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# The Community Reinvestment Act, Lending Discrimination, and the Role of Community Development Banks

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# The Community Reinvestment Act, Lending Discrimination, and the Role of Community Development Banks

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Working Paper No. 95

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## I. Overview of the Community Reinvestment Act

In response to perceived failings of banks in meeting the credit needs of the communities in which they operate, Congress, in 1977, passed the Community Reinvestment Act (CRA). Though they are private firms, banks have always been subject to state and/or federal regulation and supervision because of their important role in providing depository and lending functions. The conventional view that banks take the funds of the community, safeguard them, and lend them back to the community provides the basis for the observation that financial institutions play a vital role in the economic development of any community. If an area is denied access to credit, its funds (which could have been the basis for economic development) flow out of that area. Hence, there are concerns about "redlining"--where banks demarcate boundaries between areas where they would provide loans and where they would not--because it contributes to uneven development among communities.

Furthermore, an economic decline in a neighborhood, perhaps caused by factors extraneous to the community, may lead to a reduction in its creditworthiness, as judged by lending officers, and in turn may contribute further to the decline. Government action in this area is entirely appropriate because of the increase in social costs of a deteriorating community. This is made readily apparent by empty and decaying buildings found in some neighborhoods, but the costs in human capital losses equally enormous, even if they are not so visible. Empty homes and closed businesses mean unemployment with concomitant losses to the individuals and to society. The purpose of the CRA was to halt such decline and ensure that credit flows would

continue in communities at levels adequate to prevent cumulative, negative feedback effects of any downward spiral.

To evaluate whether banks are meeting the needs of their communities, the CRA established guidelines used by examiners for assessment (see Federal Financial Institutions Examination Council {FFIEC} 1992, and Knodell 1992). Included in the assessment factors are: types of credit services available, credit application practices, geographic distribution of credit extensions, evidence of discrimination, opening and closing of offices, loan origination, and participation in federal government loan programs. Examiners from the agencies which regulate the banks periodically assess compliance with the CRA: each bank must provide information to the examiners, and make the information available to the community to facilitate public knowledge of its community reinvestment practices.

The CRA applies to all federally insured commercial banks, savings banks, and savings associations; it does not apply to bank holding companies, correspondent banks, trust companies, check clearing agencies, and credit unions. According to Knodell (1992), compliance with the CRA is evaluated with respect to two broad categories: a) is the bank engaged in sufficient activity to "market" its services in its defined community; and b) are its services actually being used in the defined community. With regard to the first category, each bank must demonstrate that it has defined its market area, identified the financial services required in the market, and made adequate effort in providing information regarding its services to all segments of the defined community. Specifically, the bank must show that it is

not systematically and unreasonably excluding any segment of the community in its marketing activities. The second category evaluates the contribution the bank actually makes to the community: this involves review of loan applications and denials, opening and closing of offices, types of services provided at offices, and participation in community development projects. De facto redlining and discrimination would be identified if there were unreasonable disparities in provision of financial services across geographic areas by race, gender, or ethnic composition. The primary purpose of the CRA is to ensure that the management of each covered financial institution should be actively involved in formulating a business plan so that the institution will market its services to all segments of its community (Knodell 1992). However, there are no specific guidelines regarding the level of use of its services that must be attained in its community--either by the community as a whole or by specific groups within the community.

Each financial institution subject to compliance is graded during the CRA performance evaluation (FFIEC 1992). This evaluation involves the management of the institution, the examination agency (that is, the regulatory agency responsible for the institution--either the Federal Deposit Insurance Corporation {FDIC}, the Comptroller of the Currency {OCC}, the Resolution Trust Corporation {RTC}, or the Federal Reserve Bank {FRB}), and representatives from the served community. The institution must provide a CRA statement for the community it serves, with a map of its designated community, a list of the types of services it will provide, and a notice of the process through which citizens can participate in the CRA process. It must also maintain a file of public comments, and post a notice on its

premises with information for the public concerning the CRA process. The examination agency must conduct the CRA examination, provide a written examination report, provide continued CRA supervisory attention, and take CRA performance into account when evaluating applications by the institution to obtain federal deposit insurance, to open new branches, or to merge with other institutions. The public participates in the process by making oral and written comments on the institution's performance. The CRA performance examination is an essential component of the CRA, as it provides the most important forum for the dialogue among the institution, the regulating agency, and the public served by the institution.

Ninety percent of the evaluated banks receive satisfactory CRA ratings: indeed, a good number of them receives "outstanding" CRA compliance, which would seem to indicate that the CRA has been a success. However, as with any evaluation, charges have been made that there is "grade inflation" in the CRA reports. If this is in fact the case, then a re-evaluation of the standards applied would be appropriate. On the other hand, if substantial grade inflation has not occurred, and if in fact banks are meeting the credit needs of their communities as they are defined, then any perceived credit crunch or de facto discrimination must be met by a means other than the CRA. If the credit crunches are due to factors beyond the control of individual banks, then a government role in providing the credit is appropriate, either through monetary policy easing or through provision of credit by other means. If the credit crunch is due to discrimination, then the CRA standards should detect it; if they do not, then a revision of those standards is required.

However, there is good evidence that the CRA alone will not eliminate de facto discrimination in access to credit. For example, in a study conducted by the FRB of Boston, it was revealed that there was no significant difference in lending practices of banks with CRA obligations to minorities in studied neighborhoods versus minorities in neighborhoods with no CRA obligations (Bradbury, Case, and Dunham 1989). Even banks with CRA obligations in minority neighborhoods make significantly fewer loans in black communities than in white communities. Furthermore, a study by Communities for Accountable Reinvestment found that during a fourteen month period in 1987-88, BankAmerica made only one of the 1323 single-family home loans in South Central Los Angeles, while Security Pacific made only three, even though both banks won high marks for CRA compliance. However, looking at only one type of lending does not necessarily provide an accurate assessment of a bank's total lending in a community.

Some banks respond that the CRA imposes a burden and additional costs on their operations, and thus in itself contributes to the credit crunch. Any re-evaluation of the CRA standards, then, must also consider the costs to the individual banks. The appropriate guide to policy is the balancing of the social and private costs and benefits of lending activities. The goal is a policy that brings government's intervention in line with the costs to society of the market failure in lending, while at the same time, assuring that bank profitability is not unduly injured. If the CRA cannot be revised in such a way as to meet the financial services needs of underserved communities without imposing excessive costs on conventional banks, then the government must look to an alternative.

## II. Community Development Bank Proposals and the CRA

President Clinton has called for the creation of one hundred community development banks to revitalize distressed communities. In response, and as part of our ongoing research into financial system restructuring at The Jerome Levy Economics Institute, we have developed a proposal for the establishment of a nationwide system of community development banks (CDBs). This proposal was outlined in our *Public Policy Brief* no. 3, "Community Development Banking, A Proposal to Establish a Nationwide System of Community Development Banks", (January 1993).

Unlike our own, some proposals for establishing CDBs allow any depository institution that invests in the equity of a community development bank to be exempt from CRA compliance. One, for example, proposes that the investing bank be permitted to invest up to five percent of its equity in the community development bank, and that any institution that meets this maximum investment would receive a CRA rating equal to that of the community development bank in which it has invested. This means that for an investment equal to as little as one-quarter of one percent of its assets (5% of equity, with its equity equal to 5% of its assets), the institution would avoid the CRA process entirely. Furthermore, the "community" of the community development bank, as it is defined for compliance with the CRA, would include the combined market or service areas of all the investing depository institutions. This means that the investment of any particular depository institution in a community development bank would be highly diluted with respect to its own community, for

the community development bank could have a defined service area much larger than the community served by any particular depository institution.

We believe there are a number of problems with the alternative proposals that would weaken the CRA. First, the vast majority of commercial banks are already complying with the requirements of the CRA; we believe that these requirements should be retained and, indeed, strengthened, because they provide an opportunity for a dialogue to take place between each commercial bank and the public it is designed to serve. Second, in spite of compliance with the CRA, there is substantial evidence that de facto discrimination in lending exists: certain well-identified segments of society are systematically denied credit. This indicates that the CRA and anti-discrimination rules alone cannot provide sufficient access to credit for all segments of the community. Third, the existing financial system does not provide a sufficient level of transactions, payment, and savings services to certain segments of the population: furthermore, recent trends (which can be expected to continue) have caused traditional banks to reduce the supply of these services to those communities that were never well-served. For these reasons, we advocate the development of a system of CDBs designed to supplement the CRA in order to provide needed financial services to targeted communities.

We believe that while investment in a community development bank should be considered during the CRA evaluation for a depository institution, the institution should not be exempted from the process since this is not consistent with the spirit of CRA. As discussed above, the CRA evaluation process is the primary context in which a dialogue between the institution

and its community takes place. For reasons to be discussed below, this can play an important role in helping to change the banking community's expectations regarding underserved neighborhoods. Community development banks will further this process by proving that some underserved areas do, in fact, have projects that can be profitably financed. Further, allowing a commercial bank to avoid the CRA process merely by investing in a community development bank (that may have a much wider service area than the commercial bank) dilutes this process of dialogue between the bank and the community it serves. Instead, the commercial bank's community should be defined as that which it serves directly, and not as that served by all institutions which have invested in a particular community development bank. Finally, the limited and often minuscule investment in a community development bank envisioned in some proposals (as low as one-quarter of one percent of assets) cannot substitute for the CRA evaluation process, which determines the extent to which the institution has "reinvested" in its community.

Senator Bradley's proposal, titled the "Community Capital Partnership Act of 1993, is much more similar in spirit to ours. This act would provide Federal assistance to community development financial institutions in the form of operating assistance or capital assistance to community lenders that wish to expand activities into areas identified as consistent with the CDB model. This model is based on non-profit lenders in target areas that routinely make small loans or equity investments. While our model deviates in several respects from this proposal, neither would weaken the CRA.

Before examining how a system of CDBs can supplement the CRA, we analyze evidence of discrimination and redlining in lending and in other financial services that must be provided by a financial system. We argue that neither free market forces nor the CRA alone can ensure that a sufficient supply of financial services reaches every community.

## III. Lending Discrimination and Redlining

Discrimination and redlining are pervasive phenomena, particularly in the home mortgage market. Profit seeking behavior of private financial institutions does not eliminate either problem. A brief analysis of each problem will help us to understand why this is the case. We begin with the process through which loans are solicited and evaluated.

### A. Loan solicitation and application processes

By soliciting customers, a financial institution plays an important role in the initiation of loans. It must define its market area and identify potential customers; it must then provide information to potential customers. In turn, customers are generated in the mortgage market only after the sale of real estate has been initiated. Consequently, any processes that systematically deny equal access to real estate will automatically bias mortgage markets. If sellers or their agents discriminate by race, gender, or other characteristic, then banks will not be able to solicit mortgage business from those so excluded: if real estate developers systematically avoid new projects or restoration in certain neighborhoods, banks will not be

able to solicit mortgage business in these areas. Such discrimination is beyond the control of financial institutions. Even if this sort of discrimination does not occur, selective solicitation by banks can lead to exclusion of some from the mortgage business.

Once customers have been solicited, there are at least five important factors that contribute to a successful loan application process. First, the process is designed to uncover borrower characteristics: credit history, income, outgo, net worth, and collateral. Given this information, banks will try to estimate the ability of the customer to service the loan. Second, the process must consider the loan characteristics: principal amount, the interest rate, and the use of the loan. Third, the bank must consider cyclical characteristics of the economy (including both regional and national cycles). Fourth, it must estimate the prospective income flows of each class of borrowers on the basis of longer trend characteristics of the economy (both regional and national). Fifth, the loan officer must apply various rules of thumb (some formal, others informal) in evaluating the borrower in terms of the ability to pay: this is based on borrower characteristics, expected income flows, the interest rate, and maximum loan amount among other factors. Provision of credit is not like the sale of a commodity; it is a very complex process that usually involves substantial face-to-face interaction.

## B. Loan Acceptance or Rejection

The application process ends when the bank accepts or rejects the loan application. Rejection can occur for a variety of reasons: the borrower's income flows, debt burden, collateral,

wealth, credit history, or "character" may be nonconforming either with respect to the bank's standards, or with regard to underwriting standards adopted in secondary markets. Alternatively, the characteristics of the loan may not meet rules of thumb established by the bank, by supervising agencies, or by secondary markets: the size of the loan request may have been too small (given loan initiation and servicing costs, there is a minimum size of loan each bank can profitably provide at a competitive interest rate), or too large (each bank has formal and informal rules regarding size of any single loan--usually equal to a fraction of the bank's net worth). The loan may be also nonconforming with respect to underwriting standards of secondary markets in a number of ways (e.g., a mortgage on housing that does not meet FHA standards). Furthermore, the loan may be prohibited by supervisory agencies for a number of reasons, or the proposed use of the loan may conflict with regulatory practice. Finally, the application may be rejected due to discrimination by the loan officer or by other bank officers, or due to the practice of "redlining".

In essence, the complexity of the loan process provides many points at which those who probably could successfully service a loan at an interest rate that would be profitable to the bank will not receive credit. As stated earlier, discrimination and redlining only exacerbate the problem.

1) Discrimination: financial institutions are prohibited from engaging in discriminatory activity by the Equal Credit Opportunity Act and the Fair Housing Act: the Home Mortgage Disclosure Act mandates disclosure of data that help to determine whether financial

institutions are discriminating. Whether or not financial institutions regularly engage in de jure discrimination, there is substantial evidence of de facto discrimination by race [it must be emphasized, however, the data are not, and probably cannot be, conclusive]. Furthermore, it is not necessarily illegal to discriminate on the basis of income or wealth; indeed, these factors are explicitly used to determine credit-worthiness. Although these issues are very complex, we believe a convincing case can be made that certain segments of the community, particularly low-income, low-wealth minorities, are systematically denied equal access to credit.

Discrimination concerns characteristics of the borrower that are unrelated to loan default rates, but which affect the probability of a loan being made. Typically, evidence of discrimination is found by looking at micro data to see whether, after controlling for all variables that should matter, some other variable that should not matter (e.g., race or sex) still plays a role in explaining the likelihood of loan acceptance. It must be recognized, however, that loan applications may be skewed by discrimination, for the bank's solicitation process may be discriminatory if it chooses not to market loans to certain segments of the population based on these characteristics.

It could be argued that minorities receive less credit only because they are less credit worthy, since their income and wealth tend to be lower. The degree of access to credit has a direct impact on the credit-worthiness of a borrower over a lifetime. The volume of liabilities one may issue, as well as the terms on which they are issued, will affect almost every important factor that will determine an individual's economic success--from the quantity and quality of

education and training one may receive, to the type of productive activity the individual will pursue as a career. **In other words, adequate access to credit at reasonable terms is essential for many activities that will, to a great extent, determine an individual's success at servicing debt.** If a segment of society faces discriminatory treatment in this regard, it will be less credit-worthy (Isenberg and Dymski 1992).

Finally, loan officers and bank owners have a narrow view of their market. The types of activity that can be profitably financed cannot be known. As John Maynard Keynes said, it is sometimes better to follow the leader and to be conventionally wrong than it is to be unconventionally correct. Banks and bankers have a preferred habitat: this does not mean that the habitat cannot change, but that it may change only slowly. If some segments are viewed as excessively risky, they will be denied credit, thus leading to lower credit worthiness. It may be very difficult to change the perception of bankers about some segments of the community, but credit-worthiness cannot be increased until the supply of credit rises.

Some would argue that such discriminatory behavior is irrational, and as such, it will be eliminated by market forces. Even if it were true that market forces would eventually eliminate discrimination, the evidence is overwhelming that prejudicial attitudes are exceedingly long-lived: this is because they are maintained by many other societal forces. Loan officers and other bank employees (and owners) cannot live separately from their cultural environment.

Others argue that the recent trend toward securitization (particularly of home mortgages) will equalize access to credit. Since the initiating bank is not going to hold the securitized loan, it should not care whether the borrower is a white male. However, this still ignores the fact that loan solicitation and application processes provide ample opportunity for discrimination. Even in the case of securitized and government-guaranteed mortgages, the application process often includes the face-to-face interview. Indeed, securitization could actually decrease the supply of credit to some groups if secondary market underwriting criteria bias the process against some groups (see Isenberg and Dymski 1992, and Dymski 1993, for an analysis of secondary market bias against low income and minority groups).

2) Redlining: unlike discrimination, which has to do with the borrower's characteristics, redlining has to do with the characteristics of the neighborhood. A bank that engages in redlining demarcates an area in which it will not normally lend. This need not be irrational: some neighborhoods will have much higher default rates than others because of "spillovers", or "externalities"-- two identical individuals might experience very different default rates merely because they live in different neighborhoods. The redlined neighborhoods will be avoided in loan solicitation (thus, fewer applications will be received), and applicants from these neighborhoods will face systematically higher rates of rejection. In redlining, the face-to-face nature of the application does not play a major role in denial; only the characteristics of the neighborhood matter. Redlining will not be eliminated by "free markets," since pure redlining is often regarded as a good business practice. The appropriate test for pure redlining is to see whether loan solicitation is reduced and loan rejection is higher in specific neighborhoods.

In practice, however, racial discrimination is often involved in redlining. If race is associated with neighborhoods with undesirable characteristics, it can be used as indicator of these unwanted characteristics. In essence, if minorities tend to live in neighborhoods with socio-economic factors that lead to problem loans, race alone can be used to identify communities to be redlined. Loans are then not solicited from minority neighborhoods, or they are denied more frequently in these neighborhoods. The appropriate test for such "racial redlining" is the race of the neighborhood (that is, identifying neighborhoods by percent minority) rather than the race of the applicant. Racial redlining will likely be interpreted as illegal discrimination, whereas pure redlining is not necessarily illegal--so long as the case can be made that the likelihood of a problem loan is higher for each rejected applicant.

Because access to credit is so important to economic success of individuals, it will also be important to the economic success of a neighborhood. If credit is systematically denied to a neighborhood, that community will almost certainly suffer economic decline. Redlining affects to the greatest extent the value of geographically fixed assets (particularly homes and small businesses) where spillovers can be large (Dymski 1993). For these assets, the value is not determined only (or even primarily) by its own condition, but also by that of the perceived condition of the surrounding environment. Obviously, the value of a home will be determined substantially by its neighborhood. Rehabilitation of one home in a neighborhood will have significant spillover effects on others: if all the homes in the neighborhood were to receive rehabilitation loans, each homeowner could capture the spillover effects--but if only one owner rehabilitates, he/she cannot recapture the spillovers. This is analogous to the activities

of the lending banks: only if others will lend to a neighborhood can spillovers be captured, but no bank wants to be the sole lender. The process also works in reverse: if some banks withdraw from a neighborhood, "market forces" will lead to further withdrawals.

Since the net worth of a home (or business) is a primary determinant of access to credit, those homeowners and business people who find their geographically fixed assets are in the "wrong" neighborhood will also find their access to credit is cut-off as their net worth falls (Dymski 1993). "Free markets," therefore, will punish such neighborhoods: no individual bank can lend in the neighborhood unless others are willing to do so because the "externalities" created by redlining will increase the likelihood of loan problems faced by the lender that does not redline.

There is evidence of discrimination and of redlining. In October 1991, data from the Home Mortgage Disclosure Act (HMDA) indicated that minorities receive loans at a rate far lower than comparable whites. As an example, according to national data, blacks are turned down two and one-half times more frequently than whites. According to a study by the FRB of Boston, even after taking account of economic and other nonracial factors (income, wealth, lower value of housing), housing and mortgage credit markets function in a way that hurts black neighborhoods in Boston (Bradbury, Case, and Dunham 1989). Indeed, the authors found that the ratio of mortgage loans to housing varies systematically by race: black neighborhoods receive 24% fewer mortgages, even after controlling for a variety of nonracial variables. Minority applicants were 60% more likely than whites to be rejected for mortgages, even after controlling for the nonracial variables.

Part of the reason for racial differences in mortgages may be attributed to the rise of the secondary market in mortgage loans, which requires that mortgages conform to underwriting criteria so they may be sold in the secondary markets. Between 1977-81, only 3% of new loans were securitized, but between 1986-89, nearly 44% were securitized (Isenberg and Dymski 1992). Most securitized mortgages are guaranteed by federal government agencies (Fannie Mae, Freddie Mac, or Ginnie Mae). In a General Accounting Office (GAO) study of government-insured mortgage loans, it was found that 87% of the loans went to white areas, and 83% to areas where incomes averaged more than $35,000. The GAO found the number of mortgage loans bought by Fannie Mae and Freddie Mac per homeowner declines as the percent of minorities in a neighborhood rises. A study of banks in fourteen cities found that in minority neighborhoods, four cents per dollar of deposits is loaned for mortgages in minority neighborhoods, versus eight cents per deposit dollar in white neighborhoods.

These results are at least in part attributable to the underwriting criteria that eliminate low-income, low-wealth households (Isenberg and Dymski 1992). Furthermore, guidelines adopted by Fannie Mae (which holds or insures 22% of outstanding conventional single-family home mortgages) essentially require it to favor good neighborhoods with rising economic trends, and prohibit it from lending 95% of the value of homes in areas with declining markets. If minorities disproportionately live in declining neighborhoods, secondary market underwriting criteria will systematically deny credit to them.

Bankers respond that the HMDA data do not tell the whole story because other factors are

involved, which do not necessarily indicate discrimination by bankers. Low incomes mean low net wealth and, therefore, it is not surprising that low income households find it difficult to obtain loans. Many in the banking community, and its political supporters, have argued for elimination of the CRA because it is seen as burdensome, costly, or unnecessary: they argue that bankers are already making all the loans that can be profitably made--those that are not made would have high default rates because the income and wealth of applicants are too low.

Interestingly, however, industry statistics reveal that default rates are positively correlated with income, and default rates are systematically higher on mortgage loans of $140,000 or more than on loans of lesser amounts (Isenberg and Dymski 1992). Of course, there is no way to obtain default rates for those who have been denied mortgages due to low income or wealth: however, limited experience by existing community bankers seems to indicate that there are segments of the community that cannot obtain conventional loans, but that do not exhibit abnormal rates of default on mortgage and rehabilitation loans from community banks. For example, Shorebank Corporation of Chicago, a holding company that includes a bank, a real estate development corporation, a small venture capital firm, and the Neighborhood Institute (which offers low income housing development, remedial education, and training), experienced a loan loss ratio of 0.46% in 1990 and 0.67% in 1991--certainly not excessive when compared to the industry average. Shorebank has provided the finance for rehabilitation of 8,000 apartments, and only 1.82% of the loans on these are nonperforming (versus an industry average of 3.41%). During the first nine months of 1992, Shorebank's annualized earnings were 98 cents per $100 of assets (while the industry average was 96 cents).

If minorities do not receive loans because of discrimination, laws should be strengthened to end such practices. However, if they do not receive loans because of factors, such as the existence of spillovers that are beyond the control of individual banks or of borrowers, then the government must play a role in assuring that adequate credit is available.

We believe that three factors have significantly hindered the ability of low-income, low-wealth, and frequently minority residents of certain communities to obtain household and business credit: increased securitization of loans, falling numbers of bank branch offices (particularly in low-income neighborhoods), and lack of familiarity of traditional bankers with those communities that are underserved.

First, as discussed above, the increasing use of underwriting criteria in generating conforming home mortgage loans has tended to exclude identifiable segments of society. We believe that within these excluded segments, there remain a significant number of households whose demand for mortgage and rehabilitation loans could be met without entailing excessive lender's risk. As evidence, we point to the (admittedly limited, thus far) success of the community development banks already in existence. If the term is used narrowly, there are only four successful community development banks; if the term is used broadly, there are as many as several hundred. These have been able to find a profitable niche in providing limited services to low-income/low-wealth communities.

Second, due to bank and thrift failures, closures, and mergers, the number of small,

independent financial institutions operating in the US has declined substantially, particularly in low-income urban areas, and this trend can be expected to continue. In a study of five cities, Caskey (1992) found that communities with a majority of black and/or Hispanic residents are substantially less likely to have a local bank: indeed, the mean number of banks (including branches) per census tract with a majority of blacks and/or Hispanics is less than half that of "nonminority" tracts. Furthermore, Caskey found some evidence that recent bank closures have disproportionately affected low income and minority communities, and similar results for other cities were found by Leichter (1989).

Every financial institution has a "preferred habitat"--a geographically and functionally defined area within which it operates. Furthermore, the type and size of services that will be provided are a function of the size of the financial institution. For example, banks have traditionally used "rules of thumb" (often also adopted by regulatory agencies) that link the maximum size of loan made to the size of the bank's equity; a ratio of 5-10% is common. This means that a bank with $500 million in equity can make loans as large as $50 million, while a bank with $500,000 of equity can make loans as large as $50,000. The rapid decline of small, independent financial institutions has reduced the number of "small deals" that are likely to be made.

Third, bankers proceed for the most part on the basis of what has been successful in the past, and they operate to a great extent on the basis of informal (and sometimes formal) rules of thumb. They are (and should be) wary of unfamiliar activities, neighborhoods, and

characteristics of borrowers. It is not surprising that conventional banks are reluctant to lend in some neighborhoods. The CRA process can play an essential role in breaking down cultural prejudices by allowing bankers to interact with their communities. This is an on-going process that may take many years to reap substantial benefits (that is, to increase the supply of credit to underserved areas through conventional banking practices). To facilitate the transition, nontraditional alternatives are needed. As those who are already engaged in community development banking frequently argue, it is easier to make a banker out of a community activist than it is to make a community activist out of a banker. We would not want to go too far with this line of thought: however, there is something to the claim that conventional banks may never become good "community banks." Hence, we propose an alternative system of CDBs that will be designed from the ground-up to provide a limited range of services to specific communities that are not now well-served.

Geographic and functional specialization will allow the CDBs to face lower costs in certain well-defined markets, or "niches". As the CDBs establish a customer base in the targeted community, they will be able to make the "small deals" that would not be sufficiently profitable for traditional financial institutions. In some cases, the success of the CDBs will encourage the traditional lenders to move into these communities; we would view this as a success.

The establishment of a system of CDBs could increase the availability of credit to credit-worthy households that cannot meet the underwriting standards required for secondary

mortgage markets. It would also increase the number of institutions whose natural habitat is the small loan, targeted to communities not currently receiving an adequate supply of small commercial business loans. By keeping the CDBs small, we can ensure that their focus will be the "small deal". Moreover, by restricting the CDBs geographically and functionally, we can ensure that their focus will remain in their "niche"--areas underserved by traditional financial institutions.

Furthermore, geographic and functional restrictions will allow the CDBs to provide an important supplement to any "enterprise zone" programs. President Clinton has called for legislation to promote investment and job creation in Federally-designated zones. His proposal includes job tax credits, investment incentives, and employer wage credits. Estimated outlays may reach $2.4 billion over four years. One option would be to appropriate some of these funds for the establishment of a system of CDBs. This would potentially allow for much greater investment than $2.4 billion in the enterprise zones, because the CDBs would leverage the government's equity investment. [For example, given an investment of $500 million in equity in CDBs, and given an equity-to-asset ratio of 8% for the CDBs, the government's investment in the enterprise zones would be expanded to a maximum of more than $6 billion].

## IV. Transactions, Payments, and Savings Services

Traditional financial institutions, for a variety of reasons, are less able and willing to provide

transactions, payments, and savings services for low-income, low-wealth households. First, increased competition from "nonbank banks," such as money market mutual funds, tended to raise the interest rate that had to be paid to attract deposits. As the costs of attracting deposits rose, banks and thrifts turned to increased fees in an attempt to cover these costs. For example, the fees on non-interest bearing checking accounts rose from approximately $27-$35 in 1977 (at 1991 prices) to $60-$66 by 1991 (this discussion follows Caskey 1993, from which all data were obtained). Banks have also raised minimum balance requirements. One savings bank even instituted a one-dollar-per-month fee on savings accounts with balances less than $100. It found that it lost 24% of its accounts, but this amounted to only 1.6% of its deposits since the lost accounts were quite small. However, this is indicative of recent trends: rising fees and higher minimum balances have forced a segment of the population out of the traditional banking system. Many of those who have left the banking system have turned to "fringe banking"--primarily pawnshops and neighborhood check cashing outlets.

Currently, about 41% of households with income below $12,000 have no deposit account (up from 9.5% in 1977), and 31% of those with income below $18,000 have no deposit account. Because only 5% of households without deposit accounts have bank credit cards, the vast majority of these low income households without deposit accounts would not have credit cards. In contrast, 63% of those with deposit accounts do have credit cards. Thus, it is common for low-income households to rely on pawnshops for credit and on check cashing facilities for payment and transactions services.

The typical user of a pawnshop earns $8,000-$16,000 per year, lives paycheck-to-paycheck, does not have a checking account or credit card, and borrows less than $50 at an interest rate that commonly reaches 240% per year. As many as 80% of the users of pawnshops are repeat customers. Most users of check cashing facilities are low-to-middle income workers or recipients of government transfers, and they tend to be young and nonwhite. Regular users typically do not have a bank account. In a study of three New Jersey counties, it was found that almost half of all AFDC checks issued in the counties were cashed at check cashing facilities; of the users interviewed as they left the facility after cashing an AFDC check, it was found that 92% did not have a bank account. Because banks and thrifts will not typically cash checks of noncustomers, low-income households without bank accounts rely, to a great extent, on check cashing facilities. [A national survey, which included primarily urban areas in fifteen states plus the District of Columbia, found that 71% of urban banks and thrifts would not even cash a government check for a nondepositor at any price; only 14% would do it without charge, and the remainder would do it for a fee].

These facilities earn fee income from cashing checks and from issuing money orders used by customers to pay bills. The fee for cashing a government or payroll check <u>averages</u> 1.5%-3% in those states in which fees are not regulated (actual fees will fall outside the averages); the fee is 4%-15% for personal checks. Facilities typically charge more for cashing a welfare check than for cashing a social security check. Some check cashing facilities charge as much as 5-6% for cashing government checks: even in states that regulate the maximum allowable fees, the facilities frequently charge more than the legal limit (for example, in a New York

study, it was found that 49% of the users of facilities paid more than the legal maximum, and the average overcharge was 44%).

A family with an annual income of $10,000 would spend about $185 per year if it relied on a check cashing facility for its transactions and payment services: the same family, with a minimal balance in a checking account at a bank, would pay about $60 per year if it wrote six checks per month. Those that rely on the more costly check cashing facilities do so for a variety of reasons: they have no bank account; they need the cash immediately and cannot wait for the check to clear; they are afraid the check would bounce (entailing large fees), or because the check cashing is more convenient (e.g., location, hours, etc.).

A well-designed CDB system could provide an efficient and equitable alternative to expensive fringe-banking. At the same time, it could bring many of those now excluded into the payments system that most Americans use. Finally, it could offer a safe and secure repository for savings, encouraging thrift in low income communities that currently do not have adequate access to traditional banks.

## V. Community development banks

We believe that the establishment of a nationwide system of CDBs, as proposed by President Clinton, provides the means to most effectively address the issue of inadequate access to credit. The creation of banks in communities where lending is severely curtailed, if available

at all, will enhance the welfare of low-income citizens, inner-city minorities, and entrepreneurs seeking small scale financing for their businesses. Our proposal for this type of community bank draws from the pilot programs of community lending in Illinois and Arkansas, where the success of the community development bank concept has been demonstrated by the experience of the Shorebank Corporation of Chicago and the Southern Development Bancorporation in Arkansas. We will briefly outline the structure of our proposed CDB system.

The basic functions of these CDBs include: (a) the payment system for check cashing and clearing, and credit and debit cards, (b) the secure depositories for savings and transaction balances, (c) mortgage financing for households and home rehabilitation/improvement loans, and (d) commercial banking services for loans, payroll services, and advice. To be sure, there also exist functions of investment banking and asset management, but these are less important for the segments of the population that these CDBs will serve. Some services, such as check cashing and short-term loans are being carried out by (often unregulated) financial establishments of fringe banking as mentioned earlier (e.g., check cashing facilities and pawnshops)--at present, there are about 9,000 pawnshops and 5,000 check cashing facilities in the U.S., according to Caskey. The primary goals of these CDBs, then, will be to: (i) deliver credit, payment, and savings opportunities, and (ii) provide finance for households and small business throughout a designated area not adequately served by traditional banks, the CRA requirements notwithstanding.

The community service aspects of the proposed CDBs involve the payment mechanism and the savings facility. These require none of the "underwriting and judgment" skills of the banker who takes risks. Under our proposal, each CDB would offer deposit and savings accounts, check cashing services for depositors, automatic deposit of payroll and government checks, automatic payment (with customer authorization) of certain monthly bills, and credit cards (with a small line of credit determined by the customer's deposit and credit history). This will enable customers to achieve substantial savings over the costs of transactions at check cashing facilities (or traditional banks) and over the costs of short-term credit provided by pawnshops: it will encourage thrift and responsible financial behavior of customers, and will provide a source of funds to be "reinvested" in the community by the CDB through its loan-making activity.

An assumption underlying the lack of credit facilities assertion is that there are "bankable risks" and feasible "equity investments" in distressed communities that involve dollar amounts too small for the established banking community. Even "small" commercial banks customarily handle asset and liability denominations that are larger than those typically generated in low-income communities.

Projects that promise to be profitable but are not being financed because of their small size, their perceived riskiness, or the "inexperience" of the prospective management, under our proposal, would become the aim of the CDBs. Theory and evidence suggest that commercial banks exercise a high degree of discretion when approving a loan, be it for home or business,

since no application perfectly meets a guideline for obligation or loan/value ratio. Thus, loans to homebuyers or firms are not approved unless strong credit histories or established close relations with a loan officer exist. This means that individuals and firms that have been denied access to credit find it difficult to establish the required ties; in the case of firms, this problem is aggravated when they are small and, hence, lack market power.

The objective of each CDB is to be profitable, and it will be as successful as the projects it finances are profitable: this will dictate close supervision of its customers. Government seed money may be involved, but the government's investment in the CDB system should be viewed as a profit-making investment.

Since the proposal we envision for a nationwide system of community development banks has been outlined in considerable detail in a previous publication (Minsky, et. al., 1993), we have only described here the main features that distinguish it from existing and other models of CDBs.

The existing models of CDBs provide a useful starting point for the development of a nationwide strategy. However, we believe that there are significant problems with existing CDBs and other proposals that have been advanced based on these. Our own evaluation, which has been detailed elsewhere (Minsky, et.al, 1993), convinces us that the existing models should not serve as prototypes for a nationwide system of CDBs. These problems aside, the community development banks have been successful, nevertheless, especially in

residential mortgages, typically made on the condition that the structures be renovated and improved.

In addition, the existing CDBs have become the impetus for other banks to enter the business of home rehabilitation lending: these banks have been responding to the demand from consumers, and to the successful and profitable portfolio of such loans at the Shorebank. This is an example of the market working to the benefit of both business and consumer. We expect that in a nationwide system, existing banks (under pressure of competition) will respond and provide competition for the CDBs especially when default rates on such loans are lower, as the experience, thus far, shows.

Our proposal deviates from other community development bank proposals in four key ways. First, most other proposals are based on the example provided by one of the existing community development banks (such as Shorebank of Chicago). These typically rely on funds gathered from outside the community, from institutions and individuals who share the goals of community development banking, and who are willing to receive below market interest rates. However, a nationwide system cannot rely on "socially-conscious" funding. Furthermore, the assets of some of the existing institutions are comprised primarily of home mortgage loans. In contrast, our proposal emphasizes a wider range of assets, which is the key to revitalizing communities.

Second, our proposal would create a Federal Bank for Community Development Banks (FBCDB), which would be responsible for the funding, regulation, and supervision of the CDBs. It would act as the central bank, the correspondent bank, the link with financial markets, the supervising authority, and it may provide some clearing services. It would be responsible for training and for the testing of competency of CDB officers and staff. The FBCDB would be started with an initial investment of $1 billion by the Congress, which could be augmented to $5 billion as growth of the system warrants. It is designed to operate at a profit once the start-up period is over.

Third, our proposal is not a substitute for the current Community Reinvestment Act, and we do not believe that ownership of a CDB should rest with existing institutions in the commercial banking sector. Partial government ownership of the CDBs gives the government an effective method of supervision and control over each CDB. This will help to ensure the safety and soundness of the institutions, as well as ensuring that the focus of the CDBs remains the targeted functions and communities.

Fourth, our proposal deviates from others by setting-up a nationwide system of independent, for-profit institutions. The FBCDB would match up to $5 million of private investment in each CDB (so that as many as 200 CDBs could be capitalized by the initial one billion dollar government investment in the FBCDB). As a major investor, it would have representation on each board, and as a co-investor, it would automatically have the right to inspect the books of all CDBs. Each CDB would have to obtain at least $1 million in private equity investments,

up to a maximum of $5 million of private equity (matched by another $5 million from the FBCDB). Each would then operate without government subsidies.

## V. Conclusion

The CDBs should not be seen as a substitute for the CRA or for other programs designed to revitalize lower income areas. Rather, they should be seen as a complement for existing programs and for other programs that will be proposed by the Clinton administration. As discussed above, the CRA process ensures that a dialogue takes place among regulators, financial institutions, and served communities: it ensures that banks identify their communities and that they satisfy some of the needs of these communities. Moreover, it helps to expand the awareness of bankers such that their expectations about presently underserved areas are revised. It is unrealistic to expect that any financial institution can meet all the needs of any community; thus, there is a role for a CDB to play in some communities that supplements the role played by traditional financial institutions. Similarly, while we believe that CDBs have an important role to play in revitalizing low income communities, we certainly do not see these as a substitute for the wide range of programs (both public and private) that will be needed to reverse long trends of deterioration experienced by some distressed communities.

Finally, the CDBs are not intended to be welfare programs but to provide services to the community's residents, and consequently, they must meet the long-run market tests of profitability. Aside from the service aspect, community development banks will: (i) improve

the well-being of our citizens not now served because of unresponsive, yet traditional loan qualification norms, and (ii) directly increase the opportunities for potential entrepreneurs and potential employees. The basic assumption underlying the community development bank is that all areas of the country need banks that are clearly oriented toward the small customer: households that have a small net worth, a small IRA account, and a small transactions account, and businesses that need financing measured in thousands rather than millions or billions of dollars.

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