COMMUNITY DEVELOPMENT SUBSIDIARIES OF BANK HOLDING COMPANIES AS VEHICLES OF REINVESTMENT

by

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Dr. Rosser served as a faculty member of the Sociology Department of the Central YMCA Community College, and has lectured on urban affairs at the University of Chicago, Lewis University, and the Northwestern University Graduate School of Management. He is currently an adjunct Lecturer in Urban Affairs at the University of Illinois School of Public Health.

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His professional memberships include the American Society of Planning Officials and the National Association of Housing and Redevelopment Officials. His recent publications are as follows: Maintaining Viable Communities: The Investment-Disinvestment Process and Some Strategies for Housing Maintenance and Rehabilitation in the Pilsen Community of Chicago (with Calvin Bradford); "Aurora, Illinois: A Case Study of a Low- and Moderate-Income Housing Set-Aside Ordinance;" 'Using State Regulatory Authority to Stimulate Prudent Lending In a Changing Environment" (with Calvin Bradford and Stanley Hallett); Demand, Supply and Marketing of Single-Family Mortgage Credit (with Calvin Bradford and Dennis Marino); "Tying Bank Privileges to Performance."

He completed his undergraduate studies at the College of William and Mary, Williamsburg, Virginia, and received his M.Th. and D.Mn. degrees at the University of Chicago Divinity School.

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COMMUNITY DEVELOPMENT SUBSIDIARIES OF BANK HOLDING COMPANIES AS VEHICLES OF REINVESTMENT

Summary

This paper is one of a series which analyzes private sector initiated reinvestment strategies. It describes how a few bank holding companies have used provisions contained in the 1970 amendments to the Federal Bank Holding Company Act to create or acquire non-bank, community development subsidiaries in order to purchase, rehabilitate and resell and/or operate single and multi-family housing for low- and moderate-income persons.

The authors point out that to date, only fourteen bank holding companies have even applied to do community development activities through a subsidiary, and that, of that number, only four are currently engaged in *residential* redevelopment. Since the authority to grant permission to engage in such activities is vested in the Federal Reserve System, the authors note that while state governments can do nothing directly to modify the statutory authority to encourage the use of this strategy, there are things that states can do which could *indirectly* provide incentives for more bank holding companies to participate in the strategy.

COMMUNITY DEVELOPMENT SUBSIDIARIES OF BANK

HOLDING COMPANIES AS VEHICLES OF REINVESTMENT

> Government efforts to reverse the downward spiral of established neighborhoods largely have been ineffective because the various programs have cast government in the role of doer in a sphere of activity which requires considerable innovation, resourcefulness, and competitive drive. Successful activities which require such skills have been performed historically by profit-motivated, privately capitalized business organizations which draw upon public resources, when possible, to accomplish their objectives.
>
> -- Ronald Grzywinski, South Shore National Bank, Chicago, Illinois

Introduction

Commercial banks are privately capitalized businesses which are owned by their stockholders. Like other corporations in our economy, the management policies of banks are determined by those who own a controlling share of their stock. Legally, if one company owns or exercises a controlling interest in the management of another, the first company is a "holding company," and the second a "subsidiary." A holding company which has one or more commercial banks as a subsidiary is known as a bank holding company (BHC).

BHC community development subsidiaries can provide a useful vehicle for residential reinvestment. Properly structured and managed, they are capable of working with their sister subsidiaries -- commercial banks -- to increase the number of rehabilitated residential properties available for sale or rent in a community. The key to community development subsidiaries is the fact that unlike banks -- which are prohibited by law from making equity investments -- they are able to become part or sole owners of real estate projects. As part-owners, these subsidiaries can provide additional capital to developers and thereby assist in making them eligible for prudent bank credit. Or, if there are no other developers interested in rehabilitating units in a particular community, the community development subsidiary can act on its own to purchase, rehabilitate, manage and/or sell single and multi-family properties.

The authority for BHC's to establish community development subsidiaries comes from 1970 amendments to the Federal Bank Holding Company Act.[1] Those amendments state that -- subject to the approval of the Federal Reserve -- BHC's may acquire shares of stock in a corporation, the activities of which are "so closely related to banking ..., as to be a proper incident thereto." In making its determination about whether particular activities are appropriate, "the [Federal Reserve] Board shall consider whether [the activity's] performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse affects . . . "[2]

Using this legislative mandate as its basis of authority, the Board declared in 1971 that it would permit

BHC subsidiaries to make "equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas."[3] Finally, in August, 1972, the Federal Reserve Board went even further in its interpretation of how the 1970 amendments to the BHC Act could assist BHC's in fulfilling their civic responsibilities. The Board stated that BHC's "possess a unique combination of financial and managerial resources making them particularly suited for a meaningful and substantial role in remedying our social ills."[4]

In its 1972 interpretation, the Board included a list of specific projects that it deemed permissible. This list includes projects for the construction or rehabilitation of low- and moderate-income housing insured by the federal government under Sections 221(d)(3), 221(d)(4) or 236 of the National Housing Act,[5] or similar projects that are insured by state housing finance agencies. The Board also included a list of projects that "may" be deemed permissible as follows: housing projects for low- and moderate-income people which are not insured by public agencies; and commercial facilities which are designed to serve low- and moderate-income persons.

The distinction between projects that are <u>clearly</u> permissible, and those that the Board indicated it <u>may</u> approve appears to be based on the presence or absence of public (federal, state or local) subsidies and/or insurance in the project. For this reason, it behooves state policymakers to be aware of the possibilities and needs of BHC community development subsidiaries as vehicles of reinvestment.

Principal Actors and Their Roles

The parties necessary to initiate BHC community development subsidiaries are the BHC and the Federal Reserve system. The BHC must follow procedures set out in the Federal Reserve Board's Regulation Y to gain approval for conducting nonbank development activities.

If the BHC wishes to start a *de novo* development subsidiary, it applies to the Federal Reserve Bank for its district by sending proof of properly published legal notification of its intent to begin development activities. The district Federal Reserve Bank, under authority delegated it by the Federal Reserve Board in Washington, D.C., may accept notification. If the district bank makes no objection during a 45-day period following notification, the BHC may proceed with development activities. If the district bank objects, or, if the BHC plans to acquire an *existing* development corporation, the BHC must make application to the Federal Reserve Board for an individual decision about whether its subsidiary's development activities meet the legislative test set out in Section 4(c)(8) of the BHC Act of 1970.[6]

Examples of BHC Community Development Subsidiaries' Residential Reinvestment Activities

Since passage of the 1970 amendments to the BHC Act, fifteen BHC's either have notified a district Federal Reserve Bank of their intentions to engage in community development activities or have applied to the Federal Reserve Board for permission to do so. (See Appendix A.) Of that number, this paper will examine four that are currently using their subsidiaries to construct and/or rehabilitate housing for low- and moderate-income persons and one BHC whose application to do so has been approved recently by the Board.

Citizens and Southern Corporation

Among the first BHC's to make operational a community development subsidiary dedicated to providing housing for low- and moderate-income persons was Citizens and Southern Corporation of Charleston, South Carolina. Its subsidiary, known as Citizens and Southern Housing Corporation, began operating in 1971. Since that time it has built approximately 270 houses for sale to low- and moderate-income families.

During its first two years, the subsidiary used funds available under Section 235 of the National Housing Act.[7]

When these subsidies were terminated in 1973 by the Nixon administration's moratorium on federal housing programs, Citizens and Southern was left with 28 houses which had been built for sale under the federal program. These houses have since been financed by the subsidiary on terms roughly equivalent to Section 235, using a variable rate mortgage program[8] and some subsidies from the Corporation. Since the moratorium, housing construction has continued at the rate of approximately 20 houses per year.[9]

J. P. Morgan & Company, Inc.

In December, 1971, the Federal Reserve Bank of New York, on behalf of the Board of Governors under delegated authority, approved an application from J. P. Morgan & Company, Inc., to engage in *de novo* community development activity through a wholly-owned for-profit subsidiary known as The 23-Six Corporation. The approval was for "participation in the sponsorship, acquisition, construction, financing, and operation of housing for low- and moderate-income persons within the United States, its territories, possessions, and Puerto Rico pursuant to a Federal, State, or local program . . ."[10]

Although the name of the subsidiary subsequently was changed to the Morgan Community Development Corporation (CDC), the purpose remains that of making available "equity financing to experienced developers of apartment housing for low- and moderate-income families and the elderly."[11] As of September 30, 1977, Morgan CDC has investments in fourteen projects containing 1,019 units in seven states, and has an equity commitment to another 24 units. None of the projects are located in New York State. All use one or more forms of public insurance and/or subsidy. Five of the projects, containing a total of 252 units, have U.S. Department of Housing and Urban Development Section 8 rent subsidy funds available. Three of the projects that are located in Maine -- a total of 100 units -- have piggy-backed Section 8 funds on low-interest financing from the state housing finance agency.[12]

The Morgan CDC also participates in the New York City Preservation Corporation (CPC) -- "a private, not-for-profit corporation established by 34 New York City commercial and savings banks . . . to make short-term construction and long-term mortgage loans for the rehabilitation of residential buildings in neighborhoods that the city government has designated as preservation areas."[13] CPC confines its loans to "individuals, corporate property owners, not-for-profit organizations, and tenant cooperatives" of one-to-four-unit dwellings and will provide a mortgage of up to 90% of the value of the <u>improved</u> property with a mortgage term of thirty years.[14]

Morgan CDC's participation in CPC to date has consisted of a commitment of $100 million for the CPC's loan pool. $5 million has been actually drawn down. In addition, the subsidiary also has a $2 million commitment to make single-family mortgages for moderate-income families in the Bedford-Stuyvesant section of New York City. Of this amount, approximately $775,000 has been loaned out.[15]

First National City Corporation

First National City Corporation, holding company for First National City Bank in New York City, received permission from the Federal Reserve Board in 1972 to make "equity and debt investments in corporations or projects, including joint ventures and partnerships" which provide for new construction and rehabilitation of housing and "related facilities" for low- and moderate-income persons in the New York metropolitan region through a community development subsidiary known as Citicorp Community Development, Inc.[16] This wholly owned subsidiary provides construction financing, seed money and permanent financing for its residential projects.

During the period from 1973-1975, Citicorp Community Development, Inc. provided construction financing for 2,214 units. It also provided equity in the form of seed money -- so-called because these funds are used to cover costs incurred in packaging residential projects in order to secure construction and mortgage financing -- to housing sponsors for 5,571 units, and permanent financing for 594 units. All projects used some form of public insurance and/or subsidy -- such as Federal Housing Administration (FHA) 221(d)(4) and city rehabilitation programs.[17]

In addition to these activities, Citicorp received permission from the Federal Reserve in 1975 to establish Mission Park Corporation to "engage in the construction, ownership and operation of a low- and middle-income housing project and related facilities in the Roxbury section of Boston."[18] Citicorp Community Development, Inc. has an 80% interest in Mission Park Corporation with the remaining interest being held by Harvard University. When completed in 1978, the $41 million project will contain 775 units, 30% of which will be reserved for very low-income minority persons. Mission Park Corporation will operate the project "for the life of the 40-year mortgage, making Citicorp /_through its development subsidiary_7 a major landlord in Boston."[19]

Bank America Corporation

On January 24, 1977, the Federal Reserve approved Bank America Corporation's application to engage in de novo activities described as follows: "a community welfare project designed to improve neighborhoods by restoring abandoned and substandard properties located in Oakland to use by purchase, rehabilitation and disposition . . . through a /_not-for-profit_7 subsidiary, BA City Improvement and Restoration Program Corporation" (BA CIRP Corporation).[20] Originally, BA CIRP Corporation had intended to acquire, rehabilitate and resell 30 homes in predominately black East Oakland during 1977.[21] In preparation for that schedule, the BHC committed $150,000 for program funding, and an additional $150,000 line of credit to the subsidiary.

The program became operational in March, and to date the subsidiary has acquired only seven houses. One has been rehabilitated and sold, and another is nearing completion. Sale prices for the refurbished homes will range between $22,000 and $40,000. The role of the development subsidiary is limited to acquisition and rehabilitation so buyers must obtain their mortgage financing. All of the homes qualify for FHA mortgages.[22]

Illinois Neighborhood Development Corporation

In August, 1977, the Illinois Neighborhood Development Corporation (INDC) -- holding company for the South Shore National Bank of Chicago, Illinois -- applied to the Federal Reserve for permission to engage in de novo community development activities through two subsidiaries: City Lands Corporation, a for-profit subsidiary; and, The Neighborhood Institute, a not-for-profit affiliate.

The rationale given by INDC for the bifurcation of the profit and not-for-profit functions follows:

> Many aspects of community redevelopment can be addressed successfully by for-profit development activities. Others, however, can only be carried out as not-for-profit projects in the interest of community welfare. Indeed, these "unprofitable" concerns must be dealt with if other for-profit ventures are to succeed. The regeneration of a declining neighborhood requires that the full range

> of problems facing the community be addressed to break the downward spiral of decay. This must be accomplished in such a way that the housing and commercial sectors are upgraded without displacing the low- and moderate-income families who live in the community.
>
> A not-for-profit affiliate of a bank holding company is an appropriate vehicle for selected community welfare activities . . . These activities would include education, manpower development, certain not-for-profit aspects of housing improvements and commercial revitalization, security, energy conservation, and recreation.[23]

The for-profit subsidiary will operate to purchase, rehabilitate or reconstruct and dispose of "abandoned and substandard" properties by using equity participation with developers to help them qualify for prudent bank credit, or by acting on its own. INDC received Federal Reserve approval of its application in December, 1977.

Problems and Possibilities

Perhaps the most significant impediment to more widespread use of BHC community development subsidiaries is regulatory. The Federal Reserve Board interprets Section 4(c)(8) of the 1970 BHC Act as a two-part test. The non-banking activity under scrutiny must be closely related to banking <u>and</u> have public benefits which outweigh any adverse effects of performance of the activity by a BHC. Maintaining both tests gives the Board maximum flexibility in permitting or preventing non-banking activities.[25]

The Board's most extensive discussion of the closely related test arose in the context of an application from a community development corporation located in Chicago, Illinois which applied to the Board to become a BHC.[26] North Lawndale Economic Development Corporation sought to acquire 90% of the voting shares of a proposed new bank to be located in a predominately black, low-income area on Chicago's West side. Although this case illustrates the opposite phenomena from that discussed above -- North Lawndale already was, in effect, a holding company for a community development subsidiary and was trying to acquire a commercial bank as another subsidiary -- the Board's response is illustrative of the regulatory attitude that may confront even well established BHC's which want to engage in non-bank development activities.

North Lawndale based its application on its ability to meet the public welfare part of the test, and assumed that it would also meet the closely related to banking test. The Board ruled that it had permitted BHC's to engage in limited projects to promote the public welfare in the past primarily because these activities would contribute to the <u>banking</u> functions of the holding company -- not because they promoted the public welfare. Since North Lawndale was involved <u>primarily</u> in a wide range of community development activities (maintaining a health care facility, developing residential and commercial facilities), the activities were not limited sufficiently in scope, nor were they closely enough related to banking to qualify the organization to become a BHC. Although the North Lawndale application eventually was approved on the basis of a technicality -- a court ruled that the Federal Reserve had not acted in a timely fashion to disapprove the application[27] -- the Board's precedential ruling in the matter does not bode well for other community development corporations which may wish to enhance their capacity to do development by establishing or acquiring a commercial bank.

A second regulatory barrier may be the Federal Reserve's concern for bank soundness in its application of the standards in Section 4(c)(8). This concern is rooted in the traditional regulatory objectives of and responsibility for protecting the safety of deposits and the stability of the banking system. With a view towards these objectives, the Board analyzes the prospects, managerial skills, earnings, capital adequacy, and debt structure of bank holding companies as well as their banking and nonbanking subsidiaries.[28]

While the Federal Reserve's concern that unprofitable BHC community development activities may jeopardize the safety and soundness of banking subsidiaries is understandable, the regulatory agency compounds the problems of applicants by its equally strong insistence that development activities not be too potentially profitable. Several BHC applications to establish community development subsidiaries have been delayed or denied by the Board on this basis.[29]

Unfortunately, the total number of BHC's which have applied to establish or acquire community development subsidiaries is small; and, of that number, only those cited above have focused on the production and/or rehabilitation of housing for low- and moderate-income persons. These four BHC's also are very large, suggesting that those which own or control medium to small-sized banks may not have the money nor the expertise to take advantage of the community development provisions of the 1970 BHC Act.

Since state governments can do nothing formally to strengthen either the Congressional intent of the BHC Act of 1970 nor to influence the Federal Reserve's regulations concerning its application and approval process, they must look at other ways to encourage BHC entry into the community development field. Two possibilities for state-initiated incentives may be worth considering. The first, and most obvious, is that state housing finance agencies could set aside a certain portion of their low interest financing for BHC community development subsidiaries that are engaged in residential construction and/or rehabilitation. Not only might these "set-asides" help BHC's convince the Federal Reserve that proposed community development subsidiaries possess the capacity to do residential development, but they might also help more moderate-sized holding companies decide to undertake the complex and expensive process of establishing such subsidiaries.

A second kind of state-initiated incentive is neighborhood development grants to assist BHC's in covering the costs associated with establishing and operating community development subsidiaries. BHC's that are successful in receiving approval from the Federal Reserve might be entitled to receive full or partial public reimbursement for their costs. In addition, and, perhaps, more important, state funds could be used for matching grants to non-profit affiliates or equity investments in for-profit subsidiaries of BHC's.

Finally, however, in creating incentives to do reinvestment through BHC community development subsidiaries, public policymakers at all levels may want to work toward the establishment of what Ronald Grzywinski calls an appropriate "constitution" for these entities. The four elements of his suggested constitution for BHC community development subsidiaries are as follows:

1. That the costs and profits of development will be accurately reported.
2. That excess profits will revert to the benefit of the entire community.
3. That control and ownership of the institution will pass to the broad community of local residents who are most directly affected by its actions, so that local savings may always be available for the primary purpose of neighborhood renewal.
4. That the institution will possess the capacity for continuous self-renewal.[30]

If nonbanking subsidiaries of BHC's are to fulfill their potential role as vehicles of reinvestment, both the public and private sectors will have to look more closely at the problems and possibilities of these entities, and develop a rationale and strategies to overcome their current limitations.

Footnotes

[1] Bank Holding Company Act, 12 U.S.C. Section 1843 (1970).

[2] Ibid

[3] 12 C.F.R. Section 225.4(a)(7)(1976).

[4] 12 C.F.R. Section 225.127(a)(1976).

[5] National Housing Act, 12 U.S.C. Section 1701.

[6] Bank Holding Company Act, 12. U.S.C. Section 1843(c)(8)(1970).

[7] National Housing Act, 12 U.S.C. Section 1701.

[8] A mortgage contract that permits an increase or decrease in the interest rate, generally in response to changes in a specified financial indicator. The effect on the mortgagor is that payments fluctuate up or down depending on the mortgagee's cost of money.

[9] Telephone interviews with Joseph Floyd, Citizens and Southern Housing Corporation, Charleston, South Carolina (December, 1976; November, 1977).

[10] Federal Reserve Board, H.2 Release, 1971 No. 49, p.8.

[11] "Equity Financing For Low- and Moderate-Income Multifamily Housing," pamphlet published by Morgan Community Development Corporation, 23 Wall Street, New York, New York 10015.

[12] "Morgan Community Development Corporation Investments & Commitments (As of 9/30/77)," Summary table supplied by Edward M. LaMont, President, Morgan Community Development Corporation.

[13] "A New Source of Housing Loans: Community Preservation Corporation," pamphlet published by The New York City Community Preservation Corporation, 641 Lexington Avenue, New York, New York 10022.

[14] Ibid.

[15] Telephone interview with Edward M. LaMont, President, Morgan Community Development Corporation (November, 1977).

[16]Federal Reserve Board, H.2 Release, 1972 No. 4, p.8.

[17]Telephone interviews with Susan Kargman and Frank Mellone, Citicorp, New York, New York (December, 1976)

[18]Federal Reserve Board, H.2 Release, 1975 No. 17, p.7.

[19]"Two Big Banks Turn to Housing for Inner Cities," The Milwaukee Journal, 23 October, 1977, p.8.

[20]Federal Reserve Board, H.2 Release, 1977 No. 5, p.9.

[21]"Bank America's East Oakland Housing Program Runs Into Problem of Few Available Homes," American Banker, 7 October, 1977, p.1.

[22]Telephone interview with Jerry G. Buscemi, vice president and general manager, City Improvement and Restoration Program Corporation (November, 1977).

[23]"Application for Approval to Engage De Novo in Non-banking Activity as The Neighborhood Institute (TNI)," submitted to the Federal Reserve Bank of Chicago by the Illinois Neighborhood Development Corporation (INDC), 10 August, 1977, pp.6.7.

[24]Federal Reserve Board, Order Approving Acquisition of City Lands Corp. and The Neighborhood Institute, Dec. 19, 1977.

[25]Telephone interview with Larry Cunningham, Federal Reserve Board staff, Washington, D.C. (December, 1976).

[26]Federal Reserve Board Order Re: North Lawndale Economic Development Corporation, Federal Reserve Press Release (June 9, 1976).

[27]North Lawndale Economic Development Corporation v. Federal Reserve Board, No. 76-1607, (Seventh Cir.), 3/31/77.

[28]Bucher, "Bankers and the Bank Holding Company," Remarks to the 79th Annual Convention of the Florida Bankers Association (June 23, 1973), pp.10-12.

[29]Interview with Larry Cunningham.

[30]Ronald Grzywinski, Memorandum Re: "Bank Holding Companies as Neighborhood Development Corporations," 1 January, 1976, p.4.

APPENDIX A

Bank holding companies which have applied to engage de novo or acquire existing nonbanking community development subsidiaries, as reported in the Federal Reserve Board's H.2 Releases from 1970-1977. BHC's are listed in alphabetical order.

BankAmerica Corporation San Francisco, California

Bankmanagers Corporation, Milwaukee, Wisconsin

Citizens and Southern Corporation, Charleston, South Carolina

First Bank, System, Inc., Minneapolis, Minnesota

First National Boston Corporation, Boston, Massachusetts

First National City Corporation, New York, New York

First National Company of Sikeston, Inc., Sikeston, Missouri*

First Pennsylvania Corporation, Philadelphia, Pennsylvania

Illinois Neighborhood Development Corporation, Chicago, Illinois

J.P. Morgan & Company, Inc., New York, New York

Lincoln First Banks, Inc. Rochester, New York

Marine Midland Banks, Inc., Buffalo, New York

Nathan Hale Investment Corporation, Norridge, Illinois

R.I.H.T. Corporation, Providence, Rhode Island

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*Holding company dissolved in 1974.