI and minority households.

Minority borrowers, low-income borrowers, and borrowers in rural places face higher rates of denials for mortgages and small businesses. Some studies point to discrepancies in credit outcomes based on race. A 2019 test by the NCRC found that better-qualified Black and Hispanic small-business owners had worse experiences than their White counterparts when seeking business loans. Rural small-business lending declined in Appalachia between 2007 and 2010 at a greater rate than in the nation as a whole, according to an NCRC report. In 2009, credit was denied to about 9 percent of small businesses across the United States, whereas 23 percent were turned away in Appalachia. In a study of credit access constraints, the New York Fed also determined that rural status, high percentages of residents of color, lower educational attainment, and higher unemployment rates are correlated with less credit access.

DIFFERENCES IN PERSONAL CREDIT USE

Federal Depository Insurance Corporation (FDIC) data explore one aspect of credit access: personal credit usage. In 2021, seven out of 10 U.S. households reported using bank credit in the last year. This includes using a credit card or a personal loan from a bank or credit union but does not include student loans, auto loans, or mortgages. Across household characteristics, usage varied widely. (See table.) Additionally, 2.8 percent of households had a personal loan or line of credit from a company other than a bank in 2021.

The last time the FDIC asked directly about U.S. households outside of the credit economy, in 2017, one household in five had no mainstream credit and likely did not have a credit score. The use of alternative credit — borrowing outside of the traditional credit economy — includes products like payday loans, pawn shop loans, and auto title loans. While 4.4 percent of all households in the nation used alternative credit products such as these in 2021, the share grew to 7.8 percent for households without a high school diploma and 7 percent for very low-income families. The data do not

Personal Credit Use in the Past 12 months, By Household Characteristics, 2021

Row Variables	Number of Households (1000s)	Use of bank credit, last 12 months	Use of credit at company other than a bank, last 12 months	Use of alternative credit product, last 12 months
All Households	**132,517**	**72.3**	**2.8**	**4.4**
Black	16,933	49.9	3.3	7.6
Hispanic	19,368	60.0	2.8	6.4
White	86,037	78.8	2.7	3.3
No high school diploma	10,492	37.9	2.3	7.8
High school diploma	32,235	60.7	2.5	5.9
College degree	52,904	86.2	2.6	2.3
Less than $15,000	12,547	33.9	1.6	7.0
$15,000 to $30,000	17,889	52.2	2.5	6.9
$30,000 to $50,000	24,617	67.1	2.8	6.1
$50,000 to $75,000	24,563	77.8	3.2	4.3
At least $75,000	52,900	87.9	3.0	2.3
Urban area	113,835	73.4	2.7	4.3
Not in urban area	17,645	65.3	3.1	5.2

SOURCE: FDIC 2021 National Survey of Unbanked and Underbanked Households

NOTES: Bank credit includes credit cards (Visa, MasterCard, American Express, or Discover) or personal loans or lines of credit from a bank; it does not include student loans, auto loans, or mortgages. "Alternative credit product" includes the following: payday loan, pawn shop loan, rent-to-own service, refund anticipation loan, and auto title loan.

reveal how many households chose not to be in the credit economy.

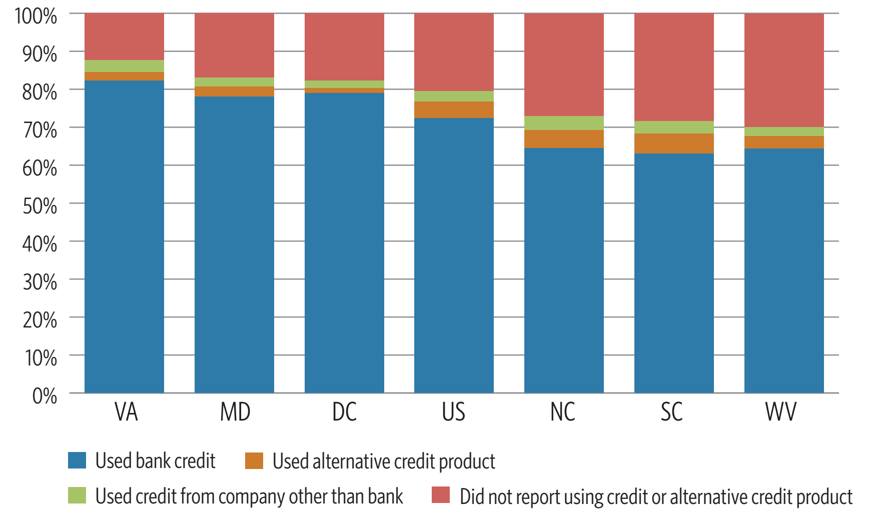
While the National Survey of Unbanked and Underbanked Households provides information from households that use personal credit, it does not explore large loans, like auto loans or mortgages. According to the Fed's Survey of Consumer Finances, differences persist for these products across family characteristics, as well. Forty-four percent of all families held a mortgage or home equity loan in 2019. That's compared to 28 percent of Black families and 33 percent of Hispanic families. And, while 37 percent of all families have an auto loan, the share falls to 27 percent for families with no high school diploma.

Within Fifth District states, North Carolina, South Carolina, and West Virginia had the lowest use of bank credit. (See chart.) Those states also had the highest use of alternative credit products. Their similarities in credit use may be related to the large shares of minority, rural, and LMI households in North Carolina and South Carolina and the high shares of rural and LMI households in West Virginia.

Due to data limitations, the data are not available across all characteristics for each state in the Fifth District. Where they are available, the data show large gaps in credit patterns between races, income, and education levels:

- **Race.** In the District of Columbia, Maryland, North Carolina, and South Carolina, there were differences of 22 to 34 percentage points between bank credit usage of Black and White households.
- **Income.** Roughly half of North Carolina and West Virginia lower-income households ($15,000 to $30,000) used bank credit versus 68 to 75 percent usage among households with moderate income ($50,000 to $75,000).
- **Education.** Between 47 and 57 percent of North Carolina, South Carolina, and West Virginia borrowers with a high school diploma as their highest educational attainment used bank credit, compared to 76 to 81 percent of borrowers with a college degree.

Personal Credit Use in the Past 12 Months, By State, 2021



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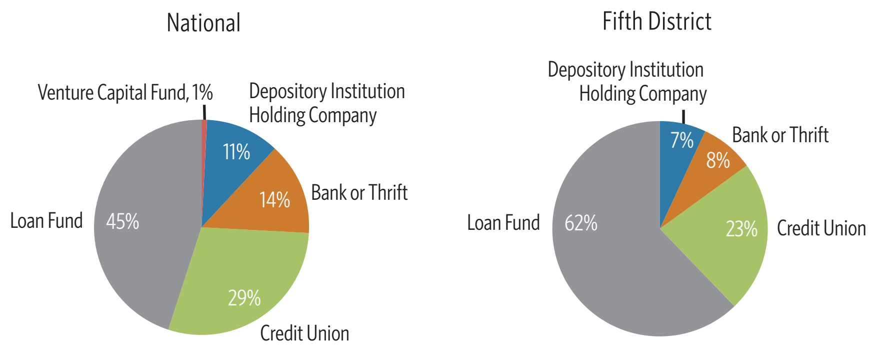
ENTER CDFIS

CDFIs are well positioned to serve borrowers outside of the traditional lending market, particularly those who are LMI, because they are purpose-built to do so. In 1994, the Riegle Act established the CDFI Fund, which is now housed in the U.S. Department of the Treasury, to promote economic revitalization and community development. The CDFI Fund is intended to be an investment and assistance program for CDFIs so that those institutions can effectively deliver financial services to underserved communities. CDFIs can be banks (including thrifts and bank holding companies), credit unions, loan funds, or venture capital funds, as well as community development corporations. Any financial institution that has a mission to serve target markets is a CDFI, but they can also apply to become certified by the CDFI Fund to access exclusive programs that provide direct funding and technical assistance.

CDFIs are often highly tailored to their community, leading to a wide diversity of institution sizes and structures. Most offer consumer, residential real estate, or business products and technical assistance (for example, business development training); they may also offer financial education. They help increase credit access both by lending directly (particularly loans that may not be offered as frequently by traditional lenders, like small-dollar loans) and by helping to address common barriers that borrowers face. Examples of borrower challenges include seeking credit with a lack of savings or liquid assets, having incomplete financial awareness and knowledge, or a dearth of credit history (resulting in a low, or no, credit score). In some cases, CDFIs help borrowers become credit ready, better preparing them for approval at a traditional lender.

In their article "An Overview of Community Development Financial Institutions," authors Anna Alvarez

Shares of CDFI Types



SOURCE: CDFI Fund
NOTE: There are currently no venture capital funds among CDFIs in the Fifth District.

Boyd of the Fed Board of Governors and Charlene Van Dijk of the Atlanta Fed described how CDFIs deliver small loans with flexible terms to meet client needs. They are able to do so by blending diverse capital from several sources. Certified CDFIs can leverage loans and grants received from the CDFI Fund to attract private capital. That's combined with capital from earned income, grant funding, fundraising, equity and debt instruments, and — for CDFI banks and credit unions — deposits.

CDFIS IN THE FIFTH DISTRICT

According to the most recent data from the CDFI Fund, there are 100 certified CDFIs within the Fifth District. Loan funds — which provide financing and development services to businesses, organizations, and individuals — and credit unions make up over three-quarters of them. But loan funds are more prevalent in the Fifth District than nationally, making up about 60 percent of all CDFIs in our district. (See chart.)

Based on a review of the available financial statements from 87 of those CDFIs, more than a third have total assets ranging from $1 million to $25 million, and a quarter have assets in the $50 million to $500 million range. Another 17 percent have assets exceeding $500 million.

CDFIs are headquartered throughout the district, but their service areas are wide-ranging: Some operate within one county or smaller locality, while others can serve several states. As examples, the Sequoyah Fund in Cherokee, N.C., is a Native CDFI that services the Eastern Band of Cherokee Indians. The Natural Capital Investment Fund, Inc., is based in West Virginia but also offers products and services in Maryland, Virginia, North Carolina, and South Carolina. CDFIs may service wide geographies, but they tend to be located close to lower-income areas. A third of Fifth District CDFIs are headquartered in LMI communities, and almost all (94 percent) are within two miles of an LMI community. North Carolina has the most CDFIs, with 23, while West Virginia has the fewest, with 7.

The 12 regional Federal Reserve Banks administer a survey of CDFIs to better understand the successes and challenges of the industry. Seventy percent of respondents to the Fed's 2021 CDFI Survey shared what innovative products they offered to increase access for their clients. The wide range of programs underscores the breadth and diversity of CDFIs' roles in their respective communities, and a few Fifth District examples are highlighted below.

Survey respondents mentioned financial counseling programs, credit builder loans, and nontraditional credit scoring to increase credit access for low-income and unbanked clients. The CARes Project, Inc. in Winston Salem, N.C., helps low- and moderate-income and credit-challenged individuals purchase cars by pairing low-cost auto loans with financial counseling and vehicle maintenance training. Education and counseling often complement lending options in the CDFI model.

Respondents also mentioned a range of programs and initiatives to support low-income homeowners and those wishing to buy a home. In addition to a slew of first-time homebuyer mortgage programs, several CDFIs mentioned loan products that can help increase the affordable or workforce housing stocks. Carolina Foothills Federal Credit Union offers a mortgage loan for manufactured homes to their low-income clients in the Spartanburg, Greenville, and Gaffney areas of South Carolina.

Several CDFIs described providing financial products, mentoring, and technical assistance targeted specifically to minority entrepreneurs and small-business owners. Through the CDFI Survey, The Sequoyah Fund highlighted a program born during the COVID-19 pandemic. Their business accelerator, TACTIX, helps businesses expand their customer base through digital marketing tools and training. The program helps improve management capability, develop more focused strategies, enter new markets, and attract new customers. These critical services help small businesses gain stability, which can improve their ability to secure credit. In addition, the Sequoyah Fund offers small-dollar business loans ($500 to $100,000) that are difficult to access in traditional credit markets.

ON THE HORIZON

Recently, CDFIs have received federal recognition as economic drivers for underserved populations. The federal

CDFIS AND RACIAL EQUITY

As revealed through data and academic literature, historical inequity in credit access still affects minority borrowers today. To better understand how CDFIs address racial equity, the Fed's 2021 CDFI Survey asked respondents about their organization's equity goals. The results indicated that CDFIs seek to promote racial equity through targeted communication with minority communities, their lending terms and programs, and improved diversity, equity, and inclusion policies within their organizations. CDFIs strive to achieve equity by developing programming and services that increase credit access in their target markets — where traditional credit is less available and utilized.

Broadly, CDFIs offer more accessible terms than the traditional credit market to reach more minority clients. This includes reduced interest rates, loan forgiveness, or gap financing. In some cases, CDFI lending products are sufficient to meet borrowers' financing needs, while other borrowers leverage their CDFI financing to qualify for additional, conventional financing. CDFIs also work to improve the accessibility of their products among minority-owned businesses with the goal of improving community economic outcomes. As one respondent put it: "We have programs that are introduced to encourage ownership of assets for Black businesses and ones that help create generational wealth."

CDFIs offer mortgage products, purchase assistance, down payment assistance, zero-down home loans, and home equity loans to support homeownership for minority clients. These tools allow homeowners to begin to build equity in their home and promote racial equity in homeownership. One responding CDFI shared that its objective is to "dismantle the deeply rooted legacy of racism in housing — from the types of homes that are built, where they're built, who builds them, and the wealth that is generated from them."

— Surekha Carpenter and Sierra Latham

government appropriated $12 billion in CARES Act funding to support CDFI efforts to mitigate the effects of COVID-19 in low- and moderate-income markets. By September 2022, the Treasury had already allocated much of this funding to CDFIs across the nation, with more than $1 billion distributed to 15 CDFIs in Fifth District states.

CDFIs are helping underserved individuals and small businesses around the country access the financial services they seek. The number of CDFIs in the United States has been growing, and responses to the Fed's CDFI Survey suggest that demand for CDFI products is also on the rise. With growing government support, the CDFI industry may be in its best position since its inception to increase access to credit and financial services across the United States and in Fifth District communities. **EF**