

PUBLIC POLICY, BANKS AND
ECONOMIC DEVELOPMENT

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SUMMARY

Approximately thirty years ago, the first urban renewal programs were launched to recover a handful of declining neighborhoods. Those programs generally displaced poor and minority families from their homes. Fifteen years ago, Great Society programs attempted to channel federal funds directly to low income residents without adequate controls or the application of appropriate managerial skills. Presently, community development grants from the federal government to local jurisdictions are doing more to prevent formal bankruptcy of the latter than to improve the economic and social conditions of low income citizens.

As Charles Schultze has pointed out, one of the major paradoxes of our society is that while we are indelibly committed to the economic and social advantages of a private market as the primary driving force of our economy, we invariably resort "to centralized regulatory bodies, governmental delivery of free services, and categorical grants to subordinate units of government" to achieve social objectives. "Instead of creating incentives so that public goals become private interests, private interests are left unchanged and obedience to the public goals is commanded."¹ That general observation can be applied specifically to all past national efforts to improve the economic, social, and environmental conditions of minorities.

After thirty years, it is clear that the traditional "government as doer" approach to the economic integration of minorities, and the establishment of healthy living environments is bankrupt. No government program, no new development finance agency, of and by itself, can retain the will to adapt on a continuing basis to differing conditions, the internal self-confidence to encourage pluralistic approaches, the independence of political pressures to pursue a primary developmental mission in a relentless manner, or the spirit of profit from risk that compels forward movement, but at a prudent pace, Equally relevant, public funds do not exist on the scale required to rebuild the economies of America's older neighborhoods. That goal can be achieved only by harnessing the power and resourcefulness of the private market economy.

Financial institutions, along with their parent holding companies and appropriate affiliates, can combine better than any other private market organization the managerial and financial resources needed for massive and sustained pursuit of domestic development. Depository institutions are the gatekeepers to the financial resources of the society. They are privately capitalized, profit-motivated, and therefore "at risk." They control the nation's private credit resources, a critical component of the development process. Through affiliates, financial institutions also can apply capital and talent resources

and initiate action directly on a variety of economic and social needs. Lastly, regulated depositories are chartered for the need and convenience of their local community service areas, they are the beneficiaries of public policies that accrue to the private benefit of their shareholders, and therefore are highly regulated. This regulation means that not only is a system of checks and balances already in place to better assure a prudent application of resources to development activities, but that a unique opportunity exists to create a set of non-bureaucratic incentives that effectively will cause the public goal of economic parity for minorities, along with neighborhood redevelopment, to become the private interest of the nation's financial institution managers.

The quest for increased profits is the primary motivation of every financial institution manager to innovate, find solutions, and pursue unexplored business opportunities. More than anything else, that entrepreneurial "spirit of search" which characterizes private market activities must be applied relentlessly to achieving development objectives. It must be institutionalized within the mainstream of the national economy if ever there is to be real hope of minorities achieving economic equality. However, direct profit margins high enough to warrant the perceived risk of investing private time, talent, and capital resources in development activities could come only from low-income families who cannot and should not bear that burden. Therefore, if the

unthrottled private energies of a banking system are to be applied to this public need, a "near-profit" incentive system must be created.

Fortunately, such "near-profit" opportunities already exist. Deposits are the raw material of the banking business; bankers convert deposits into loans and generate earnings for their shareholders by charging higher rates on loans than they pay for deposits. A financial institution's earnings, however, are limited by its success at raising deposits in a highly competitive marketplace. Within that marketplace, personal savings deposits not only are the most rapidly growing component, but also are most stable, interest rate sensitive, and deposit insurance conscious. But interest rates and deposit insurance presently are not competitive elements because federal regulations impose ceilings uniformly by class of financial institution. As a result, banks resort to other non-rate, non-insurance devices to establish competitive advantage. However, recognizing the overwhelming rate sensitivity of the marketplace, they lobby continuously for removal of ceilings and/or parity with the higher rates that savings associations are permitted to pay. It is this means to increased profit, the already federally controlled ceiling on savings deposit interest rates, that should be harnessed as the primary "near-profit" element to release the entrepreneurial drive in applying private market resources to development needs. Those depositories that choose to apply

larger portions of their credit and capital resources to genuine development activities should be rewarded with authority to pay higher rates on savings deposits, and thereby improve their competitive position in the marketplace. There would be no public cost to such an incentive. Deposit insurance ceilings, and all other "privileges" that accrue to the private interests of financial institutions should be examined with a view toward orchestrating them into a comprehensive set of private incentives to achieve the public goal of development.

Experience has shown that development credit can be extended prudently, without excessive losses, if traditional banking practices are applied soundly. However, development lending, like any development activity, is expensive and inherently unprofitable in the short term. To extend development credit prudently means that, among other things, there must be an effective system of credit risk co-insurance to insulate private lenders against catastrophic losses. Such a co-insurance system should be relatively automatic and non-bureaucratic, relying on risk sharing with private banks and after the fact examination to safeguard the public interests. Efforts aimed at creating new development finance agencies, or improving existing programs, should be directed toward this type of support of private financing efforts rather than direct lending or investing.

Experience also has shown that the successful rebuilding of local neighborhood economies requires a tripartite relation-

ship between city government, financial institutions, and local neighborhood residents. Under the arrangements proposed herein, the power of the local city government, and the financial resources of regulated depositories, would be awesome in comparison to the very limited powers of local neighborhood residents. This latter group, however, often knows best the neighborhood's needs, and is most directly affected by development activities. Both to give neighborhood residents co-equal status with city government and the bankers, and to offset the cost of development lending and other activities, research should be conducted on creating a system of direct grants to organized neighborhood residents that could be used only to leverage and subsidize other, private market, development activities. As an example, neighborhood residents then would have resources with which to induce a financial institution to increase its development lending activities, a real estate owner to improve his rental housing properties, a new labor intensive employer to locate in the community, etc. These direct, community development type grants, funded through general revenues or through a new, modest (e.g. 0.1%) excise tax on financial institution deposits, could be channeled through SBA-licensed local development corporations that would be examined rigorously after the fact.

The proposals contained herein cannot easily be enacted. They embody an unconventional approach to government regulation of private business and place much responsibility for

balanced domestic development on the well-organized and generally reluctant banking industry. However, if minority Americans as a group ever are to achieve economic parity with their non-minority fellow citizens, there must be this kind of fundamental change in the financial structure of the national economy. Aggressive participation in the achievement of that economic parity must be made into the primary, private interest of the nation's bankers. It no longer can depend on the good will of well-intentioned private lenders, or the political priority of the day. It must be brought into the mainstream of American life.

¹Charles L. Schultze, The Public Use of Private Interest (Washington, D.C.: The Brookings Institution, 1978).

Introduction

The urgency and significance of neighborhood economic development is unquestioned. Many urban neighborhoods are plagued by a myriad of problems including: deteriorating and abandoned housing; excessive unemployment; loss of local businesses and institutions; declining public services; and crime. A major cause of many of these problems is inadequate access to private capital and credit.

The effect of neighborhood deterioration on residents is debilitating. Families are often frustrated and alienated by absence of opportunities and resources experienced by Americans residing in neighborhoods nurtured by a stable local economy. The most unconscionable phenomenon characterizing such deterioration is the disproportionate impact it has had on minority families. Many of the neighborhoods which have experienced the most severe deterioration are predominantly minority.

The purpose of this paper is not to sort cause from effect, nor to indict particular institutions or programs for the current plight of many urban neighborhoods. Some urban policy analysts contend that the condition of inner city neighborhoods has resulted from discriminatory practices,¹ while others suggest that the risk inherent in the economic condition of deteriorating neighborhoods precludes the investment of limited public funds or private capital.²

Regardless of the cause of neighborhood deterioration, there is a compelling need for the creation of effective strategies to engage in neighborhood economic development for the primary benefit of existing residents. Neighborhood economic development as used in this paper is defined as the process by which the economy of a neighborhood is restructured and once again able to attract the private investment and public support necessary to sustain housing, small businesses and community institutions; to stimulate job creation; and provide other amenities and resources characterizing neighborhoods with viable economies.

This paper will review briefly several previous attempts to engage in neighborhood development. The authors then suggest an alternative strategy designed to harness the capacity, talent and resources of the financial institution industry to be used in conjunction with community organizations and local governments to achieve comprehensive neighborhood economic development.

Financial institutions could be leveraged into playing a leadership role in such a development partnership through the creation of a system of rewards and incentives. Depository institutions are well-suited to serve such a role because they are significantly capitalized, profit-motivated, self-sustaining, highly regulated and have a visible presence in most urban neighborhoods. In order to achieve effective development, however, all three sectors -- private, public and voluntary -- must have an equally influential role.

Development activities carried out by the public sector alone are characterized by insufficient resources and inadequate sensitivity to the needs of neighborhood residents. Development planned and managed exclusively by financial institutions is also likely to overlook the desires of residents as well as the comprehensive perspective of regional policy plans designed by public agencies. Community organizations could not engage in development alone because they lack the resources and capacity required to achieve effective revitalization. A development process involving all three actors should produce a creative tension characterized by considerable debate which should, in turn, insure more effective development performance.

The Limitations of Publicly Initiated
and Managed Neighborhood Development

Since the 1930's, there have been numerous well-intentioned programs initiated by the public sector to address neighborhood deterioration. These programs include public housing, urban renewal, Model Cities and the Community Development Block Grant program. Although each of these efforts has experienced limited success, they have been characterized by the following major problems.

1. Insufficient funding;
2. Inadequate leveraging of private investment;
3. Inability to be self-sustaining;
4. Limited return on investment;

5. Lack of capacity to structure flexible programs/ventures that respond to the diverse needs of each neighborhood and;
6. Absence of direct accountability of bureaucratic program managers to local residents.

1. Insufficient Funding

Most government initiated neighborhood development programs have been hampered by insufficient appropriations to achieve the ambitious programmatic goals mandated by legislative bodies. This has been caused, in part, by competition for limited public revenue among numerous interest groups.

As a result of limited funding, many local governments have "targeted" resources to a limited number of neighborhoods which are perceived to be in marginal condition, but possess the capacity to be revitalized with available funding. Neighborhoods considered to be experiencing more serious economic difficulties are often allocated minimal funding due to the assumption that available funds are insufficient to make a significant difference in the neighborhood's condition.

In addition to the problem of competing interests, the American electorate appears to lack the political will to authorize substantial expenditures to cope with the urgent economic and social problems confronting the nation's cities. However, even if such a political will could be created, concurrent with a dissipation of the urgency of competing interests, there would not be sufficient capacity to generate the revenue required to implement an effective neigh-

neighborhood economic development program through direct public expenditures.

2. Inadequate Leveraging of Private Investment

During the last four decades, many public planners and managers have been operating from a perspective developed during the New Deal which views the public sector as the most effective sector for implementing social policy. Only minimal efforts have been made to encourage the private sector to redirect its activities to implement prudent social policy goals. The urban renewal program of the 1950's and 1960's had some success in leveraging private investment, especially in the central areas of major cities. However, the overall performance of public leveraging of private investment for neighborhood development has been dismal.

The leveraging of the Community Development Block Grant program has been more effective than other public programs, but insufficient to meet the capital and credit needs of serious neighborhood development. The Urban Development Action Grant program appears to be particularly promising, but is doubtful that sufficient incentives can be offered through this program to leverage private investment in seriously deteriorated neighborhoods.

3. Inability to be self-sustaining

A second method for coping with insufficient capitalization is for community development programs at the local level to be self-sustaining. Unlike private corporations,

local development programs are unable to replenish their capital other than through direct funding from Washington. If that funding is eliminated, the program is often terminated thereby frustrating the ambitions of neighborhood residents. If the primary local vehicle for implementing neighborhood development ventures was self-sustaining, then local plans could be carried out regardless of decisions within the federal government.

4. Limited Return on Investment

One of the problems with the expenditure of public funds is that they are often viewed as grants rather than investments. Since public money is "free" and local governments, certain neighborhoods and citizens are "entitled" to receive particular grants, program managers are often not able or willing to demand that the programs yield major results.

The individuals administering community development programs are not usually at risk when they allocate funds to particular projects. In most cities, the incentive structure / reward system for local planners is more often based on grantsmanship, program planning and design rather than implementation. Maximizing the yield from a particular public investment is often perceived as something outside of the influence and control of the local "planning" process.

If public funds were truly "invested" in neighborhood ventures with expectations for maximum return and leverage, rather than treated as "grants," then perhaps limited public funds could be more productive in enhancing revitalization

efforts and attracting private resources. However, even if public funds yielded more results, they would be inadequate alone to meet the tremendous capital needs of urban neighborhoods.

5. Lack of Capacity to Structure Ventures that Respond to the Diverse Needs of Each Neighborhood

The needs of neighborhoods are pluralistic. Although there have been numerous attempts to construct typologies, most neighborhoods are unique entities. There are many similarities among neighborhoods, but most are unique in terms of their relationship with other neighborhoods and the larger region. Many neighborhoods are characterized by distinct housing stocks, historical development patterns and institutional support structures.

In order to create programs to meet actual local needs and maximize existing neighborhood resources, program designers must have a thorough understanding of the economic and social fabric of the community, as well as significant contacts and relationships with local movers and shakers. Otherwise strategies may be created which fail to meet local needs or actually intensify existing problems.

Until the creation of the Community Development Block Grant (CDBG) Program, most urban development programs were non-pluralistic. They were created to respond to neighborhood typologies without adequate flexibility for responding to distinct local conditions. To a certain extent, the CDBG program provided more flexibility to tailor strategies to local conditions. However, in some cities, particularly

larger cities, there has been a lack of performance in responding to all of the diverse needs of neighborhoods.

In order to create a pluralistic approach toward neighborhood economic development, indigenous neighborhood institutions must be utilized as a primary vehicle for channeling public and private development resources.

6. Absence of Direct Accountability of Bureaucratic Program Managers to Local Residents

The management of public development programs by large, centralized bureaucracies has been cited by numerous observers as a source of frustration and resentment for local entrepreneurs and residents. Securing access to information, decisionmakers and program performance reports has been due to several factors including, in some cases, the insensitivity of program managers. Another significant factor has been the reluctance of residents to expend the time and energy required to sort through the bureaucratic structure to get responses to specific concerns.

Although there has been substantial reform regarding citizen participation and access in the public planning process, many cities lack decentralized, neighborhood based program coordinators who are accessible and can be held accountable by local residents.

National Urban Policy

The limits of past neighborhood development efforts has been recognized, in part by President Carter's National Urban Policy. The following statement from A New Partner-

ship To Conserve America's Communities exemplifies the Carter Administration's perspective of past performance and future needs.

While we strive to be fair in providing help to those who need it, we must keep in mind that resources available for attacking the Nation's problems are scarce. We must carry out the most cost effective policies possible to address the diverse problems facing our cities...³

...Most importantly, we must recognize that these problems cannot be solved by the Federal government alone... While Federal urban programs have helped many cities and many people, these programs have had serious shortcomings...⁴

...Only the private sector can provide the capital needed for rebuilding and growing; and only the private sector can carry out the large scale development programs necessary to provide healthy local economies...⁵

The challenge is to create effective mechanisms which can implement the national urban policy rhetoric without repeating the mistakes of past urban strategies. The possibility of creating such a mechanism which possesses sufficient capital, credit, talent, and the capacity to maximize investment return and be self-sustaining is discussed below.

Local Financial Institutions As Core Development Institutions

Financial institutions possess a variety of resources, tools and knowledge which if applied to local development activity could reverse the economic decline of many neighborhoods. Banks, savings and loan associations and other depository institutions are ideal vehicles for neighborhood deve-

lopment because they are significantly capitalized, profit motivated, self-sustaining, highly regulated and have a visible presence in many urban neighborhoods.

The lifeblood of a financial institution is its deposit base. By attracting consumer and commercial deposits, a financial institution secures the capital it needs to extend credit. Financial institutions in the United States currently control \$1.6 trillion on deposit.⁶

Depository institutions generate operating income by converting deposits into loans and charging a higher interest rate on loans than they pay for deposits. Lenders earn the difference between the interest paid to the depositor and the interest charged to the borrower minus overhead and servicing costs. For example, interest paid to holders of passbook savings or statement savings accounts by commercial banks is 5-1/4%. However, these deposits are used to make loans with interest rates of 10-3/4% or more. The interest paid on certificates of deposit is higher than non-certificate accounts, thereby diminishing the spread between interest paid to depositors and interest received from loans.

As long as a financial institution is able to attract deposits, it has a self-renewing pool of credit resources. The savings deposit market, however, is very competitive. Consequently, any advantage a financial institution can offer to savers that they cannot secure elsewhere (e.g., higher interest payment on savings), the more deposits an institution should be able to attract. With a greater volume of

deposits, more loans can be extended thereby earning the institution more operating income.

Financial institutions are limited to a specified interest rate they can pay to depositors depending on the type of account which is established. For a passbook savings account, commercial banks can pay 5-1/4% interest, but savings and loan associations can pay 5-1/2%.⁷ The regulation which sets these limits is referred to as Regulation Q.

Another positive characteristic of financial institutions from a neighborhood development perspective is that they are for-profit institutions. They cannot afford to make unsound loans because their profitability would be affected. Consequently, there is a strong incentive for lenders to insure that projects they finance are financially feasible. Although this may make some institutions more conservative than they should be, it also helps insure that there will be higher performance standards for developments they finance which should have a positive impact on the neighborhood.

From a public policy perspective, the regulation of financial institutions by federal and state governments is a significant asset. They are regulated to such an extent that government examiners regularly visit each of the institutions to inspect the most minute details of individual business transactions for compliance with a host of fiduciary and consumer protection regulations. These examiners are empowered to issue cease and desist orders, remove

offending officers, and direct a variety of other summary remedies without resorting to judicial process. It is an efficient mix of private enterprise and public regulation that serves well many public interests at modest public cost. Regulated and insured financial institutions are economically potent quasi-outposts of government.

The determination of which level of government supervises a financial institution is dependent upon whether the institution is a savings and loan association or a commercial bank, and whether it is state or federally chartered. A federally chartered savings and loan association is regulated by the Federal Home Loan Bank Board, and its deposits are insured by the Federal Savings and Loan Insurance Corporation (FSLIC). Federally chartered commercial banks are regulated by the Comptroller of the Currency and insured by the Federal Deposit Insurance Corporation (FDIC). State-chartered savings and loan associations are supervised by a state savings and loan commissioner and are insured by the FSLIC. Commercial banks with state charters are regulated by a state bank commissioner and are insured by the FDIC. Commercial banks that are members of the Federal Reserve System are also regulated by the Federal Reserve Board. Mutual savings banks are currently regulated and chartered by state government and insured by FDIC.

One of the major consumer laws which financial regulatory agencies enforce is the Community Reinvestment Act (CRA).⁸ Enacted by Congress in 1977, CRA required financial

institution regulatory agencies to use their authority to encourage financial institutions to meet the credit needs of their primary service area, particularly low and moderate income neighborhoods within that area. Such credit needs are to be met in a manner consistent with safe and sound lending standards.

This law has generated a creative tension between the traditional emphasis of the examiner to insure that financial institutions are not making unsound loans and the CRA emphasis where the examiner attempts to insure that institutions are not rejecting loans they should be making. From the perspective of creating a mechanism for effective and prudent neighborhood development financing, such a creative tension is almost perfect.

As a result of CRA, there is considerable pressure on financial institutions to engage in neighborhood development activities. In addition to periodic examinations, regulators can reject a branch application because of the institution's past failure to respond to community credit needs. The recent rejection of a branch application submitted by Greater New York Savings Bank on such a basis raised considerable concern throughout the financial institution industry.⁹

Another positive attribute of most financial institutions is their familiarity with local economic conditions. Employees of financial institutions often have a range of contacts within the local community which if used effectively, will enable them to recognize and respond to

opportunities and problems in a pluralistic manner. Such sensitivity to local needs and response capacity would be a major improvement over previous non-pluralistic development efforts.

Local financial institutions are also known and trusted by many local residents, business people and institutional managers. They often possess the legitimacy and visibility needed to attract and coalesce public and voluntary support into effective action.

Not all lenders have used their resources, contacts and talent to address neighborhood needs. An unfortunate number has either inaccurately assumed that there were few prudent lending opportunities in local neighborhoods, or they perceived ventures located elsewhere as involving less risk and greater return. Once a "near profit" system of rewards and incentives is developed, however, lenders will be more highly motivated to apply their resources and talent to prudent neighborhood opportunities.

A characteristic of financial institutions which is often overlooked is their capacity to make equity investments and undertake development through subsidiary corporations. This is particularly important in neighborhoods which have been unable to attract sufficient equity investors or competent developers. Without investors or development vehicles, the availability of development financing is meaningless.

Financial institutions can make equity investments or engage in development ventures through several mechanisms.

Commercial banks can establish wholly-owned neighborhood development subsidiaries. Commercial bank holding companies can also establish subsidiaries to engage in neighborhood development. Savings and loan associations possess the capacity to create subsidiaries known as service corporations. Like bank holding company or national bank subsidiaries, service corporations can make equity and debt investments, and can engage in development directly. A service corporation may be wholly-owned by one savings and loan association or jointly owned by many associations.

In addition to possessing many assets for undertaking neighborhood development, unbridled financial institutions are threatening to some groups as primary development organizations because of their profit-maximization focus. Although the profit-orientation of lenders was previously described as a positive attribute which would insure high-quality development, there is a danger such an orientation could impose a heavy social cost on those residents who can least afford to incur costs.

Neighborhood revitalization as a public policy has substantial legitimacy among the public and voluntary sectors, and to a marginal extent, the financial institution industry. Revitalization, however, has been defined by both public policy makers and industry representatives as involving physical and economic regeneration of designated "geographic areas." It has generally not been defined as creating

economic opportunities for low and moderate income or minority residents. One means of **creating** "area revitalization", which is likely to be very profitable and of limited risk, is to entice middle and upper income residents to locate in certain neighborhoods populated by moderate income residents. Unless opportunities are provided for moderate income residents, the effect of such practices will be to discourage economic integration. If low and moderate income residents are displaced, then they will be forced to resegment in adjacent neighborhoods. The long term social and economic costs of this phenomenon are obvious.

In designing a strategy for harnessing the talent and capital of financial institutions, one must not create a system which rewards financial institutions engaging in activities which generate an unreasonable level of displacement. Obviously, there will be some displacement as a result of specific rehabilitation projects, but repeated patterns of displacement-generating activities should not be rewarded.

Financial Institution Involvement in Neighborhood Revitalization Endeavors

The response of financial institutions to the development credit needs of neighborhoods during the last two years has been promising. In communities throughout the nation, many lenders are seeking ways to improve urban lending performance. This has been primarily in response to increased awareness of local lenders to prudent urban lending opportunities; the pressure of the Community Reinvestment Act and; the develop-

ment of special public programs designed to reduce lending risk. Despite these developments, allegations of rejections of creditworthy consumer and business loan applications on the basis of "neighborhood factors" continue.

The most heralded single-family urban lending effort in the nation is the Philadelphia Mortgage Plan (PMP). PMP was created in October, 1975, involving the participation of fourteen financial institutions which agreed to make conventional mortgage credit available in Philadelphia. As of June 30, 1978, PMP participants had granted 3,598 mortgage loans with an aggregate value of \$38,431,705. The delinquency and foreclosure rate of 1.6 and .1 percent, respectively, at that time were not only acceptable, they were clearly lower than most loan officers expected.

The heart of PMP is the agreement of participating lenders to revise their loan underwriting standards on a permanent basis. This led to substantial changes in the criteria used to evaluate both the potential borrower and the property. Consequently, many of the loan applications which would have been rejected under the old underwriting standard were now approved.

Although there are no other single-family urban lending efforts approaching the scale of PMP, there are some lenders who have made significant commitments to extend single-family credit in inner city neighborhoods. The need for credit for small business development and multi-family housing rehabilitation, however, continues to be a problem. The provision of such credit involves a greater risk than single-family

credit and will require substantial incentives to channel credit into these areas.

The number of financial institutions which are undertaking development and making equity investments through subsidiaries, in addition to providing direct development financing, is limited. According to some observers, the Illinois Neighborhood Development Corporation (INDC) is the most prominent example of a bank holding company attempting to engage in comprehensive neighborhood economic revitalization.

Through its four subsidiaries, INDC is attempting to implement a new approach to the renewal of deteriorating urban neighborhoods. It intends to show that certain provisions contained in the 1970 amendments to the Bank Holding Company Act present unique opportunities for bank holding companies to underwrite broad programs of neighborhood development, reaching beyond the infusion of credit resources, to participate with local residents in the implementation of development projects.

INDC acquired a controlling interest in South Shore Bank of Chicago in December, 1973. The Bank's primary resource for combating neighborhood deterioration is its capacity to extend credit for the purpose of improving the neighborhood. During the past five years, it has made an extensive effort to extend credit to residents of South Shore for the purpose of purchasing and improving single-family homes and multi-family rental buildings, starting

and expanding small businesses, maintaining social services, and obtaining higher education.

INDC's other subsidiaries include City Lands Corporation, formed in 1977 to acquire, rehabilitate and sell residential and commercial properties, and the Neighborhood Fund, a Minority Enterprise Small Business Investment Corporation licensed by the Small Business Administration in 1978 to invest venture and development capital in neighborhood businesses. The Neighborhood Institute, a not-for-profit corporation which began operations in 1978 to initiate social and economic development activities in the South Shore area, is an affiliate of INDC.

Other bank holding companies which have established neighborhood development subsidiaries include Citizens and Southern Corporation, J.P. Morgan Company, First National City Corporation and Bank of America.¹¹

During the last eight months, two national bank subsidiaries, First Chicago Neighborhood Development Corporation and North Carolina National Bank Community Development Corporation have been created. The First Chicago Neighborhood Development Corporation (FCNDC) will support the development of Chicago neighborhoods by becoming a general partner and equity investor in residential, commercial and industrial projects. The Development Corporation has been capitalized by an initial investment of \$1,000,000 by First National Bank. The subsidiary currently is evaluating one \$10 to \$15 million revitalization project in which the FCNDC

would become a 50 percent equity partner. The North Carolina National Bank subsidiary plans to engage in housing revitalization in one neighborhood in Charlotte.

Savings and loan associations have also engaged in community development through subsidiaries called service corporations. The Chicago Area Renewal Effort Service Corporation is the most prominent service corporation engaged in neighborhood development. It is jointly owned by more than fifty savings associations in the Chicago metropolitan area. To date, its activities have focused on the rehabilitation of multi-family housing in two Chicago neighborhoods. Two other service corporation engaged in similar activities are the Greatwest Southwest Service Corporation of Chicago and One Twenty-Eight, Inc., of Cincinnati.

Other financial institutions are involved in neighborhood development programs such as Neighborhood Housing Services, not-for-profit community development programs, and publicly initiated community development. Overall, however, the commitment by the financial institution industry has not begun to involve even a small percentage of the enormous capacity and resources of the industry.

Neighborhood development initiatives by financial institutions have been inadequate for the following reasons.

- 1) The perceived risk of many neighborhood investment opportunities;
- 2) The actual risk of some neighborhood ventures;

- 3) The added cost of underwriting smaller loans which are essential for micro-scale, neighborhood development;
- 4) The competitive advantages of other investment opportunities often characterized by lower perceived risk, greater return, and lower service costs and;
- 5) The lack of sufficient incentives/rewards to encourage more efficient development activities.

An Incentive Structure For Neighborhood Development

In order to encourage financial institutions to use more of their resources to meet the development needs of urban neighborhoods, and overcome the obstacles listed previously, a new system of incentives needs to be established. Such a system must provide sufficient rewards that enhance the profitability of the financial institution industry without any direct cost to the public. Hopefully, the incentives will be adequate to reallocate capital and credit from surplus areas to areas with capital and credit shortages.

The U.S. economy employs various forms of profit improvement and risk reduction incentives to private industry to accomplish social objectives. Protective tariffs in the shoe industry protect jobs and capital investment, but also help to insure that profit margins will not deviate too widely from domestic norms. There also are subsidies to peanut growers, thoroughbred horse breeders and others. Barge operators still have the locks and waterways main-

tained without expense to them; suburban developers have had low cost federally insured loans and an enormous highway system constructed to help them improve the return on their private investments. Bankers have federally imposed limits on the rate of interest they may pay on savings accounts, thus reducing their operating expense, and federal agencies insure their depositors' accounts, thus eliminating the depositors' concern with (and therefore, the probable reduction of) the amount of capital required for each dollar of profit.

A number of existing banking regulations that were designed originally to create a stable national banking system accrue to the direct benefit and profit of bank shareholders without regard to the subject institution's fulfillment of its charter obligation to service the financial needs and convenience of its service area(s). Instead of the benefits accruing uniformly and automatically to all regulated institutions as they now do, they could be linked to the development performance of financial institutions. In several cases, (e.g. Reg. Q., Deposit Insurance) this type of incentive arrangement would not only be without expense to taxpayers, but would accrue to their direct benefit as depositors.

Regulation Q is one of the most controversial regulatory measures affecting the financial institution industry. Regulation Q was established by the Federal Reserve in 1933 to prevent rate wars among financial institutions by setting

a ceiling on bank savings deposits. Congress decided to foster homeownership by protecting the most reliable source of mortgage loans in our economy - savings and loans. Regulation Q has long been anathema to commercial banking industry, while the savings and loan industry defends the measure with vigor.

One way to encourage neighborhood development financing would be to reward those financial institutions which have exhibited a superior reinvestment record by permitting them to pay a higher rate of interest to savers than institutions with a less than impressive record.

Deposit insurance is another privilege enjoyed by the financial institution industry. Started in 1935 to bolster consumer confidence in the banking industry, deposit insurance has become a pivotal force in the growth of the financial institutions. Currently all savings accounts are insured up to \$40,000., although deposits above \$40,000 have been covered by FDIC and FSLIC when institutions failed. However, there is no obligation on the part of the government to guarantee deposits above \$40,000.

Over the years, there has been some pressure on the government to grant 100% insurance on all deposits. This proposal was criticized by an editorial in the American Banker in 1976 which suggested that the nation "would lose one of the most basic checks on imprudent bank activity: the attitude of large depositors who examine their banks and move their accounts if they feel that an institution is

not maintaining its solvency."

An alternative to 100 percent deposit insurance, is to have an insurance floor of \$40,000, and reward those institutions which are contributing to neighborhood economic development by granting them a higher level of deposit insurance on individual accounts. This will give development-oriented institutions a competitive edge in attracting more profitable deposit accounts which can be used to engage in more development.

The controversey over paying interest on federal bank reserves is another issue which can be tailored as an incentive for neighborhood development activity. Without much success, the commercial banking industry has been pushing for interest payments on funds which must be placed with the Federal Reserve by member banks. Instead of paying interest on the reserves of all member banks, interest payments might be limited to those members actively engaged in significant neighborhood development.

All of the above regulatory measures have a profound effect on the daily operations and profitability of the financial institutions industry. A two-tiered system of privileges which match neighborhood development performance could generate massive capital and credit to address an urgent public need without spending public funds.

Additonal privileges which could be awarded on the basis of development activity include the following:

- 1) The establishment of free domestic trade zones for international banking.

Such zones would permit international banking business to be conducted exempt from state and federal banking laws and regulations. Only those institutions with acceptable reinvestment records would be certified to conduct business within such zones

- 2) Interstate Branching.
- 3) Intrastate Branching in unitary banking states.
- 4) Permission to issue variable rate mortgages.
- 5) Establishment of electronic funds transfer facilities.
- 6) Permission to engage in investment banking.
- 7) Creation of federal development deposit program which would award federal deposits to financial institutions meeting reinvestment standards.
- 8) Exemption from state usury laws.

The above incentive system hinges on the evaluation of which institutions are engaging in substantial neighborhood development activity. A problem with this system is how to evaluate performance. One way would be to use an existing regulatory device, the examination of financial institutions for compliance with the Community Reinvestment Act. Examiners rate CRA performance on a scale of 1 to 5. Institutions with the highest CRA rating would qualify for the interest rate advantage, the higher deposit insurance, interest payment on reserves, and all of the other incentives. Financial institutions which fail to secure the highest rating would qualify for the minimum level of insurance and interest rate

permitted to be offered. They would not qualify for any of the other incentives.

The advantage of this type of evaluation is that examiners can examine the specific activities of each financial institution, and assess them against evaluation criteria such as those stated in the Examiners' Guidelines to the Community Reinvestment Act.¹² The disadvantage of this method of assessment is that it is non-quantitative and subjective. If lenders had a quantitative goal to achieve, then they would know exactly what to do to earn the desired incentives.

An alternative to the CRA rating system is to use loan / time deposit ratios in census tracts with a median income equal to or less than the median income of the SMSA. To benefit fully from the incentives suggested herein, a depository institution must have invested a significant portion of its personal time deposits in development activities in such census tracts.

The advantage of this system is that it establishes an objective, quantitative goal which is easily understood. The disadvantage of the system is that it permits one to assess quantity of development activity, but not quality. Under this system, a financial institution might be rewarded for producing wholesale displacement of moderate income residents because there would not be a way to determine which segment of the population is benefitting from development efforts.

The political difficulties of implementing the neighborhood incentive system are likely to be great. Regulatory agencies will criticize the proposals as lacking a thorough understanding of the sensitive purpose of the various regulatory devices. The incentive scheme is also likely to be criticized as a social intrusion into prudent financial institution regulatory and monetary policy.

Arthur Burns, former Chairman of the Federal Reserve Board, opposed a proposal for a similar incentive system on the basis that it provided indirect subsidiaries for encouraging development lending. Burns preferred the use of direct and explicit subsidiaries that are visible and more readily measured, so that the public can more easily evaluate the subsidy.

Neighborhood Participation Mechanism

The creation of an incentive system for financial institutions engaged in neighborhood development needs to be complemented by inventing a separate mechanism which would enable representative neighborhood organizations to maintain a more equal status with other development actors. The invention of a local empowerment mechanism is likely to insure that a portion of development activities will reflect the desires and needs of existing residents. Such a process must be developed without creating disincentives for private actors.

One possible means for creating an effective role for neighborhood organizations is through the enactment of a block grant program which could allocate funds to representative neighborhood organizations to enable them, in conjunction with other public and local philanthropic funds, to take equity positions in development activities or to share the risk in private lending. Private lenders or investors would not be required to secure the participation of neighborhood organizations, but such joint ventures would be attractive to private institutional actors because of the reduction in their risk exposure. With sufficient resources, neighborhood residents could induce a financial institution to increase its development lending, encourage a real estate owner to improve his rental housing properties or entice a new labor intensive employer to locate in the community.

The selection of organizations to participate in such a program would be difficult. Obviously, standards would need to be created to insure that recipient organizations are representative of local residents, are not engaging in discriminatory actions, and possess the capacity to shape deals with private actors in a prudent manner. Likely candidates for funding might include LDC's, CDC's, non-profit housing efforts, and other program based entities. Whichever entity is selected, it must be examined rigorously after the fact.

The funding of the program is likely to be a major

obstacle and there also will be opposition from local government officials who desire to allocate all direct government funding within their jurisdictions. The program could be funded through general revenues or through a new, modest excise tax (e.g. .01%) on savings deposits. Given the fact that as of the end of the first quarter of 1979 there were \$1.6 trillion in savings capital in financial institutions, \$160 million or \$2500 per \$25 million in deposits could be raised through an excise tax of .01%.

Conclusion

The proposals contained herein cannot easily be enacted. They embody an unconventional approach to government regulation of private business and place much responsibility for balanced domestic development on the well-organized and generally reluctant financial institution industry. However, if minority Americans as a group ever are to achieve economic parity with their non-minority fellow citizens, there must be this kind of fundamental change in the financial structure of the national economy. Aggressive participation in the achievement of that economic parity must be made into the primary, private interest of the nation's financial institutions. It no longer can depend on the good will of well-intentioned private leaders, or the political priority of the day. It must be brought into the mainstream of American life.

Footnotes

¹For a summary of the literature which has alleged the existence of discriminatory practices see the bibliography of Urban-Suburban Investment Study Group, Redlining and Disinvestment as a Discriminatory Practice in Residential Mortgage Loans (Washington, D.C.: U.S. Government Printing Office, 1978).

²For the inherent risk perspective, see Andrew Brimmer, Risk vs Discrimination in the Expansion of Urban Mortgage Lending (Chicago: U.S. League of Savings Associations, 1977).

³The President's Urban and Regional Policy Group, A New Partnership to Conserve America's Communities (Washington, D.C.: U.S. Government Printing Office, (1978), p. I-6.

⁴ibid., p. I-7.

⁵ibid., p. II-8.

⁶Obtained from the Federal Reserve Bank of Chicago, Research Library.

⁷As of July, 1979, commercial banks were permitted to pay a maximum of 5-1/5%, and savings and loan associations were permitted to pay 5-1/2%.

⁸The Housing and Community Development Act of 1977, Title VIII - Community Reinvestment, Public Law 95-128.

⁹"FDIC Denies Greater NY CRA - Protested Branch Bid," American Banker, April 25, 1979.

¹⁰Dennis R. Marino, et al., The Planners Role in Facilitating Private Sector Reinvestment (Chicago: American Planning Association, 1979) p. 23

¹¹Margaret Adams and Lawrence Rosser, Community Development Subsidiaries of Bank Holding Companies as Vehicles of Reinvestment (Chicago: Woodstock Institute, 1977).

¹²"Community Reinvestment Act Examination Procedures," Federal Reserve, November 22, 1978.