# Starting a

**by Peggy Delinois Hamilton • Yale Law School**

# Community Development Bank

## A New Haven Story

In starting a community development bank to meet the needs of low- and moderate-income residents, First City Fund Corporation is charting new territory in New Haven. The corporation is one of a select few nationwide showing that it is possible for nonprofits to establish strong banks.

### Banking on Communities

Since the 1994 Riegle Community Development and Regulatory Improvement Act (commonly called the Community Development Banking Act), community development banking has become a cottage industry.[1] State or federally chartered and insured by the Federal Deposit Insurance Corporation, the banks have a primary mission of community development—typically, activities benefiting low- and moderate-income individuals or geographic areas.[2] Before 1994, there were two self-proclaimed community development banks: ShoreBank in Chicago and Elk Horn Bank & Trust in Arkadelphia, Arkansas. The law established the Community Development Financial Institutions Fund, which led to today's 750-plus community development financial institutions (CDFIs), 50 of them banks and thrifts.[3]

Communities start community development banks hoping to address local needs for capital, credit, savings, investment, and transaction services. The banks are an attractive alternative to check cashers in low- and moderate-income communities (who may deduct 2 percent) and payday lenders (who may charge as much as 400 percent).[4] To the extent that they provide for savings and investment, the new banks help create wealth and alleviate poverty.

**It is possible for nonprofits to establish strong banks.**

Starting a bank, however, is no easy task. Like any business, banks must have sound management, feasible business plans, and sufficient capital to sustain and grow the business. In addition, every bank must meet the safety and soundness requirements of one to four regulatory authorities before they open. The rules regulate not only the nature of the business and the qualifications for managers, but also how much capital must be raised and maintained.

### First Things First

From my experience, raising the capital to establish a *de novo* community development bank is the most difficult step. In 1993, I was retained to help start City First Bank of D.C., a bank designed to serve low- and moderate-income neighborhoods in the District of Columbia.

From that odyssey, I learned that starting a community development bank has at least 10 discreet steps: (1) identifying the market need; (2) determining the type of financial institution that will best meet that need; (3) writing the business plan and submitting the charter application; (4) determining the need for other regulatory memberships (such as the Federal Deposit Insurance Corporation, Federal Reserve Board, or the Federal

Home Loan Bank); (5) determining the need for affiliates (such as a bank holding company, a financial holding company, or an operating subsidiary); (6) raising capital (at least $2 million net of preopening expenses); (7) securing the location; (8) hiring management; (9) providing a service and assessing impact; and (10) attaining and sustaining profitability. Of the five years it took to open that bank, raising the initial $9 million capital took nearly three.[5]

*De novo* community development banks often raise capital under Regulation D of the Securities Act of 1933. Regulation D permits the sale of securities without Securities and Exchange Commission registration—so long as the offer is not made to the public and does not involve a general solicitation. Such private offerings are made primarily to accredited investors, usually institutional investors or high-net-worth individuals.

Raising the minimum capital necessary to meet the bank's business needs and the regulatory requirements is difficult given the investment's illiquidity, the lack of operating history, the high operating losses expected initially, the focus on lower-income populations, and the competition from both unregulated lenders and traditional banks.

## Motivating Socially Responsible Investors

Community development banks seek innovative ways to motivate potential investors. For example, they may participate in the New Market Tax Credit program, the Bank Enterprise Award program, and the CDFI Fund Financial Assistance Award program (all administered by the CDFI Fund) to obtain sources of capital.[6] Such programs often reassure private sectors and can help generate stronger financial returns. Community development banks also promote their "double bottom line." Because financial returns may be lower than for their peers, the banks reach out to investors motivated to help build affordable homes, create jobs, or launch small businesses.

Nonprofit organizations also are helpful in attracting capital to community development banks. The Internal Revenue Service recognizes nonprofits as federally tax-exempt because their purposes are charitable or promote social welfare. It also recognizes that sometimes those purposes intersect with community banking.

### Supporting Social Welfare

Consider the nonprofit City First Enterprises, Inc., the bank-holding company of City First Bank of D.C. City First Enterprises is tax exempt under section 501(c)(4) of the Internal Revenue Code, which gives exemption to organizations that exclusively promote social welfare. The IRS saw the group's support for a community bank as part of its mission. With a successful application to the U.S. Department of Housing and Urban and Development and the Department of Housing and Community Development, City First Enterprises was able to contribute $4.5 million in initial capital to City First Bank. Having provided nearly half of the start-up money, City First Enterprises became the bank's controlling owner.

### Working with Government

In New Haven, First City Fund Corporation—like City First Enterprises in Washington—is establishing and becoming controlling owner of a community development bank. However, First City Fund's tax exemption is under section 501(c)(3), so it can fulfill its charitable purpose by promoting community and economic development in New Haven and adjoining towns, where it can help with capital, credit, savings, investment, and transaction services to organizations and individuals in lower-income neighborhoods. It will work with city government in (1) spurring affordable housing and small business growth, (2) providing relief to the poor and underprivileged, (3) combating community deterioration, and (4) lessening government burdens. First City Fund Corporation plans to raise $25 million to help create the bank.

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It is not new for nonprofit organizations formed "to relieve poverty, eliminate prejudice, reduce neighborhood tensions and combat community deterioration" to support loans and business enterprises in economically depressed areas. What *is* a new development is nonprofits taking a leadership role in providing financial services.

First City Fund Corporation in New Haven and City First Enterprises in Washington demonstrate that nonprofits can actually *start* a bank. Given their ability to attract socially conscious investors and provide a tax deduction for donations, nonprofits could be increasingly important in community development banking. Neighborhood groups and existing foundations would do well to consider this new way of making more financial services available to low- and moderate-income communities.

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## Endnotes

[1] Community Development Banking Act, P.L. No. 103-324,108 Stat. 2160 (Sept.23, 1994).

[2] See 12 CFR 25.12(g).

iii Certified CDFIs as of January 1, 2006, may be found at www.cdfifund.gov.

[4] Michael S. Barr, "Banking the Poor," *Yale Journal on Regulation* 21, no. 1 (winter 2004): 121-237.

[5] FDIC Statement of Policy on Applications for Deposit Insurance, February 28, 2003, at p. 5349 (available at http://www.fdic.gov/regulations/laws /rules/5000-3000.html). Normally, the initial capital of a proposed depository institution should be sufficient to provide a Tier 1 capital-to-assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary federal regulator) of not less than 8.0 percent throughout the first three years of operation. In addition, the depository institution must maintain an adequate allowance for loan and lease losses.

[6] The New Markets Tax Credit Program permits taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated community development entities. Substantially all of the qualified equity investment must in turn be used to provide investments in low-income communities. The credit provided to the investor totals 39 percent of the cost of the investment and is claimed over a seven-year credit-allowance period. Investors may not redeem their investments prior to the conclusion of the seven-year period. For the CDFI Fund New Markets Tax Credit Program see http://www.cdfifund.gov/programs/programs.asp ?programID=5. Through the Bank Enterprise Award Program, the CDFI Fund backs financial institutions dedicated to supporting community and economic development. The program complements the community development activities of FDIC-insured depository institutions by providing financial incentives to expand investments in CDFIs and to increase lending, investment, and service activities within economically distressed communities. For the CDFI Fund Bank Enterprise Award Program, see http://www.cdfifund.gov/programs/programs.asp?programID=1. Through the Financial Assistance awards, the CDFI Fund invests in CDFIs that demonstrate the following: they have the financial and managerial capacity to provide affordable and appropriate financial products and services that positively impact their communities; they are viable financial institutions; and they use and leverage CDFI Fund dollars effectively. Such awards are made in the form of equity investments, loans, deposits, or grants and must be matched by the applicant with funds of the same type from nonfederal sources. For CDFI Fund Financial Assistance Program, see http://www.cdfifund.gov/programs/programs.asp ?programID=7.