The Jerome Levy Economics Institute of Bard College

Public Policy Brief

Community Development Banking

A Proposal to Establish a Nationwide System of Community Development Banks

Hyman P. Minsky, Dimitri B. Papadimitriou, Ronnie J. Phillips, and L. Randall Wray

No.3/1993

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The Institute believes in the potential for the study of economics to improve the human condition. Its purpose is to generate viable, effective public policy responses to important economic problems. It is concerned with issues that profoundly affect the quality of life in the United States and abroad.

The present research agenda includes such issues as financial instability, poverty, unemployment, and problems associated with the distribution of income and wealth. Other research interests include the issues of public and private investment and their relationship to productivity, competitiveness, and the prospects for growth and employment. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.

Editor: Sanjay Mongia

Published by Bard College, The Jerome Levy Economics Institute, Post Office Box 5000, Annandale-on-Hudson, NY 12504-5000.

ISSN—1063-5297

Summary

A group of scholars at The Jerome Levy Economics Institute of Bard College has developed a plan to establish a nationwide system of community development banks (CDBs). The urgent need for such a measure is reflected in the Clinton/Gore proposal to create a network of 100 community development banks. The creation of banks in communities lacking such institutions is critical to the revitalization of many communities, and it enhances the general welfare of the country.

The crux of this paper is that the primary function of the financial structure is to advance the capital development of the economy—to increase the real productive capacity and wealth-producing ability of the economy. It is assumed that capital development is fostered via the provision of a broad range of financial services to various segments of the U.S. economy, including consumers, small and large businesses, retailers, developers, and all levels of government. Moreover, the existing financial structure is particularly weak in servicing small and start-up businesses, and in servicing certain consumer groups. Finally, this problem has become more acute because of a decrease in the number of independent financing alternatives and the rise in the size distribution of financing sources, which have increased the financial system's bias toward larger transactions.

The primary goals of the CDBs are to deliver credit, payment, and savings opportunities to communities not well served by banks, and to provide financing throughout a designated area for businesses too small to attract the interest of the investment banking and normal commercial banking communities. Community development banks are premised on the notion that a critical function of the financial system is not being adequately performed by existing institutions for well-defined segments of the population: low-income citizens, inner-city minorities, and entrepreneurs who seek modest financing for small businesses.

A fully funded and mature CDB would be expected to provide many core banking services, including:

– a payment system and secure outlets for savings
– the financing of housing, consumer debt, and student loans
– commercial banking services
– investment banking services
– asset management advice and special accounts

This proposal is unique since it emphasizes the need for the development of an equitable payment system for the bottom quintile of the population, which is generally denied access to checking accounts and credit cards. More attention should be given to this payment function of banking. Others have argued that commercial banks should be required to offer “life-line accounts,” but this represents an unnecessary cost that commercial banks can ill afford at the present time.

But by the same token, the importance of bringing the bottom quintile of the population into the banking system without burdening them with excessive costs associated with a “fee for services” payment mechanism is also recognized. For example, the current checking component of the payment system is too expensive for commercial banks to provide the small accounts needed by those with low incomes, and thus cannot serve as the basis for a universal payment system available to all. The CDB system, however, can be designed so that a profitable payment system is incorporated within the package of services provided to the community.

The funding, regulation, and supervision of CDBs can be carried out most effectively by the creation of a federal bank for CDBs. The Federal Bank for Community Development Banks (FBCDB) will be the clearing bank, the central bank, the correspondent bank, the link with financial markets, and the supervising authority for the community development banks. It will provide up to 50% of the equity for the community development banks, and as an investor will have access to the books of these banks. This FBCDB will also have the responsibility of overseeing the development of the professional staff of the CDBs.

The Clinton/Gore proposal for community development banks called for some 100 such banks over the next four years. Even if each of these banks has assets of $100 million by 1996, their holdings would total only $10 billion. These institutions are not to be viewed as a significant countercyclical force, nor as a major factor in the growth of the economy. They are to be seen as a set of institutions that fill a gap in the ongoing institutional structure. They may well provide part of the institutional setting in which a climate of opportunity replaces stagnation for many segments of the population.

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Preface

Institutional reform of the financial structure of the U.S. economy is likely to be among the priorities on President Clinton's agenda.

The Jerome Levy Economics Institute of Bard College has an ongoing project, under the guidance of Hyman P. Minsky, Distinguished Scholar at the Institute, on "The Reconstitution of the Financial Structure." In conjunction with this project and in response to the Clinton/Gore proposal for the creation of a network of community development banks, scholars at the Institute have developed a concept for such a proposal detailed in the pages that follow. In this concept proposal, the authors provide the rationale for—and views on the structure, chartering, organization, financing, and supervision of—a nationwide system of community development banks. In addition, an attempt is made to assess the experience of the existing pilot models of CDBs and the potential problems that these models might present for a nationwide strategy.

Recent troubles plaguing a wide spectrum of financial institutions indicate a need for fundamental reform. Is it sheer coincidence that the problems afflicting S&Ls, banks, insurance companies, and other financial agents are occurring simultaneously? The evolution of these pandemic crises has produced a financial system much different than the one created via the Banking Act of 1935, which yielded a very long period—almost fifty years—of financial stability in U.S. history. Among the troubling results of this financial evolution and innovation have been the disenfranchisement of many poor communities from the financial system: many low-income people have little access to financial services. Community development banks are a bold and serious initiative addressing the main function of a financial system—that is, the capital development of the economy. But it is a proposal that is focused on specific areas that are not presently well served by existing financial institutions.

The crux of the Institute's mission is to improve the human condition via the discipline of economics. I believe that the following proposal on community development banks contributes to that endeavor.

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January 1993

A Proposal to Establish a Nationwide System of Community Development Banks

Hyman P. Minsky, Dimitri B. Papadimitriou, Ronnie J. Phillips, and L. Randall Wray

I. Introduction

The Clinton/Gore proposal for the creation of a network of 100 community development banks (CDBs) to revitalize communities is bold, and will contribute to the success of the U.S. economy. Banks are essential institutions in any community, and the establishment of a bank is often a prerequisite for the investment process. For this reason, the creation of banks in communities lacking such institutions is important to the welfare of these communities.

The vitality of the American economy depends on the continual creation of new and initially small firms. Because it is in the public interest to foster the creation of new entrants into industry, trade, and finance, it is also in the public interest to have a set of strong, independent, profit-seeking banking institutions that specialize in financing smaller businesses.

When market forces fail to provide a service that is needed and potentially profitable, it is appropriate for government to help create the market. Community development banks fall into such a category. They do not require a government subsidy, and after start-up costs, the banks are expected to be profitable.

The primary perspective of this concept paper is that the main function of the financial structure is to advance the capital development of the economy—to increase the real productive capacity and wealth-producing ability of the economy. The second assumption is that capital development is encouraged by the provision of a broad range of financial services to various segments of the U.S. economy, including consumers, small and large businesses, retailers, developers, and all levels of government. The third is that the existing financial structure is particularly weak in servicing small and start-up businesses, and in servicing certain consumer groups. The fourth is that this problem has become more acute because of a decrease in the number of independent financing alternatives and a rise in the size distribution of financing sources, which have increased the financial system's bias toward larger transactions. These are assumptions that appear to be supported by the evidence: they are also incorporated in other proposals that advance programs to develop community development banking.

II. Rationale for Community Development Banks

The greatest danger to the community bank concept may be a lack of clarity in the concept. The primary goals of the CDBs are to deliver credit, payment, and savings opportunities to communities not well served by banks, and to provide financing throughout a designated area for businesses too small to attract the interest of the investment banking and normal commercial banking communities.

The community service aspects of the banks involve the payment mechanism and the savings facility. These require none of the "underwriting and judgment" skills of the banker who takes risks. 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.

There are six identifiable banking functions:

1. Payment system for check cashing and clearing, and credit and debit cards.
2. Secure depositories for savings and transaction balances.
3. Household financing for housing, consumer debts, and student loans.

4. Commercial banking services for loans, payroll services, and advice.
5. Investment banking services for determining the appropriate liability structure for the assets of a firm, and placing these liabilities.
6. Asset management and advice for households.

This list is not meant to imply that every bank should perform all of these functions. The argument for community development banks is that one or more of the above functions is not being adequately performed by existing institutions for well-defined segments of the population: low-income citizens; inner-city minorities; and entrepreneurs who seek modest financing for small businesses. Furthermore, this troubling situation has been aggravated by a variety of problems that financial institutions of all kinds have faced over the past years.

The 1980s and 1990s have seen a decline in the number of independent financing outlets for businesses, and a shift in the size distribution of banks and savings and loan institutions in favor of larger banks. Banks now find it increasingly unprofitable to serve many parts of the population, particularly the smallest enterprises. Our proposal would increase the supply of short-term credit to small business.

One aim of the CDBs should be to seek out 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. Theory and evidence suggest that commercial banks are reluctant to make loans to firms that have not already established close relations with a loan officer. Thus, firms that have been denied access to credit due to perceived inexperience find it difficult to establish the required ties. This problem is aggravated when the firms are small and, hence, lack market power.

The objective of the 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. Thus, if the Congress mandates subsidized financing by these banks, the Congress should budget the expected cost of the mandated spending as a subsidy to the endeavor.

Capital development of the country in general and of depressed regions in particular requires a broad range of financial services in order to raise effective demand and revitalize the regional and national economies. In other words, "capital development" is the primary concern, but this does not solely mean the provision of investment finance. The whole community needs financial reform: this includes the provision of financial services to all segments of the economy, including consumers, small and large business, retailers, developers, and all levels of government. The CDB proposal will address most of these; it will ignore finance of big business and of federal and state government. However, we need to emphasize that the CDB proposal cannot, by itself, be viewed as the panacea that will solve all of the problems afflicting economically depressed communities.

III. Assessment of Community Development Bank Experience

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 with proposals based on these). Consequently, we do not recommend that these models be applied without modification as part of a nationwide strategy. Community development banks have been successful when they have been able to attract deposits from outside the community while using the funds for residential mortgage loans.

The most successful community development bank, and the oldest, is the 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 among its services low-income-housing development, remedial education, and vocational training. On the asset side, its greatest success has been residential mortgages, typically made on the condition that the structures be renovated and improved. The loan loss ratio at Shorebank in 1990 was 0.46% and in 1991 was 0.67%. The key to its success is residential housing: as Ronald Grzywinski of Shorebank acknowledged, "the principal small business of Shorebank was quite simply housing."

The other CDB commonly referred to as a potential model is the Southern Development Bancorporation, parent of Elk Horn Bank & Trust Company in Arkansas. It uses a subsidiary called the Good Faith Fund, which offers loans from $500 to a few thousand dollars to low-income people trying to start a business. The activities in small-business loans have been less successful, as have attempts to provide low-cost checking and savings deposits for the community residents.

On the liability side of the balance sheet, the most important innovation of Shorebank has been Development Deposits, funds gathered from outside the community, from institutions and individuals who share the goals of the corporation. Presently, development certificates of deposit account for almost half of the deposit base at Shorebank. Some depositors accept below-market rates to subsidize Shorebank's work, but generally these deposits offer market rates of interest. Rehabilitation certificates of deposit, which typically pay 200 basis points below the market interest rates, make up 4.1% of Shorebank's deposits. Thus, the banks are subsidized to some extent by philanthropists and socially conscious people who are willing to accept a lower rate of return on their money in exchange for doing something they consider an important contribution to society. This asset/liability structure, which also carries federal deposit insurance, has been the key to the success of the corporation.

Shorebank's principal weakness is that, although it pays for itself, it is not profitable enough to convince other entrepreneurs with capital to imitate its success; its returns to its owners have been lower than average for a bank its size. Thus, it should not serve as a model for a nationwide system of CDBs.

IV. Potential Problems with a Nationwide Strategy

The strengths of existing community development banks may turn out to be weaknesses if current policy is followed as a national strategy. Attracting funds from the outside is important for particular CDBs, but to establish a nationwide group of banks and then expect them to compete for funds from the "socially conscious" public would be self-defeating. It is not a viable long-run strategy to promote as a national policy the transfer, for example, of the "socially conscious" funds of New York City to rural Alabama (or vice versa). A national policy should encourage local markets for the CDB liabilities just as it encourages local markets for the CDB assets. This will help to ensure that local consumers receive the broad range of financial services needed to encourage capital development of the community, particularly credit services and transaction services. The banks of a nationwide system of CDBs cannot rely on local short-term loans as a primary asset while the primary liabilities are external funds, because this ignores the payment and saving functions of the local community.

A key aspect of Shorebank is that its neighborhood was still perhaps two-thirds middle and working class when the bank came into existence. CDB managers do not claim that their model would work in the very worst ghettos. A strategy based on existing models would, therefore, neglect those at the very bottom of the economic ladder, who presumably need the most help. Reliance on external funds ignores the necessary provision of bank services to local consumers. This is why we believe that a CDB should be restricted to providing financial services in the community.

Another important factor is that the existing CDBs, because they are unique in their communities, face little competition for their core business. When they do face competition, they often do well, especially in residential loans. Shorebank discovered that its creation of the rehabilitation loan generated a demand from consumers for other banks to also provide rehabilitation loans. This is an example of the market working to the benefit of both business and consumer. However, in a nationwide system, existing banks (under pressure of competition) can be expected to respond and provide competition for the CDBs.

Because the CDBs are not intended to be welfare programs but to provide services to the community's residents, they must meet the long-run market tests of profitability. Aside from the service aspect, community development banks will improve the well-being of our citizens by increasing opportunities directly for potential entrepreneurs and for 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 deal: households that have a small net worth; a small IRA account; a small transactions account; and businesses that need financing measured in thousands rather than millions or billions of dollars.

V. A Proposal for a Nationwide System of Community Development Banks

Our proposal deviates from existing examples of CDB-type banks, and from other proposals, by emphasizing the need for the development of an equitable payment system for the bottom quintile of the population, which is generally denied access to checking accounts or credit cards. More attention should be given to this payment function of banking. Others have argued that commercial banks should be required to provide "life-line accounts." We believe that this represents an unnecessary cost that commercial banks can ill afford at the present time.

But by the same token, we recognize that it is important to bring the bottom quintile of the population into the banking system without burdening them with excessive costs associated with a "fee for services" payment mechanism. The current credit card system, one example of a fee for services system, forces those who cannot get credit cards (mainly those with lower incomes) to bear the burden of the vendor's discount to subsidize the purchasers who do have credit cards: in general, there is no discount for payment by cash. The current checking component of the payment system is too expensive for commercial banks to provide the small accounts needed by those with low incomes, and thus cannot serve as the basis of a universal payment system available to all. The CDB system, however, can be designed so that a profitable payment system is incorporated within the package of services provided to the community.

We would expect that a fully funded and mature CDB would provide many of the six functions of banking outlined earlier. However, these functions may be implemented in phases. The payment system, secure outlets for savings, short-term commercial loans, mortgage loans, and student loans should be included in the initial phase. Investment-type banking services and asset management and advice for households could be added later. If the demonstration project (which begins with 100 CDBs) proves successful, we anticipate the creation of a nationwide system of CDBs that could provide all six banking functions in selected communities (as each CDB finds its niche).

The CDB should rely to a great extent on local markets for its liabilities—this is the inherent juxtaposition with the provision of small commercial loans. This is in contrast to existing CDBs, which rely on funds from outside of their communities. First, reliance on external sources of funds conflicts with the goal of bringing the populations of depressed areas into the banking system. Second, there is some evidence that reliance on external, brokered money may have contributed to the thrift crisis (brokered money is volatile, and it allowed some thrifts to grow too quickly). Instead, a maximum limit should be set for external funds. This will help to ensure that local consumers receive the broad range of financial services needed to encourage capital development of the community. The depressed areas are great sources of funds (social security checks, welfare payments, earnings, private pensions, and so on), but these have been flowing into megabanks that use them elsewhere. Both the assets and the liabilities of the CDBs should be regionally restricted. Thus, CDBs should be permitted to hold no more than perhaps 10% of their assets in the form of liabilities that originate outside the community. These would likely consist primarily of federal government bonds. Local government obligations would also form part of the CDB's portfolio. The result will be a mechanism to provide a source of funding to the local community.

Creation of a Federal Bank for Community Development Banks

The funding, regulation, and supervision of CDBs can be carried out most effectively by the creation of a federal bank for CDBs. The Federal Bank for Community Development Banks (FBCDB) will be the central bank, the correspondent bank, the link with financial markets, the supervising authority for the community development banks, and it may provide some clearing services. It will provide up to 50% of the equity for the community development banks, and as an investor will have access to the books of these banks. This FBCDB will also have responsibility for the development of the professional staff of the CDBs. This would include training of staff, provision of information, testing of competency, and so on.

The Federal Bank for Community Development Banks will be where the community banks hold their reserve and their operating deposits. It will be the correspondent bank for the community development banks—that is, the FBCDB would help finance positions in assets and, in some cases, would take shares in deals arranged by the CDBs. The "checks" that the community bank makes available to the holders of savings deposits may well be negotiable orders of withdrawal drawn on the Federal Bank.

As the community development banks develop a mortgage business, the Federal Bank would be the agency that securitizes these instruments.

The Federal Bank will be responsible for establishing and maintaining underwriting standards for the community development banks. It will have a training responsibility for the community banks, and be the link by which the mortgages initiated by the community banks enter financial markets. Its oversight functions will exist by the right of its position as an owner.

The Federal Bank for Community Development Banks will be started with an initial investment of $1 billion by the Congress, which could be augmented to $5 billion as and if the system warrants. It will report to the Congress. Its directors and its chief executive officer will be nominated by the president and confirmed by the Senate. It will have an initial ability to borrow up to twice the federal government investment in the market. The bank is designed to be profitable once the start-up period is over. For clearing purposes, this bank will become a member of the Federal Reserve System, although some clearing services may be provided by the FBCDB itself. The FBCDB will match up to $10 million of private investment in each CDB. Because the FBCDB is a major investor in each CDB, it will have representation on each board, and as a co-investor will automatically have the right to inspect the books of the CDBs. Finally, if necessary, the FBCDB will have access to the Federal Reserve's discount window to obtain reserves required in check clearing between the CDB system and the commercial bank system. In short, the FBCDB will combine the functions of a central bank, a correspondent bank, and an investor for the CDBs.

The Payment System and Secure Outlets for Savings

Every payment system involves the use of resources and, therefore, involves costs in operating the payment system. These costs have to be borne by some sector of the economy. Access to a payment system may require an ability to pay for the services used. The payment system has evolved into a three-part structure: deposits subject to check; debit and credit cards; and currency and coin. The deposit subject to check payment system is expensive and relatively inefficient. To realize how inefficient our check payment system is, one need simply trace the flow of bills and payments through the banking system and note the number of records that are needed by the flow of payments and orders.

The costs of operating the checking system have been borne in a variety of ways. Non-par clearing, where someone depositing or cashing a check received less than the face value of the check under transaction, was a common practice for non-local checks prior to the Great Depression. In recent years, the costs of the checking system were borne by the difference between the interest paid on deposits and the interest earned on bank assets, where access to the system without explicit service charges depended on the size of the deposit balance. In addition, the Federal Reserve operates a check-clearing service which in effect subsidizes the checking system. Over the years, the checking system's penetration grew, especially after the Savings and Loan Associations and the other varieties of savings banks began to have deposits that were subject to check (although coverage and access were never universal).

Commercial banks are restricting access to checking accounts by setting higher minimum balances, offering minimal customer relations, and leveling explicit charges for account activity. The result is that larger segments of the population are now outside the check-using system than hitherto, and this trend of diminishing coverage by the check system can be expected to continue. (This is implied by the recent work of John Caskey, "Check-cashing Outlets in the U.S. Financial System," *Economic Review*, Federal Reserve Bank of Kansas City, November/December 1991.)

In contrast to the now increasingly overt costs of a checking account, the costs of credit-debit card systems are carried by an annual fee and a covert cost to the user in the form of the vendor's discount. (The payment aspect of the credit card should be distinguished from the credit aspect.) Furthermore, of the three payment systems, only the credit-debit card system is capable of being fully electronic: with a "smart" cash register, the "paper" that is signed never leaves the place of origin unless a charge is challenged. There is little doubt that an electronic plus plastic payment system will be of increasing importance in the total payment system. The losses that banks and other issuers of credit cards have taken in the current recession have led to closer scrutiny, resulting in a restriction of access to the credit-debit card payment mechanism.

For many communities, the only available banking services are those that are performed by the currency exchanges. These exchanges are a "fee for services bank," which cashes checks and provides payment services (e.g., money orders) in exchange for currency (charging a 2–4% fee for their services). In some jurisdictions, the currency exchanges are allowed to receive welfare and social security checks. The currency exchanges show that the fee schedule for making the exchange between currency and checking forms of money can make the institution profitable. The situation was aptly described by President Clinton:

> "One community leader in Los Angeles told me that in that vast place we know as the inner city, there were 177 check-cashing stands in the neighborhood where the riots began and only thirty-three banks. In the Washington, D.C., area, there are fifty major banks but only two have branches in Anacostia and neither of them has a lending office."

The currency-exchange business should be one facet of the community development banks. A recognition by the government that it is the payer's responsibility to pay its debts in a money form that the recipient can use implies that the government needs to absorb the charges levied on recipients of its checks for the exchange of checks for currency. This may require a payment by the government of 1% of the face value to the CDBs that convert government checks into currency. To reduce payment system costs, government payments could be made directly to accounts at CDBs by wire transfers.

If the now-existing currency exchanges were licensed to accept savings accounts, and if they were required to hold only short-term government securities as assets for these accounts, they would be a savings equivalent of a narrow bank. Because their assets would be restricted to short-term government bonds, these narrow banks could carry a 100% federal government guarantee on their deposits regardless of the size of any deposit, without paying deposit insurance premia to an agency such as the FDIC.

These "narrow banks for savings" would solve the problem of the non-par exchanges for some of the recipients of government checks. The deposit of government checks into these accounts could well be an electronic transfer. The CDBs would offer savings accounts that accept automatic deposits and allow a limited number of withdrawals per month without explicit charges. This would become a feasible way of offsetting the lack of elementary household banking services in poor neighborhoods. In addition, the savings facility might allow a limited number of free, negotiable orders of withdrawal to be written against these deposits; the rest would carry a service charge.

In order to protect against interest-rate risk, a 2.5% equity against such deposits may be required. (Even if a vast majority of the assets are short-term government securities, both the interest rate and default risk are minimal.) The interest rate that these banks pay on their liabilities will be keyed to the interest rate earned on the portfolio: we calculate that a 0.5 to 0.75% differential would make the savings facility profitable.

The check-cashing and savings facility dimensions of the community development banks cover the services to poorer households functions which these banks are designed to perform. The NOW accounts would eliminate the relatively substantial payment system costs incurred by the poorest members of the community; low-income residents would be integrated into the banking system, and it would be the first point of contact with a population in which we wish to encourage thrift.

Financing Housing and Consumer Debt

The community development banks will act as mortgage originators within their community. They will not engage in construction loans through this department. The mortgages will be on homes and minor community-level commercial property. In many cases, mortgage loans will include provisions for rehabilitation of property. Those mortgages that are carried will be funded by long-term certificates of deposit through the commercial bank subsidiary of the CDB, but as the banks develop it should be possible to securitize such mortgages by way of facilities that the Federal Bank for Community Development Banks will develop.

The consumer debt facilities that are available in prosperous communities are generally not available in the communities in which the development banks will function. The community development banks will be able to make credit cards available to those who have built up a savings account. The CDBs may provide student loans and other loans for investment in human capital.

Commercial Banking Services

The CDBs will provide commercial loan services for their clients. These loans will be financed by demand deposits, certificates of deposit, and other types of deposits that will carry the ordinary deposit insurance. The development and solicitation of business, the structuring of loans, and the supervision of credits are three essential aspects of commercial banking. The bank's staff for commercial banking consists of business development and loan officers. In smaller banks, these two functions may be combined, and the top management is likely to be the key business development agent.

The business development officers of a bank are just what the name indicates: they are the salespeople of the bank's services to the business community. Like all salespeople, they work a territory. A community, even if it is underbanked, has going businesses. The calling program of the business development officers of a community development bank will necessarily include the existing businesses in its neighborhood, whose needs will be explored. The question of how the bank can serve the existing businesses, not perhaps as the sole bank but as a supplement to existing banking connections, will be on the "agenda" of the business development officer.

Being devoted to the community in which the businesses they are financing function, the community development bank will, over time, develop a better awareness of the potential successes and failures in their community than is available to the branch officers of the larger traditional bank located outside the community.

The structure of a financing agreement is what is finalized in the contract: a bank's customer promises to pay money at future dates in exchange for being financed "now." The structuring of loans begins with a "pro forma," in which the business sketches what it will do with the funds, and how the funds to repay the loan will accrue to the business. The function of the loan office is to apply a quizzical and skeptical eye to the presentation. In all these negotiations, the ability of the loan applicant to perform is one question on the table.

Loan officers not only structure the loans, they often need to intervene to put in place an adequate structure to administer the enterprise.

Successful loan negotiations lead to an agreement on a scenario (program) for the borrowing firm that yields the schedule of payments on the loan, along with an understanding as to what will happen if various provisions of the contract are not fulfilled.

Supervision is the post-loan relation between a bank and its borrowing client. The relation between a business and its bank is not a one-shot affair. In a successful relationship, new credits are being negotiated even as maturing credits are paid. The business development and loan officer's relation with a bank client includes follow-ups, which are designed to assure the bank that the business is developing in such a way that the provisions of the loan are being satisfied and the payments on the debts will be forthcoming.

The success or failure of the community development bank concept will ride on how well the solicitation, structuring, and supervision functions are carried out.

Given the character of banking, it is necessary that the usual loan committee structure that includes outside directors to approve and review credits be maintained. As banking is a highly leveraged business, it is essential that those whose equity investment in the bank is at stake in the bank be represented on these committees. The training and retention of business development and loan officers is vital to the success of the community development bank concept.

Investment Banking Services

As was indicated in the discussion about commercial banking, community development banks will quite naturally find that there are investment banking activities that their clients require. In particular, a successful business may require a faster growth in its equity than is allowed by the growth of equity through retained earnings. The restrictions of the Glass-Steagall Act would not apply to these banks, for there is no feasible alternative to a community development bank for raising the size of equity infusions that are contemplated. The dollar value of each underwriting that a community development bank will undertake will fall below the usual minimum for underwritings by investment bankers.

Investment banking activities consist of underwriting and taking positions in the equity and bond liabilities of clients. The position-taking may well be by way of a venture capital fund, in which the bank joins with other investors. Although community development banks will often be centered in a poor neighborhood of a city, there are local firms (both service and manufacturing) whose principals both know the community and have investable funds. Even the poorest of our city neighborhoods are not communities that are universally impoverished. Our country has a long history of the successful development of "immigrant banks" that served ethnic neighborhoods and helped transform them from low-income to middle-income communities.

One aspect of the investment subsidiary of the community development bank will be the development of the special knowledge needed about the businesses with which it works: the investment subsidiary must be well versed in the mechanics of qualifying for the various aids to small businesses (such as loan programs of the Small Business Administration and other federal, state, and local initiatives).

The Federal Bank for Community Development Banks, described earlier, may well take positions in the equity of the community development banks. This may be done directly or by way of venture capital funds it sponsors that may be able to raise money on capital markets.

The investment banking activities of the community development banks and the Federal Bank for the Community Development Bank are natural outgrowths of the banking activities of these institutions. As the business development and loan officers of the community banks "work their street," they not only identify and develop clients for the loan and the underwriting of the bank, but they also develop knowledge of those in the community who are able to invest in other businesses. The essential postulate of the community development banking approach is that the poorer and under-banked parts of our economy are not a 100% economic wasteland: that there are human, entrepreneurial, and financial resources that can be developed.

Asset Management Advice and Special Accounts

The advice that poorer people get about investment alternatives is usually inaccurate and/or insufficient. The CDBs might develop a subsidiary that advises its clients. There is, however, a potential conflict of interest if a CDB were to give advice and sell its own liabilities to its customers. Hence, this practice would be prohibited. The types of services that would be provided would include advice concerning IRAs, pensions, and other retirement income accounts.

Structure of a Community Development Bank

A CDB will be organized as a bank holding company under a special act of Congress. The holding company will have a variety of structures. One example is:

a. A narrow bank that includes a fee for service check-cashing operation and a passbook savings facility. This narrow bank would be able to make credit or debit cards available to its clients.
b. A commercial bank that will also do mortgage financing. This commercial bank will do ordinary commercial bank business for clients in its neighborhood. Its funding would be by means of business checking accounts, household checking accounts, and certificates of deposit.
c. An investment bank is a key subsidiary of a CDB. Its main function will be to mediate in a process that furnishes equity and longer-term debt funding to existing businesses as well as new businesses in its community. One function of the business development and loan officers is to discover the potential entrepreneurial resources in the community that require financing. Another will be to know the federal, state, and local agencies and laws that aim to advance business development and to expedite and facilitate their use.
d. A trust bank that would not only act as a Trustee for various custodial activities (as required for every institution handling IRAs), but also operate a financial advice facility.

Chartering and Financing of CDBs

The Congress will define the chartering process and activities of CDBs in legislation that will also authorize the Federal Bank for Community Development Banks. These banks will be a special category of federally chartered banks that will have powers and responsibilities beyond those granted to either national or state banks. The chartering process needs to be simple: entry should be relatively easy and not costly. The acceptance of rather close supervision and guidance by the Federal Bank for Community Development Banks will be a prerequisite for chartering.

The financial parameters for a community development bank may well run from a minimum private equity investment of $1 million to a maximum total equity investment of $10 million. The Federal Bank for Development Banks may well be authorized or instructed to match the initial private investment, up to a maximum of $5 million per CDB.

These limits are set because of the prudential rule that no single financing relation should involve more than 10% of a bank's capital and surplus. These parameters make the maximum financing relation at the smallest of these institutions $200,000, and the maximum at the largest $1 million. If we use an 8.5% capital-to-asset ratio, the total footings of the CDBs will run from $24 million to $120 million. However, as the "narrow bank" facility can operate at a 40 to 1 ratio, a CDB that specializes in savings and payment facilities could have as much as $400 million in total assets.

VI. The Role of Community Development Banking in the American Economy

The Clinton/Gore proposal for community development banks called for some 100 such banks over the next four years. Even if each of these banks has assets of $100 million by 1996, the entire CDB network would total only $10 billion. A set of financial institutions whose assets add up to $10 billion is not very impressive in an American economy that will have a gross domestic product much in excess of $6,000 billion by the time these institutions can make a significant contribution to the prosperity of their area.

A system of developed CDBs that relies on an initial equity investment by the government would provide needed services to well-defined segments of the household and business sectors. These segments are not being adequately served. However, it would be incorrect to conclude that the communities our proposal targets are completely neglected by financial institutions. For instance, check-cashing outlets are examples of profitable firms that provide needed services to these communities. Our proposal would take advantage of these examples and add additional services that are currently lacking in these communities. In some cases, existing institutions, including credit unions, may well evolve into CDBs that provide a broader range of services. In other cases, new institutions will be created.

These institutions are not to be viewed as a significant countercyclical force, nor as a major factor in the growth of the economy. They are to be seen as a set of institutions that fill a gap in the ongoing institutional structure. They may well provide part of the institutional setting in which a climate of opportunity replaces stagnation for many segments of the population.

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