The failure of the L.A. Community Development Bank epitomizes how good intentions often become bad policy.

The Collapse of a Noble Idea

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In March 2004, the once-heralded Los Angeles Community Development Bank (LACDB) closed its doors because of insolvency. The government-created bank's demise should come as no surprise. Credit officers at the not-for-profit bank lacked incentives to monitor loans on an ongoing basis. The LACDB's lending was subject to pressures by public officials, which distorted decisions so as to favor politically connected borrowers. Moreover, the bank — like other public lenders — was actively encouraged to fund ill-conceived, high-risk projects. A financial institution with a portfolio of very high-risk loans was bound to fail.

At its inception, the LACDB was one component of a broad set of targeted lending programs and subsidies ostensibly directed at improving the lives of the urban poor. Others include the Community Reinvestment Act (see "Renovating the Community Reinvestment Act," Summer 2001) and entities such as enterprise and empowerment zones. The failure of the LACDB illustrates the types of problems inherent in U.S. urban industrial policy.

THE PLAN IN ACTION

The establishment of the Los Angeles Community Development Bank was part of the Clinton administration's response to the city's 1992 riots. At the time, urban industrial policy was focused on identifying areas in need of economic development, then using public funds to foster job creation.

In 1994, Los Angeles was awarded "supplemental empowerment zone" status (missing out on the more lucrative empowerment zone status), which made it eligible to receive funding for the LACDB. The bank, in turn, was set up to make loans to small and medium-sized businesses located in the designated zone.

The U.S. Department of Housing and Urban Development allocated $435 million in grants and loan guarantees to capitalize the community development bank. The federal funds were awarded to the County and City of Los Angeles, which were then to funnel the funds to the LACDB. An agreement was reached in 1995 that set forth the conditions for the annual flow of funds from the county and city to the LACDB.

The grant component of the funding included $5 million from the federal Community Development Block Grant program and $115 million in the form of an Economic Development Initiative grant. Also included was $315 million in HUD loan guarantees under Section 108 of the Community Development Block Grant program. Those loan guarantees allowed the county and city to borrow funds for the LACDB from private banks and investors at an interest rate slightly above that paid on Treasuries. Future county and city Community Development Block Grant allocations were pledged as collateral, in case the LACDB's loans were not repaid.

The bank was structured as a public–private partnership. At the time, politicians across the country were reacting to the failure of public sector programs by embracing joint public–private efforts for economic development. The goal was to find a system or method for public sector involvement that would match the success of private entrepreneurs.

The plan called for leveraging federal dollars with private funds. Private banks pledged $210 million to the effort on the condition that the LACDB identify promising lending opportunities. Over the life of the LACDB, little private bank participation occurred, providing a strong signal about the poor quality of LACDB projects.

REJECTION MEANS YOU'RE QUALIFIED The LACDB became fully operational in June 1996. Loans were to be directed exclusively toward businesses whose applications for credit had been

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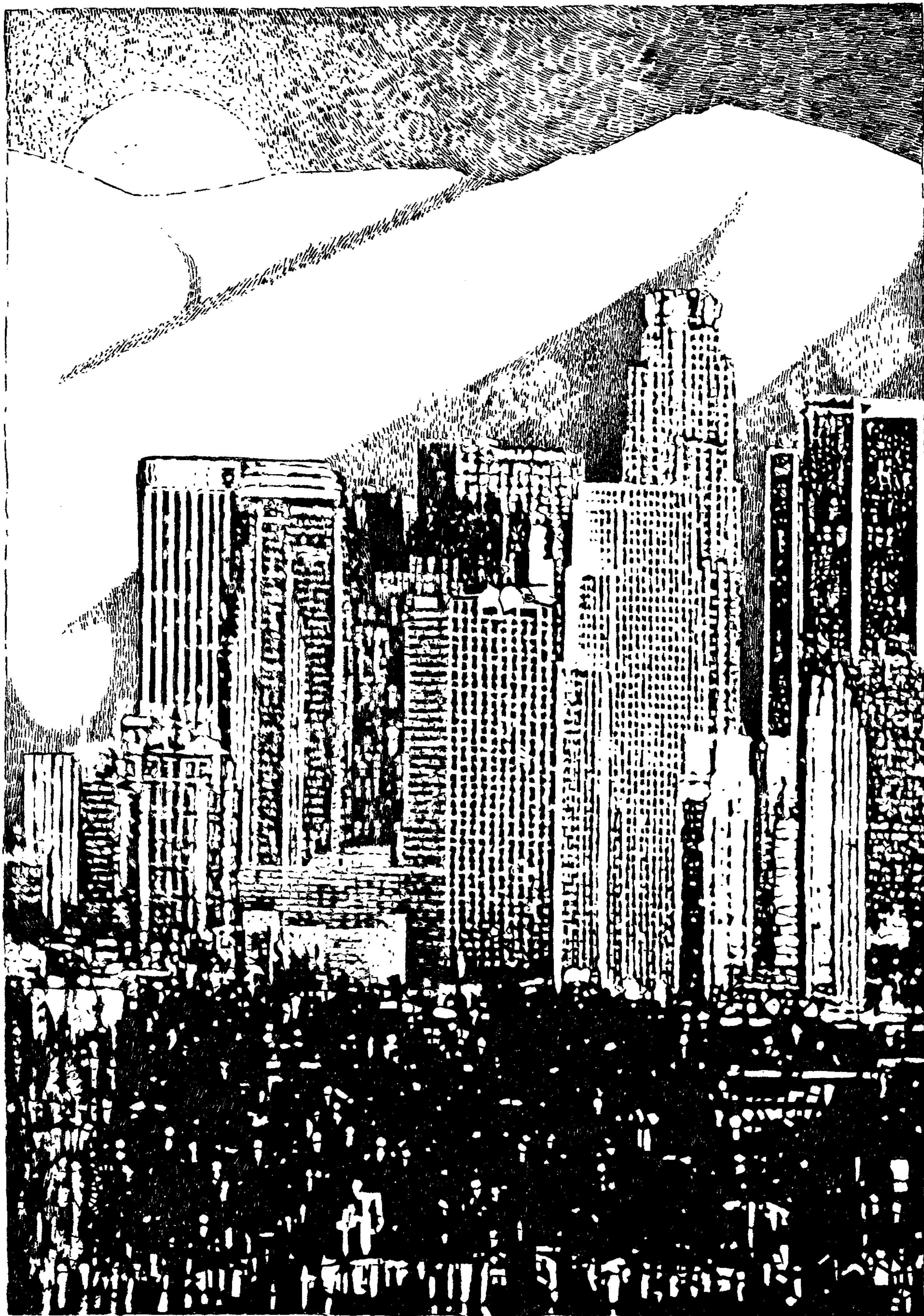

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rejected by private lenders. Businesses located in (or willing to move within) the borders of the designated empowerment zone were to receive 75 percent of the loans, and the remaining money was to go to businesses in a one-mile buffer surrounding the zone. Bank officials were responsible for assuring that 51 percent of the jobs associated with the loans were filled by residents of the empowerment zone. In addition, the LACDB was required to identify one new or retained job for every $35,000 of bank capital invested.

In order to win approval from the Los Angeles City Council, the LACDB was established as a nonprofit institution. The council argued that, because public dollars capitalized the bank, it should operate on a not-for-profit basis. Little thought was given to the perverse incentive effects associated with creating a publicly funded, nonprofit lending institution that would be inclined to issue risky loans that could lead to its insolvency. Finally, so as not to compete with private banks, the LACDB was prohibited from engaging in retail banking; the bank was not permitted to take in deposits. The end result was a substantial reliance on public funds, leaving the bank free from the market and regulatory oversight that constrains the actions of private financial institutions.

The LACDB made business loans, but also engaged in venture capital investments. Between its inception in 1996 and October 2003, the bank committed $130 million in 252 separate loans and investments. Empowerment zone businesses ultimately received only 42 percent of the money, well below the program's 75 percent requirement. Buffer zone businesses received 55 percent, even though they were only to receive 25 percent. The remaining 3 percent of the financing went to businesses located in other low- to moderate-income census tracts in the city, which was permitted under the Section 108 program. The observed lending patterns may have met federal lending guidelines, but clearly did not meet the LACDB's stated objectives. According to the bank, 3,623 jobs were created, but empowerment zone residents filled only 20 percent of those positions.

IN THE RED As of the fall of 2003, the LACDB had $16 million in outstanding loans. Since 1996, the bank received $43 million in repayments and charged off $39 million worth of loans. Assuming the remaining $16 million in outstanding loans would have been repaid, the bank still charged off an astounding 40 percent of the funds it lent. To put that in perspective, the current charge-off rate for private commercial banks is less than one percent. Over the last 20 years, it never rose above two percent. Consumer credit charge-off rates are around six percent.

Over the seven years it was in operation, the LACDB's venture capital fund committed $35 million to businesses in or near the Los Angeles empowerment zone. Of that, $26.6 million was actually invested. As of October 2003, the fair market value of those investments was only $7.6 million. Lenders at the LACDB were supporting investments that were poorly thought out. In March 2004, the city decided to cut its losses and the bank was shuttered.

The poor performance in loan repayment and investment tells us two important things. First, the LACDB did a poor job assessing loan risk and investment prospects. The high lending losses indicate a lack of lender oversight that would normally accompany private bank loans. Clearly, the high risk in lending extensively in distressed urban areas was poorly managed by the LACDB staff.

DESIGN PROBLEMS

The fundamental assumption of proponents of community development banks is that private banks overlook viable investment opportunities. The proponents presume that employees of a federally funded, nonprofit bank can and will identify those overlooked business opportunities and make them happen.

Given the incentives of the individuals involved, that is a hard premise to defend. It rests on concerns that private banks discriminate in lending (avoiding otherwise profitable investments), as well as the even-more-incredible premise that credit officers at a nonprofit community development bank are more adept than their private-sector counterparts at assessing the potential success of firms that plan to operate in poor neighborhoods.

Lending is a risky business. To manage that risk, private banks diversify their loan portfolio. In the case of the LACDB, the constraints on lending produced a non-diversified portfolio of high-risk loans. Default rates would be high even in a growing economy. A recession would predictably lead to bank failure.

If job creation was a key objective, limiting loans to firms in the designated empowerment zone was counterproductive. By setting constraints on firm location, the program reduced the potential for subsidizing or encouraging job creation. Public safety, proximity to amenities, and the state of public infrastructure (roads, for example) play an important role in business location decisions. Those are attributes that distressed, poor areas lack.

Another fundamental design flaw was the nonprofit nature of the institution and its dependence on public funding. In Los Angeles, the loan process was politicized with city council members showing an interest in directing funds to their own districts. Where such pressures exist, loan decisions are distorted; funds may go to the politically well connected instead of to promising business prospects.

The profit motive is the key to effective and efficient operation of any business. Private banks and financial institutions invest their own resources and specialize in finding economic projects to fund. Those that succeed do so because they are good at identifying viable projects. The nonprofit structure of the LACDB distorted those incentives and made it highly unlikely that the bank would significantly promote inner-city growth and job creation.

Different managers could not have improved the poor performance of the LACDB loan portfolio. It was the lack of proper incentives to monitor and assess risk that led to the not-for-profit bank's failure.

THE CASE AGAINST GOVERNMENT LENDING

The establishment of community development banks has been justified on the basis that private financial institutions under-

serve inner-city communities. However, there is little evidence of discrimination against qualified borrowers. In fact, there has been significant growth in lending in low-income neighborhoods. For example, between 1993 and 1997, home loans to low-income urban borrowers increased 37 percent. That was higher than the increase for moderate- or high-income urban borrowers over the same period.

Changes in technology and deregulation of the banking system have changed the financial system, improving access to capital. Computer technology has significantly reduced the cost of checking credit histories, so loan approvals today are less likely to be based solely on personal contacts, private knowledge of a borrower, or racial or ethnic factors.

As to the government's ability to improve on private financial market failures, the opposite is true: Government agencies do a poor job directing capital to its highest-valued use. Evidence from countries with large, government-owned or government-controlled banking systems suggests that such controls slow economic growth.

Few independent studies have focused on the accomplishments of government-sponsored inner-city lending programs. Self-reporting by lending agencies exaggerates successes and ignores failures. Agencies report jobs created, but there is no discussion of situations where loan recipients fail or seek bankruptcy protection and suppliers are not paid; those job losses are not reported.

One economic development program that has been examined is the Small Business Administration's Minority Enterprise Small Business Investment Company (SBIC), established in the late 1960s. The program's rationale was the same as the LACDB's — to provide funds to underserved inner-city businesses. SBICs are privately owned firms that finance small- and medium-sized minority-owned firms. The Small Business Administration subsidizes SBIC loans. The SBIC industry as a whole has lost money.

An investigation of successful SBICs (i.e., those that did not fail) found that they did not invest extensively in small, minority-owned businesses. The majority of the SBICs that survived invested in New York City taxicab medallions, hardly an engine of inner-city economic development. Others held a significant portion of their funds in bank certificates of deposit. Neither investment supports the idea that public loan subsidies promote inner-city economic development or job creation.

CONCLUSION

The Los Angeles Community Development Bank was an ineffective policy tool for promoting inner-city economic growth. The bank failed because it had a nondiversified portfolio of high-risk loans and investments. Its not-for-profit status and use of public funds distorted the incentive structure for lending. From the very beginning, the bank was a long shot to succeed.

Policymakers need to face the facts — there are areas in cities today that do not have the basic conditions needed for economic growth. As a result, those areas will continue to have high rates of unemployment and poverty. What can the government do? Rather than wasting billions of dollars on ineffective loan programs, policymakers should focus on fostering the conditions needed for economic growth. Providing more police in order to reduce crime, improving schools, and repairing inner-city streets are basic public goods that would benefit residents and create an atmosphere attractive to private investment.

In addition, transportation regulations should be rewritten to facilitate low-income residents' access to employment, wherever it can be found. Deregulating taxis and allowing private bus services would increase transportation services available to inner-city residents, improving access to jobs across the city.

In terms of economic development, the government should quit trying to do what the private sector does better. The LACDB is a classic example. The United States has the most competitive and efficient financial system in the world. It specializes in finding worthwhile business projects to finance. It does that job well, even in the inner city.

Loans are not welfare. Established welfare and unemployment compensation programs assist families and individuals. Loans are different. Scarce loan funds should only go to businesses and individuals who have a project that makes economic sense. There is nothing wrong with turning loan applicants down, as private banks do, if their plans have little chance of succeeding. In the long run, bad loans do not create jobs or generate economic growth. R

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