The Heritage Foundation

CONGRESSIONAL TESTIMONY

The Role that Community Development Financial Institutions and Minority Depository Institutions Serve in Supporting Communities

Testimony before

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SUBCOMMITTEE ON FINANCIAL INSTITUIONS AND CONSUMER PROTECTION

February 9, 2022

Joel Griffith
Research Fellow, Financial Regulations
The Heritage Foundation

Chair Warnock, Ranking Member Tillis, Members of the Senate Subcomitee on Financial Institutions and Consumer Protection. Thankyou for the opportunity to testify on the role that community development financial institutions and minority depository institutions servce in supporting communities. My name is Joel Griffith. I am a Research Fellow in Financial Regulations at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

The Community Development Financial Institutions fund (CDFI) provides grants to community development financial institutions, community development entities, and other private financial institutions. The CARES Act provided $12 billion CDFIs and Minority Deposit Institutions, or MDIs. The $3 billion to the Treasury CDFI fund is equal to a decade's worth of typical funding.

The CDFI all too often amounts to corporate welfare in the form of grants, bond guarantees, and tax credits. This favoritism hinders competition and distorts private markets—misallocating limited resources.[1] In addition, a lack of transparency results lax accountability to taxpayers, misdirection of limited resources, and lost confidence in the fairness of our system.

[1] Justin Bogie, David R. Burton, and Norbert J. Michel, "2017 House Financial Services and General Government Bill: Reduces Spending, But Does Not Go Far Enough on Policy Changes," Heritage Foundation *Issue Brief* No. 4591, July 7, 2016, http://thf-reports.s3.amazonaws.com/2016/IB4591.pdf

The 2021 Emergency Capital Investment Program (ECIP) Highlights Elevated Risk of CDFI Lending.

As the risk of default grew during the pandemic on loans made by CDFIs, Congress in March 2021 authorized the Treasury Department to invest up to $9 billion in CDFIs. This would allow them to boost capital requirements and continue lending.[2] The extent of the demand for taxpayer assistance through the Emergency Capital Investment Program (ECIP) underscores the danger stemming from looser underwriting standards, government subsidization of the CDFI businessmodel, and the lack of transparency.[3]

In October, the Treasury announced "204 credit unions, banks, and bank and savings and loan holding companies requested total investments of over $12.88 billion under the Emergency Capital Investment Program (ECIP). This demand exceeds the amount available for investment by $4.13 billion."[4] This suggests that distressed or non-performing loans threatened the operational capacity of more than 1/3 of the CDFI depositories.

Another troubling component of the new government largesse is the State Small Business Credit Initiative (SSBCI).

The American Rescue Plan provided $10 billion to re-start the State Small Business Credit Initiative (SSBCI).[5] This State Small Business Credit Initiative (SSBCI) funds state programs that provide government loan guarantees and government loan purchases to favored entities-- based on company size and business sector. This partially replaces decisions over allocation of capital made by individuals and investors with the preferences and dictates of bureaucrats often for the benefit of the politically favored.

Numerous problems plagued this program in the past.[6] For instance, the Treasury's Office of Inspector General (OIG) identified noncompliant expenditures related to California's SSBCI loans which "constitute a 'reckless' misuse of funds…"[7] The OIG also identified "reckless misuse" of funds and "conflicts of interest" within the New York program related to one of the venture capital firms participating in the state's SSBCI program.[8]

---

[2]The Consolidated Appropriations Act of 2021 authorized $9 billion of direct Treasury investment in CDFIs through the Emergency Capital Investment Program (ECIP). U.S. Department of the Treasury, "Emergency Capital Investment Program," https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program (accessed Februay 8, 2022).

[3] Due to the Home Mortgage Disclosure Act (HMDA) reporting threshold being lowered, data from CDFIs is likely to be even lower going forward. See Comgressional Research Service, Report R36980, "Single-Family Mortgage Pricing and Primary Market Policy Issues," December 2, 2021, https://sgp.fas.org/crs/misc/R46980.pdf (accessed February 8, 2022).

[4] U.S. Department of the Treasury, "Treasury Sees Robust Demand for Emergency Capital Investment," October 18, 2021, https://home.treasury.gov/system/files/136/ECIP-Demand-Announcement-10-18-2021.pdf (accessed February 8, 2022).

[5] U.S. Department of the Treasury, "Treasury Issues State Small Business Credit Initiative Program Implementation Guidance," November 10, 2021, https://home.treasury.gov/news/press-releases/jy0474 (accessed February 8, 2022).

[6] Congressional Research Service, "State Small Business Credit Initiative: Implementation and Funding Issues," April 23, 2018, https://www.everycrsreport.com/reports/R42581.html (accessed February 8, 2022).

[7] U.S. Department of the Treasury, OIG, "Small Business Lending Fund: California Needs to Improve Its Oversight of Programs Participating in the State Small Business Credit Initiative", May 24, 2012, p. 3, https://oig.treasury.gov/sites/oig/files/Audit_Reports_and_Testimonies/OIG-SBLF-12-003.pdf f (accessed February 8, 2022).

[8] Congressional Research Service, "State Small Business Credit Initiative: Implementation and Funding

These states were not alone. The OIG found only four states to be in full compliance with the program. Is this government-provided capital actually filling a funding need of small businesses not already met by the market? The data strongly suggest no. For instance, the $1.5 billion in SSCBI funds in the Small Business Jobs Act of 2010 was expected to generate $10.5 billion in new small business financing by state government lending programs. This is just a small fraction of the total value of the $644.5 billion small business loans outstanding in 2019 (the most recent year available).[9] Although marketed as a pandemic economic response, SSBCI funding is now available for years into the future. This operates as a slush fund for politicians across the nation—a purpose detached from combatting the economic fallout from the shutdowns.

Small Businesses are Being Serviced by the Credit Markets

It's a misnomer that credit markets are not providing funds to small businesses. Most small businesses are saying they are generally not looking for more credit.[10] Only three percent of respondents in a January 2022 National Federation of Independent Business (NFIB) survey reported their borrowing needs were not satisfied. Only 1 percent reported financing as their top business problem. The survey also reported, "Only a net 2 percent reported their last loan was harder to get than in previous attempts (up 1 point)."[11] In past economic crises, 37 percent have reported financing and interest rates as a top concern.

CDFIs are now leveraging their operations to fund investments with below market-rate debt in Opportunity Zones.[12]

Unfortunately, these types of targeted development programs fail to help those in need. In fact, they have a history of unintended consequences and corruption.[13]

Subsidies from Washington fail to address the underlying causes of concentrated poverty – causes such as lack of educational choice, restrictions on worker freedom, and onerous local regulation and mismanagement. The gleaming luxury apartment buildings, high-tech industrial parks, and designer shopping centers constructed in these zones generally serve individuals who are already thriving.

Place-based economic planning won't help those saddled with more complex institutional problems.
For example, workers without adequate skills will not suddenly be qualified for higher-paying jobs. Those with meager incomes will not suddenly be able to afford luxury housing.

Wide-ranging surveys conducted by federal, state and private researchers of targeted economic development programs find that

Issues," April 23, 2018, p. 41, https://www.everycrsreport.com/reports/R42581.html (accessed February 8, 2022).

[9] U.S. Small Business Administration, Office of Advocacy, "Small Business Lending in the United States," September 2020, https://cdn.advocacy.sba.gov/wp-content/uploads/2020/09/10092920/Research-Summary-Small-Business-Lending-In-The-United-States-2019.pdf (accessed February 8, 2022).

[10] William C. Dunkelberg and Holly Wade, NFIB Small Business Economic Trends, NFIB Research Center, January 2022, https://assets.nfib.com/nfibcom/SBET-Jan-2022-Final.pdf (accessed February 8, 2022).

[11] Ibid.

[12] James Hargens, "Opportunity Zones Revisited: The Role of CDFIs in Driving Equitable OZ Impact," Summit, June 2, 2021, https://www.summitllc.us/blog/opportunity-zones-revisited-the-role-of-cdfis-in-driving-equitable-oz-impact (accessed February 8, 2022).

[13] Joel Griffith and Adam Michel, "Opportunity Zones: Understanding Them in the Context of Past Place-Based Incentives," Heritage Foundation *Backgrounder* No. 3420, July 10, 2019, https://www.heritage.org/sites/default/files/2019-07/BG3420.pdf.

these programs produce few positive results for the intended recipients. They often leave communities poorer than they started.

A series of studies find current residents of targeted areas don't see an increase in wages following the development aid, but they do experience rising rental costs. Higher living costs without higher wages result in a lower standard of living for the communities the politicians were trying to help. A congressional report found no "general improvement in the economic conditions of the locals."[14]

Analysis of six similar state programs shows subsidies attracted new businesses which proceeded to snuff out a similar number of existing competitors employing native residents. The net impact on the number of businesses was zero. In Maryland, manufacturing jobs declined faster in the incentive zones than in the rest of the state and did not benefit zone residents.

Moreover, these programs come at a huge cost to taxpayers – in many instances exceeding $100,000 for each job created. And this sea of government money leads to corruption and graft. Directors of the Gary Indiana Urban Enterprise Association were charged with conspiracy, mail fraud, and federal program theft of nearly $1 million. In Atlanta, targeted subsidies are connected to corruption and mismanagement, resulting in 82 percent of the programs achieving not one of their goals of helping poor communities.

Past place-based programs have relied upon complicated tax credits and direct subsidies with many government strings attached. These programs, by their very nature, can't resolve the complicated institutional barriers to economic opportunity.

In addition, because politicians are empowered to decide which neighborhoods win and lose, these programs tend to breed cronyism. Often, these decisions benefit politically connected developers and investors who have rigged the system in their favor. Unfortunately, CDFIs are using their sway to funnel more capital into these projects.

The Reality: Small Businesses are Being Serviced by the Credit Markets.

It's a misnomer that credit markets are not providing funds to small businesses. Most small businesses are saying they are generally not looking for more credit.[15] Only three percent of respondents in a January 2022 National Federation of Independent Business (NFIB) survey reported their borrowing needs were not satisfied. Only 1 percent reported financing as their top business problem. The survey also reported, "Only a net 2 percent reported their last loan was harder to get than in previous attempts (up 1 point)."[16] In past economic crises, 37 percent have reported financing and interest rates as a top concern.

Conclusion

Broadly available tax cuts benefit all Americans, especially the most vulnerable, through a strong economy that generates demand for workers and raises their

[14] See Joel Griffith and Adam Michel, "Opportunity Zones: Understanding Them in the Context of Past Place-Based Incentives," Heritage Foundation *Backgrounder* No. 3420, July 10, 2019, https://www.heritage.org/sites/default/files/2019-07/BG3420.pdf.

[15] William C. Dunkelberg and Holly Wade, NFIB Small Business Economic Trends, NFIB Research Center, January 2022, https://assets.nfib.com/nfibcom/SBET-Jan-2022-Final.pdf (accessed February 8, 2022).

[16] Ibid.

wages through productivity gains. Institutional and local reforms are needed to enable residents of impoverished communities to seize the opportunities created by a strong national economy.

State and local governents share a responsibility to eliminate artificial barriers to economic growth and affordable housing. Minimum wages, occupational licensing, and unreasonable zoning restrictions are three examples of policies to review. Regulations are costly to businesses and individuals, they lower real incomes, reduce entrepreneurship, exacerbate income inequality, and increase the price of consumer goods.[17]

Lastly, failing public schools contribute to a relative lack of education, marketable skills, and other forms of human capital. This directly impacts earnings capacity. To better equip the next generation to prosper, parents should be enabled to select educational alternatives for their children. Many of the underperforming public schools are located in economically deprived areas with a disproportionately large minority population.[18] Elevated numbers of students drop out before graduation; many graduates lack proficiency in basic reading, writing, math and specialized skills.[19]

The government granted education monopoly fails millions of students who are subsequently unable to effectively compete in the labor market. Education choice options that allow students and parents to choose the best school for them, have been shown to help the poorest students attain better outcomes over government assigned schools.[20] Over time, the opportunity gap between minorities and the rest of the nation will close due to enhanced educational quality. This will translate into greater income and wealth accumulation.

In contrast to these specific policies, more government "investment" in CDFIs will fail to yield consistent increases in employment, wages, or advances to general economic opportunit for those who have been left behind.

[17] Dustin Chambers, Patrick A. McLaughlin, and Laura Stanley, "Regulation and Poverty: An Empirical Examination of the Relationship between the Incidence of Federal Regulation and the Occurrence of Poverty across the States," Mercatus *Working Paper*, April 2018, https://www.mercatus.org/system/files/chambers-regulation-poverty-mercatus-working-paper-v1.pdf.
[18] Duncombe, Chris. "Unequal Opportunities: Fewer Resources, Worse Outcomes for Students in Schools with Concentrated Poverty," Commonwealth Institute, October 26, 2017, https://www.thecommonwealthinstitute.org/2017/10/26/unequal-opportunities-fewer-resources-worse-outcomes-for-students-in-schools-with-concentrated-poverty/.
[19] *The Condition of Education 2018*, National Center for Education Statistics, U.S. Department of Education, 2018, p. 4, https://nces.ed.gov/programs/coe/pdf/coe_cnb.pdf.
[20] Jason Bedrick and Lindsey M. Burke, "The Next Step in School Choice," National Affairs, Winter 2015, https://www.nationalaffairs.com/publications/detail/the-next-step-in-school-choice.