INCREASING ACCESS TO CAPITAL IN THE RIO GRANDE VALLEY

Financial Innovations Lab® Report

Milken Institute

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Financial Innovations Labs® bring together researchers, policymakers, and business, financial, and professional practitioners to create market-based solutions to business and public policy challenges. Using real and simulated case studies, participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

Acknowledgments

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About the Milken Institute

A nonprofit, nonpartisan economic think tank, the Milken Institute believes in the power of finance to shape the future. The Milken Institute produces rigorous, independent economic research—and maximizes its impact by convening global leaders from the worlds of business, finance, policy, academia, and philanthropy. By fostering collaboration between the public and private sectors, we transform great ideas into action.

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Even in the Rio Grande Valley's tough economic climate, there is innovation, progress, and potential to be found.

Introduction

Communities across the country are facing economic stagnation and high unemployment. With declining federal funding for stimulus and safety-net programs, there seem to be few avenues for long-term growth.

At the same time, there is money on the sidelines. Investors are searching for new opportunities that offer even modest returns in a low-interest-rate environment and a difficult financial landscape.

The solution to overcoming both sets of challenges may lie in uniting Wall Street and Main Street. Instead of looking abroad for the next great asset class, investors may find surprisingly attractive options available right here at home—in the form of financing local development. Innovative investment approaches can provide the returns that investors desire while offering communities a path to jobs and economic growth.

For decades, community investors have leveraged public funding with private investment to provide capital for services like affordable housing and small business creation. The rise of public-private partnerships and Community Development Financial Institutions (CDFIs) enabled communities to access financing that they would otherwise be unable to tap while also providing investors with reasonable returns. Collaborations between federal agencies, foundations, corporations, and venture and private equity investors have led to scaled-up activity in community development across the country.

Nowhere is the potential of this approach more evident—and more sorely needed—than in the Rio Grande Valley (RGV). One of the poorest regions in the United States, it spans four counties in southern Texas. The Valley, like most of the southern U.S. border regions, faces serious challenges in diversifying its economy and accessing capital, but it is ripe for growth and offers vast opportunities for investment.

The ailing housing market in the Rio Grande Valley.

A significant barrier to expansion and prosperity is limited coordination and capacity among capital providers. Government resources are available but difficult to navigate, especially as budgets for community programs continue to be slashed. Financial institutions are reluctant to lend to community residents and entrepreneurs because of the perceived risk of default. With little physical or financial infrastructure in place, the capital markets stay away—and are unaware of the opportunities the region has to offer.

There are resources available to support viable community growth in places like the RGV, but up till now, they have been deployed without strong overall coordination and a focus on creating wealth for the low-income population. Truly leveraging the work of market participants in the region—from philanthropy to government to community investors—will require more coordinated efforts to pool existing resources and create both financial and policy incentives to attract new forms of funding to the region. It will also require federal collaboration and policies to create an ideal investment environment. Through innovations such as public-private partnerships, philanthropic investments, and scaled community development programs, the region can see increased access to capital for development, from affordable housing to entrepreneurship.

To make this vision a reality, the Milken Institute, in coordination with the Ford Foundation, convened a Financial Innovations Lab® in Weslaco, Texas. This event brought together investors, business development non-profits, bankers, academics, and policy activists to discuss the region's development challenges and potential solutions. Their goal was to help the RGV find sustainable pools of capital to improve community development and promote economic growth. With a primary focus on affordable housing and entrepreneurship, participants set out to identify financial mechanisms and policy models that could scale up the investment activity already taking place in the region. Participants came up with a series of potential models that would unite philanthropic capital with public funding and private investment to create opportunity in an underserved community.

Issues and Perspectives

The Rio Grande Valley encompasses Cameron, Willacy, Hidalgo, and Starr counties, which hug the U.S-Mexico border. More than a third of the population here lives below the poverty line. The median household income is less than $25,000 per year, approximately 45 percent lower than the state average of $49,000.[1] The population is expected to double in the next 30 years. Three-quarters of this growth is expected to come from births in the region, with a much smaller percentage of growth coming from continued migration from south of the border.

Much of the land in the Valley is zoned for agricultural use, but poor soil and limited water supplies make farming difficult; agriculture accounts for less than 2 percent of the region's economy.[2] The government is a crucial source of jobs, along with the education, retail and health sectors.[3] The region is plagued by high unemployment: 13 percent of the population is categorized as underemployed, compared to 8.5 percent for the rest of Texas. Diversifying the economy is a major challenge; the region lacks the stability of sectors such as manufacturing or value-added services.

It is tough to attract long-term capital into such an underdeveloped economic ecosystem. The funding resources that do come in are from state and federal agencies that have a variety of agendas and focal points. And while government support is vital and productive, a lack of coordination and standardization among the various programs has limited opportunities for public funding to truly leverage additional private capital. Without clearly defined incentives to attract additional investment or a regional plan to focus on the various market opportunities that could interest investors, it's virtually impossible to reach the scale necessary to generate real growth.

The RGV's residents face multiple barriers in accessing capital, especially when trying to build personal assets. The region's economic conditions impact the willingness of financial institutions to service the local population. Many residents lack credit histories, making traditional lenders reluctant to extend credit or approve loans. According to a 2009 FDIC survey, more than 50 percent of households in Texas with incomes below $30,000 can be categorized as unbanked or underbanked; they cannot access many of the services and programs available to those in mainstream markets.[4]

Without access to mainstream financial products and institutions, low-income residents of the Valley are often overwhelmed by an overly complex financial system. A rise in predatory and payday lenders has fostered a cycle of debt and desperation in many Valley households. Indeed, payday loans can cost as much as 500 percent in interest and do nothing to build credit histories, perpetuating the barriers.

More than 90 percent of the Rio Grande Valley's 1.1 million residents are Mexican-American, and more than a quarter of those are foreign-born. The median age is 28 years old as compared to 36 years old in the United States as a whole. This adds up to many young adults and young families who may be struggling to adjust to a new culture and language, perhaps with the added burden of needing to send money to relatives back in Mexico.[5] Low levels of educational attainment, English proficiency, and financial literacy keep the majority of the local population from fully participating in the economy. Many traditional lenders write them off as poor credit risks, hindering their ability to buy a decent starter home or start the kind of small business that can provide a rung up the ladder.

In reality, the CDFIs in the region, supported by the philanthropic community (including the Ford Foundation), have had tremendous success in their lending programs, demonstrating the fallacy in the perceived risks seen by traditional banks.

The high cost of health care is another financial pitfall in this region. Since the unemployed have no access to employer-based insurance, it's no surprise that a much higher proportion of residents in the RGV are uninsured than in Texas as a whole. Education levels are also low, despite the 1987 South Texas Higher Education Initiative that led to the formation of six higher education institutions from El Paso to Brownsville.[6] Only a small fraction of Valley residents have college degrees.

Our Financial Innovations Lab focused on funding mechanisms that will spur the creation of jobs and housing, but fully developing the region's human capital will require improvements in education, financial literacy, and access to health care.

Barriers to Regional Prosperity

Lab participants collectively agreed that the major barriers to increasing prosperity and wealth in the region are 1) access to capital, and 2) coordinating efforts to achieve equitable economic growth. The capital currently available does not appear to be enough to significantly dent the region's challenges.

Standardization and organization are the catalysts needed to channel the existing capital into the right programs in industries that most need it. Funding streams for housing, transportation, industrial development, workforce development, and education have been operating independently from one another and have also been divided and parsed by municipalities without adequate overall regional coordination to avoid inefficiencies. This has limited the region's ability to leverage important opportunities for sustainable economic growth. Participants agreed that the first steps taken by a variety of well-meaning organizations can only achieve the scale necessary to meet the capital needs of the communities if there is better coordination within the development ecosystem as a whole, across industries and sectors. The consensus was that the region's issues must be addressed simultaneously, with greater levels of coordination; no single issue can be tackled in isolation.

Barrier 1: Accessing capital for affordable housing

With their lack of credit histories and limited access to financing, the Valley's residents have dramatically reduced options for building assets—especially when it comes to housing, which represents the biggest asset for most American families. There is great demand for affordable, safe housing, but since banks and other traditional lenders are less likely to approve Valley residents for mortgages, their needs have not been met.

Colonias

With few traditional housing options available, unincorporated developments have proliferated in the Valley. Colonias exist primarily on land that is worthless for farming or that lies on a flood plain. Developers have put up subdivisions in these locations, but the living conditions are below all permitted residential standards. Colonias typically have little or no access to electricity, potable water, or sewage services. Buildings have gone up in piecemeal fashion and are rarely to code. A 2006 study commissioned by the Texas secretary of state revealed 1,364 colonias in the Rio Grande Valley housing an estimated population of 238,480.[7]

Developers of colonias manage the lack of credit histories among Valley residents by offering properties on a contract-for-deed basis. In these transactions, the occupant makes monthly payments toward the value of the property until the full price (typically including a high interest rate) has been paid in full.[8] The seller maintains full ownership of the property until the final payment has been made. The developer can repossess the property for one missed payment. In the meantime, buyers do not build equity in the property from the payments they've made, making them unable to leverage or use the property as collateral regardless of the progress of the contract.[9]

Contract for Deed

In contract-for-deed transactions, the seller of a property keeps legal title on the home until the buyer makes their last payment of the full amount, including interest. The buyer has an equitable title to the property that allows him to legally live there, rent to a third party, or make improvements.

Why the property owner enters into the contract:

- Protects against risk of default, since the potential buyer has poor or nonexistent credit
- Cheap to develop

Why the buyer enters into the contract:

- Needs affordable housing
- Allows them some mechanism to begin to purchase property despite having poor or no credit

Pitfalls for purchasers:

- Property can be repossessed for just one missed payment
- Typically located in remote areas far from most places of employment
- May lack electricity, sewage, or potable water
- Often has a high interest rate

While the situation in the colonias is harsh, the workforce has at least seen a rise in the number of skilled construction laborers because the homes are often built by residents themselves. Investment in public infrastructure development, including drainage, sidewalks, utilities, lighting, and roads, has offset some of the challenges faced in the colonias, though there is still much work to do.

Colonias often lack basics such as heat and electricity.

Outside of the colonias, residents of the RGV lack many other options for affordable housing. Because of the region's unemployment and the lack of opportunities to build personal assets, the entire Valley suffers from restricted lending. The local Community Development Financial Institutions (CDFIs) have a hard time keeping up with demand because most residents want to purchase a home but cannot access low-cost capital. Unfortunately, the programs in place to assist them are too small-scale to meet the need. They need more private-sector partners, but investors are gun-shy about risk in this economic climate.

With housing finance operating at a trickle, towns across the four counties have been unable to turn to the housing sector as an economic driver. Much of the workforce could be better served by formalizing their skills within the construction field, but they face limited job opportunities because the affordable housing sector is not scalable. Those residents with experience and training often abandon the Valley for more lucrative positions in Austin, San Antonio, and Dallas, reinforcing a local cycle of poverty.

Barrier 2: Accessing capital for entrepreneurship

Lack of access to capital has left many Valley residents stuck in sub-standard housing or unable to pursue better construction jobs—and it's a similar story when it comes to pursuing dreams of entrepreneurship. As previously noted, banks display reticence in lending to local communities as there is a perceived risk. Additionally, because loan values are relatively low (often from $15,000 to $50,000 to finance a new small business in the area), the due diligence and administrative costs involved make business lending in the RGV less attractive to banks than markets where larger, more substantial loans are the norm.

Business development is also severely limited by a dearth of available capital. Investors remain skittish: Venture capital is shrinking and low-cost financing for small business expansion is increasingly difficult to find. These private-sector challenges have an overwhelming impact on local communities, especially those as poor as the four counties in the RGV. Financing exists, but credit is tight. Business investment is only available to those who can minimize potential risk.

This scarce capital is exactly what's needed to revitalize the region by diversifying its economy, attracting companies to the area or seeding local startups. A study by the Cross Border Institute for Regional Development (CBIRD) noted that "key to a region's technology-based growth is the leveraging of regional business, academic, government, and community assets."[10]

Maximizing the potential for business growth through public-private partnerships requires coordination and alignment of the public agencies and the funds that are so crucial to the region. This also assumes proper functioning of the public sector apparatus.

Barrier 3: Coordinating existing resources

Public policies and agency actions are often misaligned and can have a varying degree of impact depending upon the specific area that they address. Because of the borders and various sub-divisions in the region, cities and counties are not likely to cooperate; they have no incentive to benefit an adjacent area. An additional problem inherent to Texas legislation is that decisions affecting local communities must be approved at the state level—and unfortunately, the needs of the RGV are seldom on the radar of policymakers in Austin.

Government programs cannot replace the private-sector investment needed to create sustainable growth, and yet in a region like the Valley, well-coordinated public and philanthropic investment is essential to seeding private investment. In this era of vast government budget gaps, funds that are crucial to the survival of community development programs are being slashed. Bobby Calvillo of Affordable Homes of South Texas stressed the importance of government subsidies to local lending programs but said that federal grant funding is expected to decrease between 15 and 20 percent.

Ultimately, one of the biggest barriers is that no single entity has mapped the capital sources available to the region and brought forward ideas to leverage these pools of funding in a strategic and coordinated effort. Lab participants agreed it was important to understand all of the market players in the region and align their incentives to truly broaden access to capital.

Government support

Federal agencies provide significant funding for low-income areas in the U.S., including the RGV (see table 1). But the various programs have differing levels of effectiveness and operational barriers. Like any government bureaucracy, they may entail challenges ranging from the length of time it takes to receive approval and final funding to a simple shortage of resources.

Government funding is a limited yet integral source of capital in the Valley. The U.S. Department of Housing and Urban Development, for example, controls Community Development Block Grants and HOME Investment Partnership money that makes its way to targeted communities through local governments. Decision-making is done locally, and is ideally responsive to the specific needs of the community. Also available to the RGV are CDBG Disaster Recovery funds to address the damage left behind by Hurricane Ike in 2008. These funds are reserved to rehabilitate affordable housing and improve related infrastructure, spurring development activities that will sustain the regional economy.

The USDA also has several programs that move development funds and resources to the region. The USDA Rural Community Development Initiative, for example, has developed the Stronger Economies Together program, which gives training and technical assistance to entities working to promote regional development across county lines in areas that fit the criteria of "rural." Similarly, the USDA 502 loan program is particularly useful for the RGV: It provides loans for low-income (50-80 percent of area median income) and very low-income (below 50 percent of area median income) households to find affordable housing.

The U.S. Small Business Administration (SBA) provides loan guarantees and grants for small business development through revolving loan funds. In South Texas, the SBA is also active in securing disaster loans as a result of damage done by Hurricane Ike in 2008. For businesses damaged in a disaster that cannot secure financing elsewhere, the SBA can provide loans of up to $2 million at 4 percent interest over a 30-year repayment period.

The Treasury Department's CDFI fund also provides new market tax credits and the certification of CDFIs, which provide low-cost capital for affordable housing and small businesses in the RGV. Since it began in 1994, the CDFI Fund has allocated $1.36 billion to CDFIs.[11]

The Economic Development Administration, within the U.S. Department of Commerce, provides assistance programs to support small business growth and promote entrepreneurship. It also runs the Regional Innovation Acceleration Network (RIAN) program to designate and coordinate organizations that provide venture funding for business development.

TABLE 1 *Government programs*

USDA Rural Development program

Rural Housing Services
- Provides homeownership options, farm labor housing, rental assistance, and community amenities
- Provides direct loans, loan guarantees, and grants

Rural Business-Cooperative Service
- Financial resources and technical assistance to businesses and cooperatives in rural communities
- Establishes strategic alliances and partnerships that leverage public, private, and cooperative resources to create jobs and stimulate rural economic activity

Rural Utilities Service
- Provides public utilities (electricity, phone, water, and sewer) to rural areas through public-private partnerships

Rural Energy for America Program (REAP): grants for energy efficiency and alternative energy for agricultural producers
- Increase profitability, reduce energy consumption, create jobs, and spur economic development

Land Grant Institutions

Revolving loan fund grants or loans to cities to provide small businesses with financing

HUD development tools

Community/ Empowerment Zone/ Enterprise Community (RC/EZ/EC) Initiative: extension recently ended and renewal status undetermined

Sustainable Housing and Communities grant

Section 3 opportunities

Congressional Grants
- EDI-Special Project (EDI-SP) grants and Neighborhood Initiative (NI) grants

Section 108 Loan Guarantee Program
- Community Development Block Grant ($3.1 billion Hurricanes Ike and Dolly relief)

Economic Development Administration (EDA) programs

Economic Development Assistance Programs

Economic development planning programs (Comprehensive Economic Development Strategy or CEDS)

The Jobs and Innovation Accelerator Challenge

Treasury/CDFI Fund

Bank Enterprise Award (BEA) Program

Capital Magnet Fund (CMF) program

Community Development Financial Institutions (CDFI) program

Financial Education and Counseling (FEC) Program

New Markets Tax Credit (NMTC) Program

Certification – Community Development Entity (CDE)

Certification – Community Development Financial Institution (CDFI)

SBA programs

Lending programs
- Loan guarantee program: works through banks and non-bank lenders with entrepreneurs. Maximum loan is $5 million.
- 504 Loan Program: funding to purchase fixed assets
- MicroLoan Program: $35,000 to $50,000 administered independently

Disaster assistance loans

Entrepreneurial Development programs
- Small Business Development Center: technical assistance centers funded with states
- Women's Business Centers
- Service Corps of Retired Executives (SCORE): funding a team to educate and mentor small-business owners

HUBZone: program for businesses in Historically Underutilized Business Zones
- EDI-Special Project (EDI-SP) grants and Neighborhood Initiative (NI) grants

Small Business Investment Companies
- Aimed at filling the gap in the capital markets and providing long-term funding for growth-oriented small businesses
- Intended to spur technological advances

Community Development Financial Institutions and nonprofit assistance

CDFIs provide vital financial products for low-income regions and populations that are typically underserved by traditional financial institutions. In the case of the Valley, CDFIs represent an effective vehicle for aggregating government and private funds dedicated to community development and for financing affordable housing and business development.

CDFIs finance community facilities such as health and training centers, offer loan products to individuals, and provide training and technical assistance to their borrowers. Many of their clients are typical of the RGV: unbanked, underemployed, and at high risk of resorting to predatory lending. CDFIs can offer mortgages to low-income families, and they educate and train their clients who have little or poor credit histories and limited experience with financial products.

For example, the Community Development Corporation of Brownsville (CDCB) began improving colonias through home rehabilitation and reconstruction, then building new homes. It offers homeownership programs throughout the region to increase access to capital, partnering with local lenders to secure attractive rates for consumers and institutions alike. They also offer financial planning training and educational services. Historically, they have leveraged funding from the public sector to create low-cost financing options for Valley residents, with very low default rates.

There are also nonprofits that promote entrepreneurship by providing technical assistance and support for the development of new industries, especially in the manufacturing sector, to create better jobs and economic growth. The McAllen Economic Development Corporation, as one example, provides services to new and existing companies that wish to expand and diversify the business ecosystem in the RGV.

Philanthropic and institutional capital

There are foundations actively working in the Valley. The Ford Foundation, as well as the Marguerite Casey Foundation, the Open Society Foundation, and others are interested in community investment and finding solutions to the region's economic challenges. Philanthropic capital, whether deployed through grants or program-related investments, can represent the much-needed incentive to increase lending and investment in the region for both affordable housing and small business creation. And while activity thus far has been limited to traditional grants and selected investments by the Ford Foundation specifically, a wider menu of philanthropic tools could be utilized to support economic growth. But again, the lack of coordination between foundations has proven a barrier for local organizations that hope to take advantage of the potential ability of a grant or investment to serve as a credit enhancement.

Additionally, the region's universities provide opportunities for small business incubation and technology assistance. For example, The University of Texas–Pan American runs an incubation program that supports new technologies and industries; it also provides both business and personal finance programs. The university has also started to support start-ups more directly, working with private companies and community development corporations to invest in new technology ventures. Its first regional start-up recently received more than $1.5 million in grant money to commercialize a new nanotechnology, in hopes of creating over 100 jobs and generating over $80 million in net revenue.[12]

The University of Texas at Brownsville is also actively involved in promoting small business creation in the region. Its International Innovation & Entrepreneurship Center has helped launch 67 companies, with better than a 70 percent success rate.[13] This support is crucial to the region's future, as it can help build financial infrastructure.

Private investment

Texas has a growing venture capital community, centered in Austin. This nascent industry has not yet reached the RGV and will likely not impact the amount of VC or private equity being channeled into the region because of current economic conditions.

However, some small firms are beginning to invest in the Valley through venture development organizations (VDOs) like EDCO Ventures. VDOs are firms designated by the Economic Development Administration through the Regional Innovation Acceleration Network. They partner with foundations and utilize CRA credits and philanthropic money to make investments in small and medium-sized companies. Investments can range from $50,000 to $800,000, often as direct equity financing, but VDOs can also offer technical assistance and can serve as incubators. These organizations are critical in the RGV, as private equity represents a necessary stream of capital to reach scale and commercialization.

Creating consistency

Unfortunately, while there are many pools of capital available to the region, no single solution that currently exists is large enough to have a measurable effect on its own. The training provided by the USDA's Stronger Economies Together, for example, does enhance the abilities of its clients, but without enough higher-wage jobs in the region, they eventually take those skills and move away to find work once their training is completed.

Similarly, if small businesses need bonding capital to become an official vendor for a HUD project, local CDFIs could be coordinated to help them meet those needs. Some small businesses may not have the sophistication of accounting or the knowledge of securing surety bonds to fulfill this requirement.

In order to incorporate low-income people into economic development, planners must coordinate with government, philanthropy, and local and national financial institutions so as to not duplicate efforts and create real scale.

Creating Solutions: Policy Innovations

Coordinating different *areas* of development—whether affordable housing, small business investment, or education and training—is paramount to building success. Participant Mike Loftin, executive director of Homewise, said that the region needs to use a standardized economic development process that could be applied to all low-moderate income areas in the country.

During the Lab, several courses of action were discussed, but consistent threads emerged: maintaining subsidies, collaborating to make the best use of existing intellectual capital and flow of incentives, standardization to reduce the cost of making the support structures operational, and integrating the various organizational processes to minimize costs and maximize human capital investment.

Solution 1

Establish a regional leadership council in the Rio Grande Valley

There was a strong desire to keep the momentum of the day's discussion moving while the region's development leaders were engaged and of like mind. One of the most enthusiastically received proposals discussed during the Financial Innovations Lab was the creation of a coalition of RGV working groups to coordinate initiatives across the region and across sectors to maximize their impact.

Participants acknowledged that each development organization faces its own challenges in integrating their work into the larger landscape of activities in the RGV, but that solutions to reach scale are feasible. Most importantly, there was unanimous recognition in the group that the many interests and development sectors are cordoned off into silos, and a lot more could be achieved through cooperation.

There is a collection of tremendous experience in community development in the Valley; the organizations represented at the Lab have extensive working knowledge of the region. It's crucial to build on their knowledge, expertise, and progress. The first step in creating the coalition was to identify the organizations and sectors that must be included to ensure success. The next step involved drafting action items to facilitate invitations to join the coalition.

Lisa Prieto of The University of Texas–Pan American suggests a task force organized by the university to facilitate greater collaboration among Valley stakeholders.

Acknowledging previous attempts to form such regional groups, participants agreed that the coalition should become an organization that can facilitate real growth by uniting the various development components, identifying any areas of overlap or need, and leveraging the vast experience of the group to scale up coordinated activities and create a one-stop shop for financial and technical assistance in the region. The coalition would increase efficiency and serve as a mechanism for communication and relationship-building.

One of the preliminary objectives discussed in the Lab was to change the region's narrative to focus on the positives and the potential. The coalition can reframe the RGV's identity, moving away from talk of a downtrodden community and putting the spotlight on a young and able workforce that's ready to build industry. As Robert Nelson, president of UTPA, said, "We are a reflection of the future of the United States."

Updates from the field

Following the Financial Innovations Lab, The University of Texas–Pan American and the University of Texas at Brownsville organized the first session of the RGV coalition. Its first regional planning meeting took place in early 2012 in Weslaco, Texas, and brought together representatives from all of the relevant sectors in the region who are working on economic development. Agenda items included mapping all current activities in the region, as well as defining ways to standardize approaches. This follow-up to the original Financial Innovations Lab session is testament to the impressive momentum in the Valley and the continued determination of stakeholders to support long-term economic growth.

Solution 2	*Promote education at all levels, from job training to personal finance*

Lab participants agreed that expanding financial access programs would have a significant impact on the region. It can help the Valley's economy achieve sustainable progress, as the growth of local businesses attracts outside investment.

Participant Ann Cass of Proyecto Azteca stressed the importance of entrepreneurship education to the Valley and especially the colonias. She credited local educational institutions with building the capacity of small-business owners, but pointed out the need for more educational assistance on this front. On a larger scale, the University of Texas–Pan American has been helpful in the region by securing patents for entrepreneurs through its strong incubation program.

Educating prospective homebuyers will drive demand, which Mike Loftin of Homewise identified as a significant problem with the local housing market. Many Valley residents have simply never been educated in how credit works and how to manage a mortgage. Several organizations are working to improve financial access programs, but it would be better to have one concentrated effort and a standardized approach. Once this is established, there will be well-prepared homebuyers and greater demand.

Participants debated the best ways to deliver such educational programs and agreed that partnerships between CDFIs, foundations, and the mainstream lending and investment communities would encourage more active engagement with the local community. If banks and venture capital firms do not have the appetite or budget to support financial literacy programs directly, foundations might subsidize this through support to community development organizations that can partner with the mainstream institutions to create educational programs.

Solution 3	*Continue and expand federal programs that provide additional capital to communities*

As government spending remains under a microscope, many federal programs have faced significant cuts or a complete zero-ing out of funds. As Congress continues to scrutinize expenditures, participants felt that certain programs are crucial to maintain. Because federal funding is often the incentive needed to attract low-cost capital into the region, it is important for these programs to remain intact (or in some cases, to expand) in order to leverage and maximize the limited resources still available.

Example: USDA Rural Housing Programs

Lab participants agreed that of all the government-funded initiatives, the USDA's housing programs have had the most measurable success in reaching low-income communities, especially in the Valley. But budget reauthorization remains uncertain. There was a consensus that the USDA Section 502 Home Ownership and Section 523 Self Help programs must be continued to ensure access to capital for rural communities.

To date, the 502 program has provided loans to place more than 2 million families into homes, with default rates well below the national average.[14] It has been difficult for Valley residents to build sustainable wealth, but these programs provide the necessary capital to move them into safe, affordable homes. Indeed, the 502 program has created wealth of over $40 billion for its loan recipients, providing the crucial component of asset building and prosperity creation in these communities.[15] The homes built and sold through the 502 program have also created close to 90,000 jobs over the past five years.[16] The Self Help program, which provides loans and grants, working from a budget of only $37 million, has also created a path to economic sustainability by organizing groups of 8 to 10 families to build their own homes, building assets and skills.[17]

As these programs face cuts and perhaps even total elimination, participants argued that their continuation is crucial to the economic viability of rural communities, not only in the Valley but across the country. Their ability to leverage private-sector financing for homeownership has been a great success.

Example: CDFI bond program

In an average year, the CDFI industry originates about $1 billion of loans and investments, which in turns attracts an additional $1.5 billion of private investment.[18] In 2010, Congress established the CDFI bond guarantee program through the Small Business Jobs Act. The hope is that this type of program will increase volume by 15 to 20 percent per year, scaling up the long-term patient capital available to low- and moderate-income communities like the RGV.

Unfortunately, the CDFI industry has historically had difficulty scaling up activity because of a lack of standardization across sectors and across products. Consequently, tapping into the bond program (whether at current levels or at an expanded level) might be challenging for organizations in the Valley. Even putting together a consortium of organizations working in the RGV to obtain funding through this bond program for local investment may prove difficult.

More capital in the industry is desirable, but to effectively channel this funding and leverage additional investment, adequate infrastructure must be in place. To succeed on a larger scale, standardization is needed to ensure that the capital can be deployed; there also has to be enough technical and financial support to keep up with any added transaction volume. In the RGV, this would require additional expenditures to expand organizational capacity. This expansion would need to be better understood in terms of the opportunity costs associated with an increase in overhead versus the potential revenue generated by the origination of loans at a significantly higher level.

However, participants agreed that whatever the operational challenges facing the bond guarantee program, it merits continued congressional support. As the program matures, it should have a charter to potentially expand its volume and funding capacity to meet demand.

Example: The EB-5 visa program

The EB-5 visa program provides a green card to any foreign investor who invests at least $1 mllion in a U.S. company that will create or preserve at least 10 jobs.[19] In certain targeted regions, the investment amount can be as little as $500,000. The investment can be made to a company directly, or through a regional center. The program, established in 1990, has seen moderate success but truly began to get traction over the past few years; applications for these visas quadrupled in 2011.[20] There have been debates as to the program's effectiveness and whether or not its structure encourages questionable business choices. However, just as securitization remains an effective tool to leverage funding despite its improper use in the mortgage crisis, so too can the fundamentals of the EB-5 program be a tool to attract investment, especially in lower-income regions that desperately need it.

The RGV is especially ripe for such a program, given its proximity to Mexico and the immigration challenges that plague the region's workforce. Because of the natural synergies in utilizing the EB-5 in the RGV, regional centers have been created to facilitate the EB-5 process. For example, the McAllen Economic Development Corporation received approval for the creation of the EB-5 Regional Center, covering investments in Hidalgo County. The structure of the center and its potential portfolio of investments will hopefully overcome some of the challenges of the EB-5 process, including the lengthy application process, the difficulty in tracking job creation, and the qualification of projects that truly benefit the community. Additionally, the USANOW Regional Center, also in McAllen, was recently created to support foreign investment in the RGV.

The regional center approach is due to expire at the end of September 2012. Given the interest in the area, there was a sense from participants that the program should be continued, just as the EB-5 program as a whole undergoes additional modifications to improve efficiency and effectiveness.

Creating Solutions: Financial Innovations

Solution 4	*Deploy the next generation of program-related investments (PRIs)*

Program-related investments (PRIs) are made by foundations to support their mission and programmatic activities. As an alternative to traditional grants, PRIs are counted toward the 5 percent payout foundations are required to make under the Tax Reform Act of 1969.

Foundations are willing to accept a lower rate of return on these investments in order to achieve a social objective. PRIs most often take the form of below-market loans or credit guarantees and equity investments in qualifying organizations. Their returns can be recycled into additional investments, extending the philanthropist's impact beyond what a traditional grant can do. Foundations can make PRIs that extend beyond the 5 percent payout requirement, but the investment must be made at "commercially reasonable" market rates of return.

For example, the Bill & Melinda Gates Foundation recently agreed to provide a $30 million credit enhancement to secure $300 million in tax-exempt bonds for charter school expansion in Houston, Texas. The Ford Foundation, a pioneer in the PRI field, has provided loans to nonprofits working on regional economic development, offering lower interest rates than the organizations would normally be able to obtain. To date, the Ford Foundation has committed $580 million to PRIs. The projects have proven extremely successful and have been replicated by other foundations.

PRIs extend the notion of "venture philanthropy" by offering the capability for foundations to invest in socially beneficial ventures that a typical commercial bank will not finance. As we have seen, commercial banks tend not to want to lend for low-income housing real estate due to slim margins, worries about credit risk, and lack of collateral. While the monetary returns in low-income housing are not attractive to a commercial bank, the additional social returns fit the philanthropic agenda.

Examples of PRIs

- Loans for sustainable development (capitalization funds)
- Bridge loans and construction financing
- Credit enhancements/credit wraps (guarantee insurance)
- Equity investments for economic development (community reinvestment funds, nonprofit lending, venture funds)
- Loan guarantees

Participants discussed potential models for new PRIs in the Valley, based on the groundwork laid by the Ford Foundation. While there has been PRI activity in the region for many years, more can be done to create innovative models that can be adopted by philanthropic organizations active in the Valley.

» **Example:** A capitalization fund for new businesses, either working directly with the businesses themselves or through an intermediary.
» **Example:** Pooled fund of venture or community reinvestment financing.
» **Example:** A credit guarantee as part of a special-purpose vehicle that aggregates the home loans serviced by local CDFIs as part of a securitized home product.

Solution 5	***Formalize the Rio Grande Valley Multibank and establish loan pools***

Given the lack of investment and private capital participation in the RGV, multibanks provide an opportunity for national banks to support economic development and in turn earn CRA credit.

Multibank community development corporations are designed to bridge financial gaps and spread the risk on projects that would not get traditional bank financing. They provide two distinct advantages that are particularly useful for this region. First, they offer centralized expertise that is required to service a distinct population with distinct needs. Second, they are able to delegate specialized tasks to the bank members who can more specifically and effectively target investments for community development.[21]

Through a loan pool, they can close the gap that exists between a borrower's needs and the funding options that are available from traditional lending sources, while also mitigating some of the potential risk of default.[22] In the RGV, many borrowers lack equity or have low FICO scores, and therefore do not meet traditional underwriting requirements. (Fannie Mae loan underwriting is stringent, with a FICO score requirement of 680. FHA underwriting guidelines are set at 620.) Because a multibank's pool mechanism spreads potential risk and in turn creates a well-diversified portfolio of loans, it can serve disadvantaged communities.

The Rio Grande Valley Multibank was established in 1995. Its founding investors include Wells Fargo, JPMorgan Chase, Bank of America, International Bank of Commerce, Texas State Bank, and the National Cooperative Bank Development Corp. Expansion investors include Frost Bank, IBOC-McAllen, and Lone Star National Bank. Unfortunately, during the recession, the Multibank's activities became stagnant.

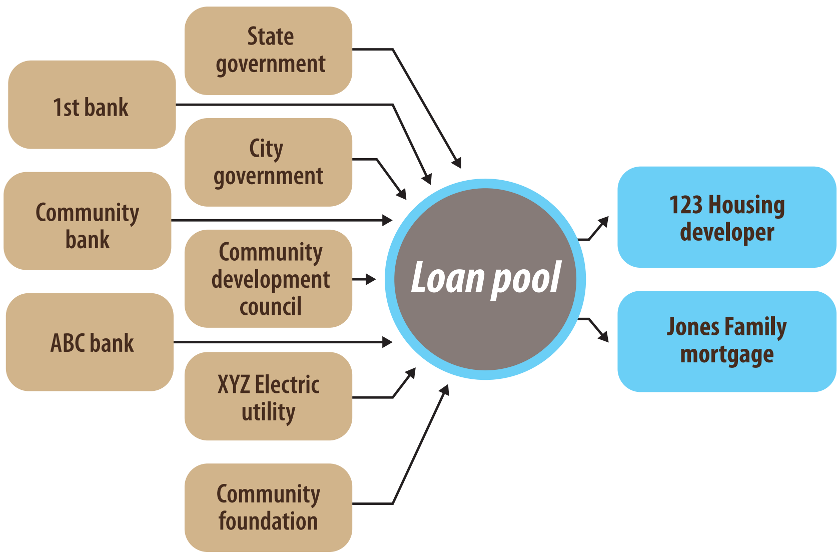
Lab participants debated the best way to jumpstart the Multibank's activity. As previously mentioned, additional partners from philanthropy or government might be able to provide assistance to overcome some of the barriers to more volume, such as providing financial literacy assistance. Given the amount of activity from the public sector in the region, it would make sense to leverage more of the total funding landscape (see figure 1). This could increase the overall capitalization of the bank, while standardizing lending practices within the region.

The multibank is a particularly effective development tool for the RGV. Its local staff knows the demographic challenges and the employment opportunities available in the region.

Valerie Piper from the U.S. Department of Housing and Urban Development and Bobby Calvillo of Affordable Homes of South Texas discuss successful government programs that have enabled broader access to lower-cost capital for homebuyers.

FIGURE 1

Partnerships within a loan pool



Source: Federal Reserve Bank of St. Louis.

By uniting all of the resources available, the multibank could become a model for regional economic development. As community development expert Letty Shapiro put it, "Multibank CDCs are like orchestras. They bring together a group of experienced players who jointly work on projects to create something that they could otherwise not accomplish individually."[23]

SOLUTION 6

Attract new investors through a securitized loan product

Given the region's existing demand for mortgage products and its rapid population growth, the RGV has the potential to support the creation of a securitized product that pools home loans. The home loan market needs to reach adequate scale to effectively deliver capital. Participants liked the idea of aggregating a collection of CDFIs to reach the loan volume necessary to build a securitized pool. In the experience of those on the ground, including participants from Affordable Homes of South Texas and the Community Development Corporation of Brownsville, the client base has a low foreclosure rate, even through the recession.

Additionally, even as the real estate market crashed, the properties in the Valley didn't lose value. However, traditional banks will not take regional properties as security, which creates the space for an alternative market. The Valley has both homes and demand, but the markets are not working because of the lack of volume in financing transactions. Money is out there, but in order to run efficiently and sustainably, the market needs informed homebuyers and standardization so that the products can reach a scale that is efficient.

Mike Loftin of Homewise LLC explains how mortgages in the RGV could be aggregated and packaged as a securitized product. Also pictured here are Lisa Davis and Phillip Clay of the Ford Foundation.

Due to the increasing population, regional home loan volume is expected to reach $100 million—a level that can work for securitization. But deploying $100 million is a challenge for the CDFIs currently working in the region. According to participant Mike Loftin of Homewise, developing the homebuyer's savings and liquid assets is crucial to sustaining the industry because it affords lending institutions the ability to receive down payments and customer fees, which are necessary to launch a securitized pool of real estate assets.

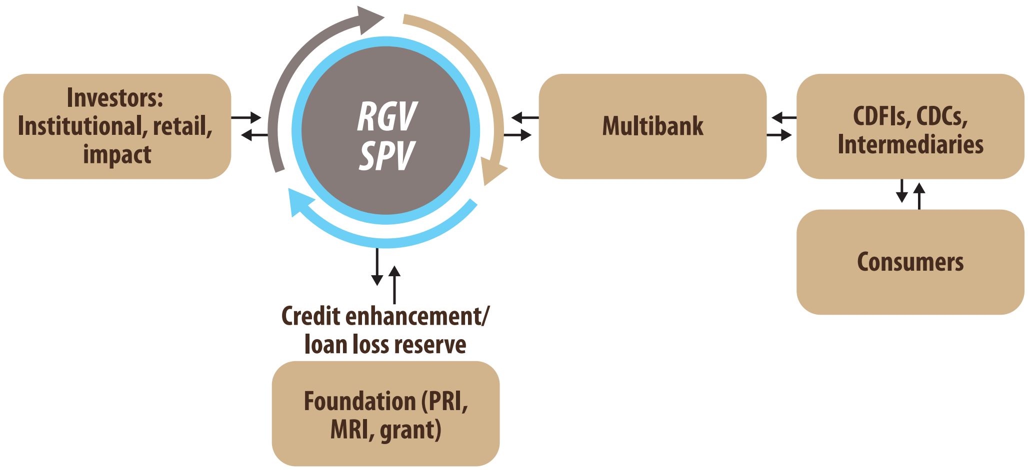
Structure

Securitizing home loans in the RGV could start with creating a special purpose vehicle (SPV), as seen in figure 2. The SPV would pool home loans as assets which could be the basis of an issuance of a security, in this case a mortgage-backed security. The loans would be originated by the Multibank directly, channeled through local CDFIs.

Additionally, the specific design could also benefit from philanthropic guarantees, such as a loan-loss reserve created by the Ford Foundation as part of a PRI. This would help improve the overall credit worthiness of the securities and would also allow foundations to leverage their philanthropic capital to attract significant private investment into the RGV.

FIGURE 2

A securitization model: RGV special-purpose vehicle

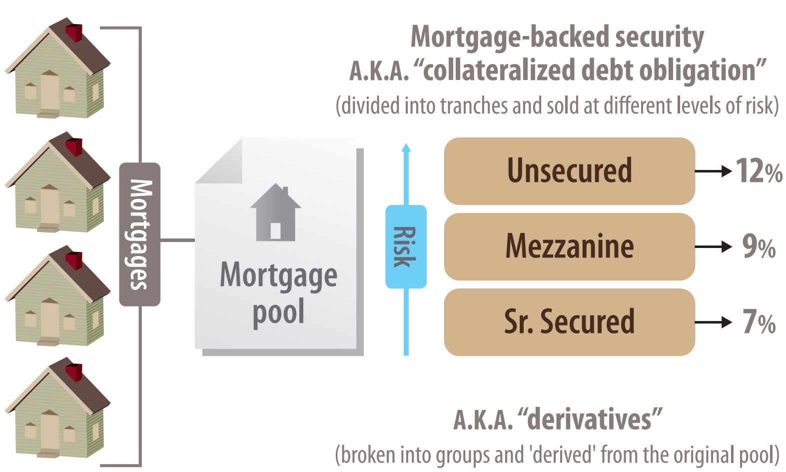


Source: Milken Institute.

The securities would be attractive to a variety of investors—from larger institutional investors who are looking for a steady rate of return, to impact investors who may be willing to take a lower return because of the social return in providing affordable housing. The security could feature different tranches to appeal to the risk and reward appetite of various stakeholders (see figure 3).

FIGURE 3

Attracting a different tier of investors



Source: Wade Brooks.

Without this potential revenue stream, CDFIs will continue to be dependent on grant funding and won't be able to meet the region's demand for housing. Increasing capital by creating a securitized product would help leverage the pools of financing available.

Solution 7	***Create public-private partnerships to make equity investments and/or provide later-stage financing***

Participants analyzed the ability of loan pools or the CDFI bond guarantee program to help secure financing for small business startups, as recounted earlier in this report. In addition, there was discussion regarding the best way to attract equity investments to scale up sectors and industries in the region. Today there is relatively limited venture capital or angel investing in the Valley, but proposals were floated to create incentives to attract investors.

Building off the work of the Economic Development Administration in creating venture development organizations, some discussion focused on how to best utilize government funds to support additional capital market investment.

For example, the Rural Business Investment Company (RBIC) Program is a joint initiative between the SBA and the USDA that is designed to promote economic development, wealth creation, and job creation in rural areas by encouraging and assisting developmental venture capital. RBIC is designed to target profit-oriented investment in rural enterprises and to provide technical assistance via Operational Assistance Grant funding. Seventy-five percent of RBIC investments must be made in businesses located outside of a standard metropolitan statistical area or within a community with a population of 50,000 or less. At least half of the investments must be in small businesses. The effort was approved but remains unfunded. However, it is an interesting proposal for the government to use its funds to create the right incentives to attract venture capital and private equity to low- and moderate-income areas.

Business development can also be aided by maximizing tax-advantaged areas. In 1993, the Rio Grande Valley was designated a Rural Empowerment Zone as part of a federal program that until recently allowed high-poverty regions to access benefits such as employer tax credits, enterprise zone facility bonds, and job training assistance.[24] The program is integral to community development and has had notable success in 20 years. Though its future is still undetermined as of this writing, participants argued that it should be renewed. Empowerment Zone status is an important tool in attracting outside investment, especially when a goal is overall industry building. However, just as other sources of capital remain in silos in the Valley, the tax incentives could be better integrated in the suite of options to be bundled by businesses to attract private financing. This is especially true as the business ecosystem continues to expand in the Valley.

Because the Valley faces challenges in overcoming the increasing unemployment and stagnation, participants agreed that there must be a concerted effort to diversify the economy. Public-private partnerships could target companies that would expand the local business ecosystem. Advanced manufacturing, tourism, and the energy sector all represent potential avenues for significant economic growth and job creation. Health care, construction trades, and business financial services are also potential growth areas.

Conclusion

Regional economic growth is predicated on increasing access to capital—especially across disadvantaged communities. National and local organizations are constantly looking to better align their programs to effectively distribute much-needed funding, and indeed, more can be done to leverage the public and private programs that are already in place.

In the Rio Grande Valley, the momentum is palpable. The Financial Innovations Lab proved to be a valuable platform for bringing together the various stakeholders working in the region, allowing them to share their considerable expertise. It gave rise to the formation of a coalition that will continue the process of coordinating, targeting, and expanding development efforts aimed at sustainable economic growth.

Many of the ideas generated at this event focused on creating incentives and partnerships to attract new investors into the region. But equal emphasis was given to programs that educate and empower residents themselves, creating opportunities for them to build home equity, financial literacy, and entrepreneurial skills. The Valley's way forward lies in fully developing its human capital.

Poverty is a harsh reality in the Valley, but even in this tough economic climate, there is innovation, progress, and potential to be found. Many admirable development efforts are under way—but now it's time to expand these efforts to meet the community's growing needs. Standardizing financial products and creating a regional leadership council focused on economic prosperity that benefits all residents of the Valley will be the key to making a greater impact. The solutions need to flexible enough to shift with the markets and expand even as government funding contracts. The goal is to deliver immediate benefits to communities in need—and to generate sustainable economic growth for generations to come.

APPENDIX

Financial Innovations Lab Participants

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