Conference Keynote Address

Remarks by

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Enhancing the community development finance field's access to the capital markets is an important topic and one that I care about quite a bit. Facilitating capital flows to address the economic needs of people in distressed areas is an element of overall economic growth, and so the Federal Reserve System's Community Affairs function plays an important role in helping the System address important growth imperatives. I saw the importance of these activities firsthand when I was at the University of Chicago. The enormous progress that has been made on the south side of Chicago from 1990 to today is a testament to the importance of community revitalization efforts and the ability of community development finance to transform neighborhoods.

Public funding for community development faces budgetary challenges. Private charitable sources, though often very generous, can be somewhat unpredictable. It is important, therefore, that community developers are able to tap the power of markets to ensure sustainable funding for these activities. Of course, there's a real challenge in building a bridge between the two very different worlds of capital markets and community development. The world of Wall Street practices strict market discipline, emphasizing the need for standardized products, tough underwriting requirements, and careful management and evaluation of risks. The world of community development, on the other hand, has a commitment to people in neighborhoods that have been left out of the economic mainstream and have unique characteristics and needs.

It is important to think about bridging these two worlds because there is so much work to be done, and the tremendous growth in this area suggests that the field is reaching a new level of maturity. In 1991, for example, around 2,000 community development corporations (CDCs) had built about 300,000 units of housing and 17 million square feet of commercial space. By the end of this year, it is expected that 4,600 CDCs will build more than a million units and 126 million square feet of commercial space. Community development financial institutions (CDFIs) have become more sophisticated and more innovative, and the field is growing. There are now more than 600 CDFIs, with $19 billion dollars of assets and $20 billion of finance activities, and they report relatively low charge-off rates of only about 1 percent. Marrying these two disparate worlds by using the capital markets to leverage community development resources could lead potentially to revolutionary change in the funding of community revitalization.

There are significant challenges to bringing these two worlds together, but there already have been demonstrations of success. The Community Reinvestment Fund in Minneapolis, for example, issued two rated securities in 2004 and 2006 totaling $130 million. For the first time, the senior tranches were privately rated by a major rating agency as AAA, opening the door to new institutional investors. Community Development Trust, one of the nation's only community development REITs, has recently securitized about $45 million in mostly Low Income Housing Tax Credit loans, representing 2,000 affordable units. These are just a couple of examples that show the feasibility of tapping the capital markets to finance community development activities.

The history of the Chicago Mercantile Exchange and Chicago Board of Trade may shed some light on the current problem in community development of creating liquidity in a market of heterogeneous assets. In the 1870s, the market for grain did not enjoy the very deep liquidity we see in today's market. At the time, Chicago was facing competition from exchanges in Minneapolis, St. Louis, and from some in Europe that had created innovative structures to make markets more liquid. In order to create a liquid market for grain trading, buyers and sellers of grain needed a way of systematically analyzing the different kinds of grain that came into the exchange from different sources. In other words, the market needed a way of grading the grain. The market created special silos that combined grain from a number of sources. Buyers no longer bought a silo of grain from one source, but a silo of, for example, "Winter Wheat Number 2" that would be graded in a way that allowed buyers to know exactly what they were getting.

To facilitate the creation of a futures market, the exchange then established minimum quality standards, which might be analogous to a lender's underwriting standards, based on the need for market participants to evaluate the reliability of promises of future deliveries of grain to the buyer. Buyers and sellers of grain ultimately became members of the exchange, supported by an underpinning of standardized measures of grain quality and minimum standards for exchange members. Eventually, the exchange itself became counterparty to all of the transactions. All of the market participants were members of the exchange, and so if something went awry, the members were liable to make good on it. They mutualized the risk, so, for example, a buyer of a standardized contract for "Winter Wheat Number 2" didn't necessarily care from a financial standpoint who the seller was because of the presence of the central counterparty–the clearing house–that stood as a guarantor to both sides of the transaction.

These innovations were developed by, and for, market participants. There was no government involvement or regulation. These durable constructions survived World War I and the Great Depression without any government guarantees, without any government insurance, and, until only relatively recently, without any government oversight.

This example of the development of the Chicago grain market raises some poignant questions for the community development industry. Can a similarly durable structure be developed for community development? Is it possible to do so without government intervention or subsidy? How can the industry certify the quality of its assets? How can the industry make data provision systematic? How can more informed and uniform underwriting standards be developed that adequately address the unique and inherent risks associated with certain asset classes? How can community development make its risk factors more known, more systematic, and easier to price?

None of these questions is easy, but the answers may lead community development to a transformative change in how it finances its work, and there are already examples of this kind of thinking in the marketplace. I was pleased recently to join the Board of Directors of NeighborWorks America. One of the subsidiaries of NeighborWorks, Neighborhood Housing Services of America (NHSA), works in a way that has some of the characteristics of the Chicago grain market. It certifies the quality of particular lenders so that outsiders don't have to do the due diligence on each individual group. Rather, they can give the NHSA "Good Housekeeping Seal of Approval," based on systematic criteria that provide comfort to investors, and that's an important first step.

The community development finance field faces some fundamental questions about how the value of market discipline can be tapped to strengthen community lending transactions. The most critical way to harness market discipline is to think about how data can be systematically provided. The markets are very good at dealing with systematic data. They have a lot of difficulty dealing with unique situations. The gap between Wall Street and community development can be bridged by knowing the kind of systematic disclosure that investors want and knowing the unique features of communities that the community development field works with.

In conclusion, I'm very confident that the expertise and dedication found in the community development industry can move the industry in the right directions to address the obstacles as well as expand the opportunities of facilitating a more active secondary market for community development. There will no doubt be challenges associated with this work, but the future looks bright, and I offer my encouragement to everyone who is diligently working toward a financing system that works efficiently at scale for community development.