

And some of the early features are simply inapplicable or objectionable to today's CDCUs. Among them:

- Romantic, reactionary politics. To a certain extent, the original institutions were established in order to preserve a feudal, hierarchical, clerical world. That world has long passed in the United States and the CDCUs have no connection to it.
- Racism and chauvinism. The early associations accepted the ethics of their time, and this often included anti-Semitism and discrimination against women. While there may be an occasional and well-justified expression of ethnic pride in some of today's CDCUs, they are not racist, and many of their leaders are women.


 CHAPTER 3

DEVELOPMENT IN THE UNITED STATES

The founders of credit unionism in the United States possessed a combination of idealism and practicality characteristic of many American reformers. They believed that if people joined together in cooperative spirit and action they could solve the old problems of scarcity of credit and exorbitant interest rates.

—J. Carroll Moody and Gilbert Fite¹

Even mainstream credit unions are becoming a 'working people's alternative,' since they are so often associated with the workplace. The unemployed, the underemployed, and those in service sector jobs generally don't have access to a credit union of their own.

—Episcopal Church statement²

By joining a CDCU, poor people seeking loans can make their case to a neighbor who understands their problems.

—National Federation of CDCUs

The Mainstream Credit Unions

A decade after the *caisses populaires* were started in Quebec, credit unions were introduced into the United States.³ Three people were particularly responsible for the first American credit unions: Alphonse Desjardins,

¹ Moody and Fite, xi.

² Episcopal General Convention.

³ The most complete account of American credit union history is Moody and Fite. It concentrates on developments at the organizational center of the credit unions, the Credit Union National Association. Unless otherwise noted, the material in this section is drawn from this source.

Pierre Jay, and Edward A. Filene.

Desjardins started the first two American credit unions, in St. Mary's parish, New Hampshire, in 1908, and in St. Jean Baptiste parish in Lynn, Massachusetts in 1910. Both were *caisses populaires* of the type that he was founding at a fast clip north of the border. The members were French Canadians who had emigrated to New England within the previous generation. The local leader in each case was the French-speaking, Catholic parish priest.

Desjardins' role in the history of American credit unions stems not so much from the institutions he personally founded, however, as from the influence he had on the thinking of Jay and Filene. Jay, a descendant of the first Supreme Court chief justice, John Jay, was appointed Commissioner of Banking in Massachusetts in 1906. He learned about the European people's banks and about the *caisses populaires*, corresponded and visited with Desjardins, and then drafted the country's first credit union enabling law which was passed by the Massachusetts legislature in 1909.

Filene, a department store owner in Boston, first became interested in cooperative credit during a visit to India in 1907. Upon his return he began to take initiatives in founding credit unions, lobbying for favorable legislation, and developing a national organization of credit unions. For thirty years, until his death in 1937, he was the leading force behind the credit union movement in the country. Among many other achievements, he founded and funded the institution that became the Credit Union National Association or CUNA, the principal trade association of credit unions in the country. In 1920 he hired Roy F. Bergengren, and then paid his salary for many years, as managing director first of the Massachusetts Credit Union Association, then of the Credit Union National Extension Bureau, and finally of CUNA.

Since Filene was Jewish, the credit union movement entered the United States without the stench of anti-Semitism that had marred it in Germany and in Quebec. One of Filene's purposes was to dispel the bias that Jews were usurers. In a statement that one could be forgiven for finding ambiguous, a Boston rabbi who was associated with Filene wrote that Jewish support of the credit union movement "helps to make the people realize that not all Jews are alike, that not all are bad, that not all are money lenders or usurers."⁴ Anti-Semitism was not completely banished from American credit unions, however. The author was told that for years, although no longer, CUNA Mutual Insurance Company had an unwritten rule that Jews could not be hired.

⁴Ibid., 33.

As the initiative for credit union development passed from Desjardins's hands to Filene's, the spirit of the institution began to change. Cultural nationalism and religious identity were no parts of Filene's purpose. He had a liberal, universal vision of the potential of credit unions; they could be useful to all working people.

In contrast to Desjardins, Schulze-Delitzsch, and Raiffeisen, Filene saw credit union members principally as employees, not independent producers. As early as 1909 he wrote,

As a large employer, I have long felt that some provision should be made by which people of small means can, in case of necessity or distress, borrow at reasonable rates of interest and under thoroughly honest and fair conditions.⁵

Filene did not follow Desjardins' initiative of organizing credit unions in parishes but instead urged that they be organized among the employees of different companies.

As the American credit union movement developed, the emphasis on lending for a "productive purpose," which had been central to both the German and Quebec credit unions, disappeared. The Massachusetts Credit Union Act of 1909 called for loans for useful and beneficial purposes, not production. Useful and beneficial can be defined in broad terms, and in time they came to mean consumer purposes. In 1915, Filene wrote out a list of eight credit union principles.⁶ On the subject of lending, the principles included rigid exclusion of thriftless and improvident borrowing, small loans with frequent partial repayments, and the use of character and industry as the main basis of securing credit. There was no hint that business or productive loans should be favored.

Filene's ideology had some similarities and some differences from the views of both Henry Wolff and Hermann Schulze-Delitzsch, described in Chapter 2. Like Wolff, the English cooperator, Filene saw potential credit union members as people whose incomes were low but who were employed. They did not need jobs; jobs were provided by the capitalist employers, of which he was one. They needed credit at reasonable rates to finance consumer purchases. Unlike Wolff, however, he believed in capitalism, and did not see cooperatives as challenging the capitalist structure of business in any way.

Schulze-Delitzsch had believed in capitalism also, but the version he fa-

⁵ Ibid., 25-26.

⁶ Ibid., 37.

vored was the small-scale capitalism of the English political economists, with many independent entrepreneurs confronting each other in competitive markets. The German people's banks existed in large measure to provide the capital for those small enterprises so they could hold out against the destructive power of large corporations. Filene had nothing against small-scale operators, but he was equally comfortable with large companies. The credit unions he foresaw would help companies of all sizes, not by providing their capital, but by providing the needed service of low-cost consumer loans to their employees and thereby improving the level of satisfaction within the work force. Class conflict was not a part of Filene's vision; to the contrary, he saw credit unions as a means for bringing employer and employee together.

In common with the *caisses populaires*, but in contrast to the German people's banks, the American credit unions were not established for the purpose of drawing outside funds into the members' communities. The funds to be lent would come from the members themselves. The 1909 Massachusetts act defined a credit union as "a cooperative association formed for the purpose of promoting thrift among its members." The question of unlimited liability for loans to the credit union did not, therefore, arise.

From its early beginnings in New Hampshire and Massachusetts, the credit union movement grew enormously. Every state passed laws permitting the chartering of credit unions, and in 1934 the Federal Credit Union Act was passed. Both the states and the federal government examined and regulated credit unions. Federal examination began in 1934, and in 1970 it was lodged in an independent agency, the National Credit Union Administration (NCUA). Federal share insurance came much later than deposit insurance for the banks, in part because of active opposition from within the credit union movement—many credit union leaders were opposed to paying for the insurance, and also to the increase in government control of their operations that insurance would lead to. By 1970, however, share insurance was imposed. The number of credit unions grew steadily from the early days, reaching a peak of about 20,000 in the early 1970s. By the early 1990s, the number of credit unions had fallen to about 14,000, mostly because of mergers; nevertheless, the number of credit union members continued to grow, reaching about 60 million. At the end of 1992, the combined assets of federally chartered credit unions plus federally insured state chartered credit unions totalled \$261 billion.⁷ State leagues and corporate central credit unions were formed in each state to provide services to credit unions.

As credit unions grew in the United States, they retained some of their

⁷ National Credit Union Administration, 1992 Annual Report.

early features, but developed in new ways as well. The great majority continued to define their field of membership by a place of employment or an occupation. A much smaller number were based on membership in an association such as a cooperative, a labor union, or a church, and a smaller number yet had a geographic field of membership. Table 3.1 shows the distribution of credit unions by common bond at the end of 1991.⁸

Table 3.1

Number and Proportion of U.S. Credit Unions by Common Bond
(December 1991)

Common Bond	Number	Proportion
Occupational	10,203	73.0%
Associational	2,014	14.6
Residential	937	6.7
Multiple groups	796	5.7

In a formal sense credit unions remained cooperative institutions, with each member having a vote in the election of the board of directors. As they grew bigger, however, they ceased to rely upon the work of volunteers as they had in the early days, and came to depend upon both paid staff and professional management.

A high proportion of the lending in American credit unions was for personal purposes, and the preponderance of this was for consumption. In 1991, as noted earlier, just over one percent of credit union loan dollars outstanding were used for a business purpose, while the remaining loans were all personal, including mortgages.⁹

At the end of the twentieth century, as at the beginning, most Americans are employees, and need loans to finance consumer purchases, especially of durable products. There is a big difference, however, between the typical American employees who were members of credit unions in 1910 and today. In 1910, they could reasonably be called members of the working class, people who were just at the edge of subsistence. Today, they are more appropriately called members of the middle class. As noted in Chapter 1, the median income of a credit union household now exceeds the median income of all households in the country. Of course, the incomes and living standards of employees varies widely throughout the country and within communities,

⁸ Credit Union National Association, *Operating Ratios and Spreads, Year-End 1991*, 66.

⁹ *Ibid.*, 21.

but the majority are comfortable. Just as the center of the American population has moved from working class to middle class, so too the credit unions that serve them have changed their orientations. From agents of social change, they have gradually transformed themselves into institutions providing a useful service to the middle classes.

One way of seeing this change is in the gradual transition in terminology, from "credit union movement" to "credit union industry." A "movement" implies change, resistance to authority and power, and transcendent ideals. As ambiguous as their motives were, the early credit union pioneers all had visions of social movements. Most credit unions, however, gradually transformed themselves into more ordinary business institutions, whose success was measured by their financial statements more than by the quality of their members' lives. They became one more competitor in the financial marketplace. Their members no longer had to fear victimization by the local loan shark, but instead had access to many different sources of credit, of which the credit union was just one. People who chose to work in credit unions were no longer necessarily making a commitment to the betterment of intolerable conditions among their neighbors, but instead were often seeking an attractive career path.

Yet the change from movement to industry was not smooth, consensual, or even complete. At many points in their history, credit unions faced critical decisions in which the philosophical issues, the soul issues, were central. Among them, one of the most important was the removal of Roy Bergengren from the position of managing director of CUNA in 1945. With Filene's support, Bergengren had built and coordinated the movement since 1920. He was a practical visionary. He retained a clear sense of credit unions as a movement and as a part of a larger movement. He saw them as cooperatives, working together with other cooperatives to change the economic system. In 1938, towards the end of the Great Depression, he wrote:

*... there must be some reorganization of economic society on a cooperative basis. . . . Capitalism in most of its aspects has failed, and in the long run we cannot develop economic democracy on the principle of dog eat dog and the theory that the shrewdest, the most unscrupulous, the smartest of our number, should survive at the expense of all of the rest of us.*¹⁰

Moody and Fite show that this attitude became increasingly uncomfortable for many credit union people. They came to dislike even mentioning

¹⁰ Quoted in Moody and Fite, 193.

that credit unions were cooperatives, let alone part of a broader cooperative movement, lest they seem to be critical of the corporate system. Their sponsors were, after all, the companies whose employees comprised their fields of membership. Bergengren saw this opinion as short-sighted, and contrasted it to his view:

One group thinks of the credit union as a personnel activity in industry. As such, it takes care of the short-term credit problem of employees on a humane basis, and performs a useful function which is appreciated by both employee and employers. The other concept is that cooperation is a sort of circle made up of segments, and that the credit union is one of the segments, and therefore a part of the cooperative whole.¹¹

Bergengren's enemies in CUNA portrayed him as incompetent to run a large organization, and after years of conflict finally succeeded in forcing his withdrawal in 1945. The conflict over Bergengren was repeated a quarter century later in 1971, when CUNA's then managing director, J. Orrin Shipe, was fired by the board of directors. By that time, power at the national level had shifted markedly to the CUNA Mutual Insurance Company, which was operated on strict commercial principles. On the basis of a series of interviews, Moody and Fite concluded that the cause of Shipe's dismissal was that he believed in credit unions as a movement, while the majority of the CUNA board saw them as an industry. The crisis of capitalism that was associated with the Depression was long gone, and Shipe did not follow Bergengren's lead in seeing credit unions as part of an alternative to a dying capitalist system. But he had the missionary spirit of the movement's founders. He wanted CUNA to work with low-income credit unions, with small credit unions, and with credit unions in poor countries. He saw credit unions as an instrument for changing the lives of people in need. His critics wanted CUNA to help credit unions become full-service financial institutions, capable of competing against the banks for the deposits of middle class Americans.¹² As in 1945, the "industry" proponents emerged victorious over those who favored the "movement."

The transformation of the credit union ethos is not complete; even today the practical issues of the credit union "industry" have to compete with the idealism of the "movement." But for the most part, credit unions in the United States are a standard, if relatively small, component of the nation's

¹¹ *Ibid.*, 215.

¹² *Ibid.*, p. 279. Also based on conversations with Shipe's son, Robert P. Shipe, manager of First American Credit Union on the Navajo Reservation in Arizona.

financial system, catering to the savings and borrowing needs of middle-class employees.

The historians of American credit unions, Moody and Fite, take the position that this evolution was inevitable and even desirable:

*In the 1960s the [credit union] movement joined the War on Poverty by seeking to establish credit unions in the black ghettos where rates of unemployment were high and incomes low, as well as among Spanish-Americans and poor whites. These efforts were generally unsuccessful, even with federal aid. By the very nature of credit unions their benefits were confined mainly to those with jobs because a member had to have money to invest and means to repay loans. This meant that credit unions had little to offer the hard-core, unemployed poor who did not need loans so much as grants or jobs.*¹³

The leaders of the community development credit union movement disagree.

The Emergence of Community Development Credit Unions

Community development credit unions represent a departure from the mainstream credit union industry, a departure that harkens back to the earliest days of the credit union founders. Their purpose is social change, the improvement of the living conditions of people in need. CDCUs certainly constitute a movement.

The first American CDCUs, as distinct from mainstream credit unions, were founded in Black, Southern, rural communities in the late 1930s and the early 1940s. A few of those early CDCUs have lasted to this day, including about ten in eastern North Carolina.¹⁴ The oldest surviving CDCU is Bricks Community in Enfield, North Carolina, which even today is tiny, with under \$200,000 in assets and just one full-time employee. The early North Carolina CDCUs were created by working people who were enmeshed in the plantation system, whose incomes were very low, and who lacked access to credit on any but the most exploitative terms. Here and there, other community credit unions were started in the 1950s; for example, one credit union in New Mexico brought together miners who were Spanish speaking with min-

¹³ Ibid., 334-335.

¹⁴ I would like to thank James Gilliam of St. Luke Credit Union in Windsor, North Carolina, for his insights into the credit union history of his state.

ers who were Polish speaking.¹⁵

Table 3.2¹⁶ shows the chartering year of 165 CDCUs that were in existence in early 1993—the dates range from 1937 to 1993. Many more CDCUs were founded but later failed or merged; the table shows only those that have survived.

Table 3.2

Founding Year of 165 CDCUs

Year	Church	Non-Church	Total
1935-39	1	1	2
1940-44	1	6	7
1945-49	1	3	4
1950-54	4	8	12
1955-59	12	5	17
1960-64	12	4	16
1965-69	4	37	41
1970-74	1	15	16
1975-79	0	12	12
1980-84	4	18	22
1985-89	1	8	9
1990-	1	6	7
Total	42	123	165

Low-income credit unions appeared at a fairly slow rate from the end of the Second World War through the early 1960s; church-affiliated credit unions predominated during this period. The largest number of surviving CDCUs date from the late 1960s. In fact, the number of credit unions serving low-income populations exploded in that period. By one estimate, 400 were formed. Three different groups converged to promote these credit unions: CUNA, a group of activists in the civil rights movement, and the federal government's Office of Economic Opportunity (OEO).¹⁷

¹⁵ Thanks to Ricardo Garcia of the College of Education in the University of Idaho, the son of the credit union's organizer, who told me about life growing up in the miners' credit union.

¹⁶ Most of the data in the table comes from the call reports that were introduced in Chapter 1 and will be analyzed fully in Chapter 5. The survey of 400 low-income credit unions in Gore, Rosenthal, and Smith shows roughly the same distribution of chartering dates. The figures for the 1990s come from the National Federation of CDCUs.

¹⁷ Most of the information that is used in this section on the CDCUs that were founded in this period comes from Robinson and Gilson. Other sources are Livingston and National Federation of Community Development Credit Unions, "The OEO Credit Union Experiment: Implications for Community Development Banking." My thanks to several veterans of the OEO credit unions who talked with me about their experiences, including Ernest Johnson, Pearl Long, and James Taylor.

A few people within the CUNA management—people who still believed in credit unions as a movement—had begun to consider the credit needs of poor urban and rural communities in the late 1950s. In 1958, CUNA instituted a broad study of the credit needs of the poor, and on the basis of this study it organized and funded two experimental rural credit unions, one in Texas and one in Nebraska, in 1961. In 1964 it added five urban credit unions in poor neighborhoods, this time allocating \$50,000 to defray the start-up costs. The credit unions were intended to meet people's needs for small loans, for purposes such as car and home repair, medical expenses, and education. A technical specialist from CUNA kept watch over all of these experimental credit unions, and reported that they were finding success hard to come by. In 1966, CUNA was forced to spend another \$50,000 to keep the credit unions solvent, but in that same year it joined forces with the Office of Economic Opportunity to effect a major expansion in its program.¹⁸

The Black civil rights movement of the 1960s also played a role. One of the weapons that members of the white southern establishment had during the period of the demonstrations for racial equality was that they could cut off virtually all credit to people who were identified as activists. Simply joining in a march with Martin Luther King, Jr., for example, could result in a person's losing department store and agricultural credit. Ernest Johnson recalls that civil rights leaders raised this problem in discussions with federal officials. They were encouraged by those officials to cooperate with the OEO in the setting up of cooperative, self-help lending institutions that could mobilize the savings of local Blacks and thereby allow the Blacks to avoid the necessity of interacting with credit institutions that were dominated by whites.¹⁹

Some of the African American credit unions that were established in the late 1960s are still run by people whose first active public involvement was with the civil rights movement. Pearl Long of NEJA Federal Credit Union in northern Florida, then a school teacher and now retired, recounted to the author stories of the demonstrations that the credit union founders participated in and of the risks that they took.

The strongest force behind the establishment of CDCUs in the 1960s was the federal government. The War on Poverty was announced by President Lyndon B. Johnson in his State of the Union address in January 1964. The government set up the Office of Economic Opportunity (OEO) to coordinate a range of programs designed to raise the living standards of the one-

¹⁸ This paragraph is based on Robinson and Gilson.

¹⁹ This paragraph is based largely on conversations with Ernest Johnson, who, in addition to his credit union duties, is a member of the Southern Christian Leadership Conference.

third of Americans whose incomes fell below the poverty line. In 1966, with the encouragement of civil rights leaders, the OEO joined in a working partnership with CUNA to found credit unions in poor rural and urban locations throughout the country.

Some of the OEO credit unions still exist today. Most of them failed, however. By 1975 just half of the original 400 were still active, and by the 1990s only ten percent had survived. The experience of the OEO credit unions, and the reasons for the failure of so many of them, are worth consideration at a time when the federal government is once again taking the initiative to bring financial services to poor communities. To anticipate, the OEO history shows not that government intervention into low-income financial markets is necessarily doomed, but that particular federal policies in the 1960s, policies which both were and are avoidable, were responsible for the problems with the program.

Most, although not all, of the OEO credit unions were sponsored by a Community Action Agency (CAA). The CAAs were institutions established for the purpose of empowering local poor people, advocating for the rights of the poor, and providing some direct services such as food and nutrition, family planning, day care, emergency shelter, etc. The credit union was an additional activity undertaken by the CAA. Only about one-third of the new credit unions received direct funding from the OEO; the funding was generally in the form of salaries for up to three staff members. The remaining credit unions received encouragement and some technical assistance as they started up, and many of them were provided with space in the CAA facility.

From recent interviews that Ceretha Robinson and Anne Gilson of the Woodstock Institute have conducted with staff and board members of the early OEO credit unions, and from documents prepared at the time, it appears that many of the credit unions succeeded in lending money and providing financial services to poor people. The loans were often very small, for purposes like buying food, paying medical bills, consolidating debts, and buying school clothes. The credit unions were places where people could cash checks and buy money orders without paying exploitative fees at liquor stores and similar establishments.

To a large extent, however, the OEO experience represents an enormous and costly case study in how the government should not sponsor financial institutions for the poor. On the whole, concludes the Woodstock Institute report, it was a top-down effort, not the result of local grass-roots organizing, and in retrospect it seems as if failure were almost built into it by design.

The arithmetic of growth and self-sufficiency was never fully confronted by most of the planners of the OEO credit unions. Some of the credit unions

were given grants to pay for three staff members in the hope that they would eventually be able to cover those expenses out of their earned income. But three staff salaries plus other office expenses might total about \$40,000 annually. If the credit union was earning a spread on its assets of 8 percent,²⁰ it would need total assets of a half million dollars to generate \$40,000 in earnings, and even then it would have nothing to put aside for reserves and capital growth. But deposits of a half million dollars were unthinkable for most OEO credit unions operating in poor communities. After several years' operation, many of them were still struggling to bring in their first \$100,000 in member savings. The consequence was that many of their leaders never took seriously the possibility of becoming self-sufficient and operated as if the grants would last indefinitely. When the grants were abruptly cut off in the early 1970s, some of the credit unions collapsed in short order.

Other OEO credit unions received no grants to cover expenses, and in the long run they may have been more fortunate, since they were forced from the beginning to rely upon their members' own volunteer efforts. But they too faced problems that eventually forced many of them into liquidation or merger. All of the sources of information on this period are in agreement that one of the most serious problems facing the OEO credit unions was inadequate training. Although the OEO provided some training through CUNA, it was never enough to meet the needs fully. In spite of CUNA's interest in the OEO credit unions at the national level, few individual credit unions or state leagues offered the newcomers any assistance. As a consequence, many credit unions operated with informal and incomplete accounting systems and made serious errors in their business management. At times, loans were not tracked, payment delinquencies were allowed to accumulate, funds were not prudently invested, and expenses were allowed to rise.

Other problems were of a more sociological or cultural nature. Veterans of the OEO credit unions told the Woodstock Institute's interviewers that many of the members of the credit unions were enmeshed in the welfare system and had developed a sort of grants mentality; they apparently did not fully understand that the loans they received from the credit union had to be repaid.

The connections that the credit unions had to the CAAs, while helpful in some ways, were a handicap in others. Some of the Woodstock Institute's informants recalled that the CAA leaders tried to use the credit union for patronage. Others said that the CAA leaders wanted to establish a relationship of dependency between community members and the institution and

²⁰ A spread of 8 percent would result from average net earnings on assets that were lent or invested of 13 percent, minus dividend payments to the members on their savings deposits of 5 percent. These are fairly typical rates for the period.

that this brought them into conflict with the credit union whose mission was to foster independence. When government funds for the CAAs dried up in the 1970s, some of the CAAs exploited the credit unions by charging relatively high rents for the use of the facilities.

It appears that the CAAs were generally not appropriate sponsors of credit unions, since their focus was largely on the delivery of and advocacy for social welfare, not on community economic development and certainly not on banking.

A reading of the Woodstock Institute's interviews leads one to the conclusion that the root problem was that the credit unions were initiated by the OEO in Washington, and then by the staff of the CAAs. They were not for the most part a response to local community organizing, and many therefore failed to develop a group of volunteers who were committed to their ongoing success. When hard times came, the OEO credit unions had few resources on which to fall back.

Two public policies of the early 1970s signaled the end for many of the OEO credit unions. First was the cutoff of subsidies to the credit unions, along with the reduction in support to the CAAs, as the new Republican administration of President Nixon retreated from a commitment to the War on Poverty. Many of the OEO credit unions were not self-sufficient by that time.

The second problem, ironically, was the requirement, imposed in 1970 by the NCUA, that all deposits in the country's credit unions be insured. The NCUA Share Insurance Fund, which provided most of the deposit insurance for the country's credit unions, imposed financial criteria for eligibility; credit unions were required to maintain a certain level of capital, or reserves, in order to protect themselves against losses—and thereby to protect the insurance fund. Most of the OEO credit unions, however, could not meet the capital standards. After considerable protest and negotiation, they were given a grace period of two years to come into compliance with the insurance regulations, but even this concession was not enough for a number of them which were eventually forced to close their doors.

Those in the country's credit unions who feared increased government regulation as a result of the insurance requirement were correct. After 1970, federal and state regulators substantially increased the rigor of their examinations and held credit unions to higher standards of performance and safety. A number of OEO credit unions which survived the trauma of the early 1970s nevertheless failed eventually because they could not meet the examination requirements.²¹

²¹ Chapter 7 discusses in more detail the dual effects of the increasingly rigorous examination standards. CDCUs which could meet the standards emerged stronger. But examiners often had no understanding of the particular difficulties that poor people's credit unions faced, and ended up closing institutions that could well have survived and made a contribution to their communities.

The legacy of the OEO period is not entirely negative. Loans and other services were provided even by the institutions that did not succeed in the long run. Lessons were learned. And most importantly, some of the credit unions overcame all the handicaps and survived. In African American communities in the rural southeast, over a dozen CDCUs founded by the OEO still sustain their struggling communities. One in the Florida panhandle, North East Jackson Area Federal Credit Union, makes crop loans to small farmers. Others provide a full array of small consumer and business loans. A small credit union in south central Iowa meets the credit needs of people associated with the still existent community action program. In the poorest area of Los Angeles, Watts United Credit Union, sponsored by the OEO in the wake of the 1965 riots, makes consumer loans to low-income people, many of them on welfare. Approximately 40 CDCUs from the OEO period are still functioning, still making a contribution.

All of the surviving OEO credit unions are still relatively small—none of them over \$5 million in assets, many under \$1 million. But they are important beyond their size. Their staff and board members and volunteers come from the local communities and understand well the financial problems that their neighbors are facing. Moreover, the OEO credit unions are a critical part of the CDCU movement as a whole. While the newer CDCUs exceed them in number, still the OEO institutions provide continuity and a sense of history that the low-income credit union movement would otherwise lack. Their experience gives some reassurance to the other people in the movement that obstacles can be overcome and that their own credit unions can last into the indefinite future.

Chapter 7 will outline President Clinton's new proposal for federal support of what he calls Community Development Financial Institutions, including CDCUs. As that chapter shows, the new plan is designed to avoid the problems inherent in the OEO approach. The President's proposal anticipates that most of the support to poor people's financial institutions in the 1990s will be in the form of capital or reserves, not in the form of subsidies for operating expenses; thus the institutions will not be seduced into operating beyond their means. The program will be administered not by a poverty agency lacking expertise in finance, but by its own separate administration. It will offer support to existing community financial institutions which have a track record of performance, as well as to start-up institutions which have demonstrated community involvement.

From the perspective of the 1990s, therefore, it appears that one of the important legacies of the OEO period is that it has provided the experience to help design an effective public-private partnership in support of community development in low-income areas.

New CDCUs continued to appear in the 1970s and the 1980s.²² By then the government had backed off from organizing and chartering low-income credit unions. The newer credit unions were initiated by a variety of local groups and grass-roots organizations, not by federal officials. Each of these more recent CDCUs has its own unique story. Some were organized by activists who had tried to promote change in their communities in the 1960s and who turned to CDCUs at a later date because they seemed to be an institution with some chance of permanence. Some were spinoffs of existing community organizations. A few were sponsored by churches, particularly in African American neighborhoods, although the pace of new church CDCUs slackened in the most recent period. In the 1980s especially, CDCUs were organized by groups of people in response to the closing of bank branches in poor neighborhoods; in some cases the organizers of the CDCUs were able to use the Community Reinvestment Act to pressure the departing banks into contributing resources, for example, buildings, equipment, deposits, or in a few cases, even staff.

The newer CDCUs appeared in all parts of the country and among varied population groups. Most were urban, although a few—including two of the most innovative, Central Appalachian People's Federal Credit Union in Kentucky and Community Trust Federal Credit Union in Florida—were rural. Some were in predominantly African American neighborhoods, as had been many of the earlier CDCUs. But others arose among different ethnic groups, including Latinos, Asian Americans, and Native Americans, as well as in predominantly white low-income neighborhoods. Some were in desperately poor areas, but others were in mixed-income communities where the resources of middle-income members could be used in support of lower-income members.

Most of the earlier CDCUs had had a straightforward mission, namely to meet poor people's unmet credit needs and to provide a safe place to save. Some of the newer ones developed new ideas about how to operate a savings and lending cooperative. Among them were several of the credit unions described in Chapter 1: Central Appalachian People's in Kentucky, with its dozens of branches spread throughout the mountains; Self-Help in North Carolina, with its statewide charter and its exclusive focus on business and housing lending; and Santa Cruz Community in California with its commitment to community development lending. There were others. In Apopka, Florida, Community Trust Federal Credit Union, chartered in 1982, succeeded in organizing migrant farm workers, many of whom did not speak English. While

²² The author's understanding of the history of CDCUs from the 1970s to the present comes from his own involvement in the movement, from discussions with CDCU activists, and from reading documents that were generated over the years by the credit unions.

banks had seldom been willing to lend to poor migrants before, Community Trust took the risk. It found that most—but not all—of its members paid back their loans, even when they were in a distant part of the country. Over the years Community Trust has faced serious problems, and the NCUA threatened to liquidate it in 1991-92, but it has survived. In Ithaca, New York, Alternatives Federal Credit Union, chartered in 1978, has devoted much of its attention to real estate lending to low-income borrowers.

While some new CDCUs were appearing, however, the NCUA showed increasing reluctance to grant new charters, and it liquidated or merged many existing CDCUs. This was part of its general policy to reduce the number of small credit unions. As Table 7.1 in Chapter 7 will show, the pace of new chartering fell to almost zero by the early 1990s, while liquidations and mergers continued at quite a high rate, so that the number of credit unions in existence fell sharply from a peak in 1970. NCUA's policy followed from its view that people's needs for credit union services could best be met by expansion of the existing larger credit unions, that small credit unions were likely not to be viable in the long run, and that they were more expensive than it was worth to examine and regulate.

But the NCUA's view was simply incorrect in the poorer neighborhoods of the country. For the most part, these neighborhoods did not have existing large credit unions which low-income people could join. The credit unions were not physically located in those neighborhoods, and in any case most low-income people did not have the jobs or belong to the organizations that would have made them eligible for credit union membership. The consequence of the NCUA policy was therefore to restrict very severely both the growth of CDCUs and the access to credit unions of any kind by low-income people.

In the early 1990s, this policy appears to be changing. In 1992, for example, seven new CDCUs were chartered. These included South Central People's in the area of Los Angeles which had been severely damaged in the disturbances in April of that year, and Central Brooklyn, described by its founder, Mark Griffith, as the world's first "hip-hop credit union." New CDCUs were set up in Omaha, Nebraska and in Denver, Colorado, and new charters were expected in Camden, New Jersey and Washington, D.C. A charter was granted to a Korean Catholic church in Oakland, California. In response to President Clinton's call for a new emphasis on community development banking, the NCUA was once again willing to entertain charter applications from poor communities, provided that they were well thought out.

The National Federation of Community Development Credit Unions

The CDCU movement has been assisted by a trade association, the Na-

tional Federation of Community Development Credit Unions. The Federation was incorporated in Washington, D.C. in 1974, but its origins go back a few years earlier to 1970 and 1971 when a group of limited-income credit unions got together to deal with the problems created by the new federal requirement for share insurance. The credit unions were successful in their negotiations with the government and decided to make their association permanent.

Initially the Federation had no income. It was simply an association of credit unions, and the central work was done on a volunteer basis. It received its first small grant in 1977 and in 1979 it began a three-year period of substantial grant support. The Community Services Administration, successor to OEO, provided the Federation major funding, reaching a peak level of a half million dollars in 1981. The funding was in support of technical assistance that the Federation provided in conjunction with the government's revolving loan program for low-income credit unions, a program that will be described more fully in Chapter 7. At first the Federation shared responsibility for the training with the National Center for Urban Ethnic Affairs, but in 1981 the NCUEA staff was folded into the Federation. At that time the Federation's staff numbered about a dozen.

The period of government largesse passed quickly, however. The grant expired on September 30, 1982, and most of the staff members left. Two, the Executive Director, Jim Clark, and Clifford Rosenthal, who had joined the staff in 1980, stayed on, drawing just a day or two of salary a week, and tried to hold the Federation together. A few months later, Clark left and the Federation was in danger of closing. Rosenthal managed to pull together a few small grants, however; in the fall of 1983 he hired Annie Vamper of the National Credit Union Administration, and the two began the uphill task of reconstructing the organization.

In 1984, the organization started to grow again. Rosenthal obtained several grants—initially from the New York Foundation and from the New York Community Trust—in support of credit union organizing in the city of New York, in areas that had been abandoned by banks. The Federation helped to establish a credit union on the Lower East Side of Manhattan, and worked in a half dozen other areas of the city. Meanwhile the membership of the Federation consisted of between 50 and 100 CDCUs from around the country. While the grants were directly in support of community work in New York, they helped to pay modest salaries for Rosenthal and Vamper, who in turn were able to spend part of their time coordinating the national movement.

In the long run, however, it was clear to the staff and board of the Federation that a national movement could not be carried on the back of organizing grants in just one city. As early as 1982, when federal support was ending, the

Federation decided upon the strategy of a capitalization program. The idea was to attract deposits and loans from "socially responsible investors"—foundations, churches and other organizations that were prepared to earn less than the maximum possible return on their funds, provided the money was put to work on behalf of a good cause. The Federation would act as an intermediary, soliciting the deposits and placing them in CDCUs, while taking a cut of about a percentage point to cover its own expenses. Since most of the Federation's member credit unions were certified by NCUA as serving low-income people, they were able to accept non-member deposits. The deposits raised the spread or net earnings rate of the credit unions, and in some cases they also increased the capacity of the credit unions to make loans to their members.

The capitalization program grew slowly at first, reaching only \$100,000 in 1986. In that year, however, the Federation received a major deposit from the John D. and Catherine T. McArthur Foundation, and assets rose almost overnight to about \$1 million. That proved to be the turning point in the program; thereafter, substantial support was obtained from the Presbyterian and Roman Catholic churches, from the Ford Foundation, and from a number of other socially responsible investors. In 1993, the capitalization program stood at \$4 million and was growing, although it was still a long distance from its ultimate goal of \$20 million.

During the middle and late 1980s, the Federation struggled to establish its own credibility as a representative voice to be taken seriously on the national scene. A breakthrough occurred in 1985, when it was invited by the White House to do a study of the role of credit unions in capital formation in low-income communities.²³ The study presented new data and developed new arguments about the actual and potential importance of CDCUs. Thereafter the Federation was turned to increasingly for its views, and it found that its views were often heeded.

Consequently, and in spite of the fact that its resources were exceedingly limited, the Federation became an effective advocate with the Congress, White House, and NCUA. For most of the 1980s, its principal goal was to restore the revolving loan program to low-income credit unions that had been eliminated in 1981. It also lobbied in favor of increased technical assistance to CDCUs, relaxation of the restriction on non-member deposits in CDCUs, greater sensitivity on the part of federal examiners to non-white and low-income communities, and the chartering of new CDCUs. It took a leading role in proposing what became President Clinton's initiative on community development banking. Its staff developed close working relationships

²³ See Gore, Rosenthal, and Smith.

with some of the board and staff members of the NCUA.

In the late 1980s and early 1990s, the Federation continued to obtain grants to support its technical assistance and training programs. It still emphasized its work in New York City. Programs there included job training for low-income individuals to prepare them for entry level jobs in credit unions, and technical assistance for low-income housing and small business development. It won a large grant from the Ford Foundation to set up networks of CDCUs—for mutual support and technical training—in four separate areas: the cities of New York, Philadelphia, and Chicago, and the state of North Carolina. It also obtained grants first to study minority church-based credit unions, and then to set up a support network for them. In 1992, with the assistance of a major grant from the DeWitt Wallace-Reader's Digest Fund, it started a program of children's credit unions in eleven CDCUs, based on the model developed at the D. Edward Wells credit union, described in Chapter 1.

Another important activity of the Federation has been to provide help to community groups trying to organize and secure charters for new credit unions. As noted above, beginning in the 1970s, both federal and state regulators became increasingly reluctant to see new credit unions start. Faced with this resistance, the task of the Federation became harder each year, up through the early 1990s.

The Federation represented the CDCUs in developing working relationships with other types of progressive financial institutions operating in poor neighborhoods, including community development loan funds, community development banks and microenterprise lenders.²⁴ With representatives of these institutions, it formed the Coalition of Community Development Financial Institutions which argued for President Clinton's community development banking initiative and had an influence in shaping it.

Over time the Federation succeeded in attracting as members increasingly greater proportions of the credit unions located in low-income areas of the country, but this trend was countered by the overall reduction in the number of CDCUs. In the 1990s the trend turned upwards; by 1993, the Federation had 109 member credit unions in 30 states plus the District of Columbia and American Samoa. It holds an annual meeting which representatives of the member credit unions attend. In addition to providing training seminars and business sessions, they offer an occasion for the people in these institutions to meet and learn from one another.

As the programs of the Federation have grown, it has developed enough

²⁴ For descriptions of the loan funds and the microenterprise lenders, see Stevens and Tholin; and McLenighan and Pogge.

sources of income to expand its staff. Member credit union dues rose from \$21,000 in 1988 to \$33,000 in 1992, but the dues represented a smaller and smaller portion of the Federation's total income, just 3 percent in 1992. The bulk of the Federation's income comes from grants, contracts, the spread on the capitalization program, and CUNA. In 1993, the Federation's staff had risen to 10 people. Most were non-white, reflecting the Federation's overall membership.

The most important development in stabilizing the Federation was its merger with CUNA, the Credit Union National Association, in 1991. The Federation had grown up outside the CUNA umbrella, and many of its members were suspicious of or even hostile to CUNA. CUNA was seen to represent the large and mainstream credit unions, mainly white and middle class, that had largely forsaken the mission of social change that was central to the CDCUs. A number of CDCU leaders told the author in interviews that they had encountered a certain lack of cooperation from the credit union leagues in their states.²⁵ By the turn of the decade, however, it was becoming clear that both sides would benefit by closer organizational cooperation. From CUNA's side, it was facing increasing skepticism from Congress that credit unions deserved tax exemption and other legal benefits that derived from their status as cooperatives. The country's credit unions were looking more and more like banks, and the Congress was increasingly considering treating them just like banks. So, at least in the opinion of board members of the National Federation who talked with the author, CUNA wanted to be able to say publicly that its members were serving a social purpose well beyond that provided by the banks, and the CDCUs were perfect for this. In addition, CUNA had embarked upon Operation Moonshot, to raise the country's credit union membership from about 60 million people to 100 million. To do this, it would need to make major inroads into poor communities, and the CDCUs could be a help in this. The Federation, for its part, needed ongoing, permanent organizational and financial support. Its staff salaries were low, and completely vulnerable to the changing fashions of foundation support. Affiliation with CUNA promised to bring with it salary support for the staff, plus medical and retirement benefits, plus access to the enormous technical resources that CUNA had available. The concern, from the Federation's side, was to retain its autonomy in terms of setting policy, while enjoying the benefits of CUNA affiliation.

Long negotiations produced an agreement under which the Federation's

²⁵ The leagues are the trade associations in each state that represent most or all of the state's credit unions. They provide technical assistance and in some cases operate a central financial facility. The state leagues are affiliated with CUNA on the national level.

offices would stay in New York rather than move to CUNA headquarters in Madison, Wisconsin, and the Federation's board of directors would retain responsibility for the organization's policy. At the same time, the affiliation provided that part of the executive director's salary would be paid by CUNA, and that the position would report, for some purposes, to a CUNA vice-president. As the partnership worked out, in 1992 CUNA covered 19 percent of the Federation's operational expenses.

Summary

By the early 1990s, then, CDCUs had reached a position of reasonable stability and were prepared for expansion. Some of them had been in existence for 50 years. They had survived the roller coaster of the late 1960s and early 1970s when hundreds were chartered but many soon failed. They had made it through the 1980s, when almost any program in the country dealing with poor people was viewed with hostility by many in positions of public authority. Liquidations and mergers of CDCUs continued throughout the 1980s and early 1990s, and the CDCU movement had figuratively held its breath in the late 1980s when no new CDCUs were chartered. But most recently the chartering of new CDCUs has begun again, and interesting innovations in cooperative community finance are springing up around the country. The trade association, the National Federation of CDCUs, is stronger than ever, continuously inventing and implementing new programs. CUNA, representing the whole credit union industry, has taken a new interest in CDCUs, and backed that interest with support. NCUA has begun to consider CDCUs as rather more of an asset, and rather less of a bother, than it once did. There is a new interest by the federal government in promoting community development banking, to be discussed in detail in Chapter 7, and this interest is likely to translate into substantial real support.

No one imagines that the hard times are over. Institutions that work with the poor will always be in a tenuous position. More CDCUs will be liquidated and the chartering of each new one will be a struggle. But overall, the CDCU movement was in a much stronger position in the early 1990s than it was a decade before.

Why does the success of the CDCUs matter so much? To answer this question, Chapter 4 turns to the issue of how ordinary financial institutions treat poor communities in the United States.



CHAPTER 4

WHY ARE CDCUs NEEDED?

I was born in Lee County, Alabama in a small town where poverty and ignorance were accepted as a way of life. People in Lee County worked hard but earned little, especially people of color...My own family had no access to credit from banks or from other sources. We were victimized by loan sharks who operated through finance companies and businesses, as these were our only sources for credit.

—Ernest Johnson, CDCU specialist¹

In many American cities the most accessible financial institution is a check cashing facility. In some areas these institutions charge as much as 10 percent just to cash a government check. People who want to save have no place to go; businesses have no access to capital.

—Senator Bill Bradley, D-NJ²

It has been our experience that the voluntary initiatives of banks have been entirely insufficient to address fair access to credit and that regulators have been undependable in enforcing the Community Reinvestment Act.

—Gilda Haas, Communities for Accountable Reinvestment³

¹ John Ernest Johnson. "Low Income Credit Unions: Failures that Lead to Success." Master's thesis, Antioch University, Yellow Springs, Ohio, 1991.

² Testimony before the U.S. Senate Banking Committee, July 15, 1992.

³ Testimony before the Subcommittee on Housing and Community Development and the Subcommittee on Consumer Affairs and Coinage of the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs, May 7, 1992.

Financial services and financial institutions are seriously lacking in low- and moderate-income neighborhoods in the United States. The existing conventional financial institutions—banks, savings and loan associations, and even credit unions—have not provided the services that are needed. To a large extent, the financial tasks in poor areas have been left to the informal sector—to check cashers, liquor stores, pawnshops, finance companies, and loan sharks—and this has left poor communities at a severe disadvantage.

The evidence shows that fewer loans are available to residents of poor communities than to people and businesses in middle- and upper-class areas. Banks are more likely to deny loan applications from the poor. What is true of the poor is doubly true of the non-white; even among the poor, racial minorities have less access to loans than do whites. These assertions are well documented in the case of home mortgage loans; in small business and consumer lending the available information is less comprehensive but suggests the same conclusion. There are fewer branch offices of financial institutions in poor communities than in other areas and recent branch closures have exacerbated the discrepancies. Many of the poor have to turn to currency exchanges or check cashers to conduct the simplest of financial transactions; these institutions charge relatively high fees and offer limited services and no insurance protection. The branches of conventional financial institutions that do exist in poor communities serve largely to drain resources out of those communities rather than bring capital to bear on pressing problems. The federal legislation that has been designed to address these sorts of problems is largely, if not completely, ineffective. The extent to which the problems are the consequence of active discrimination and racism, or rather the consequence of the impersonal functioning of normal capitalist markets, is not clear, but it may not matter very much. What matters is the severe lack of financial services in poor communities. Community development credit unions—which offer essential financial services to poor communities at reasonable rates—are therefore critically needed. This chapter discusses these issues.

Financial Institutions as Intermediaries

Financial institutions such as banks and credit unions are a key to economic development. They function as the intermediaries between savers on the one hand, and consumers and investors who can make productive use of loans on the other hand.⁴ They pool the savings of a large number of people,

⁴ For the classic analysis of financial institutions as intermediaries, see Gurley and Shaw.

and subsequently lend those savings at a rate of interest sufficient to cover the cost of funds and their own expenses.

At first blush, financial institutions might not seem to be very critical players on the economic scene. They do not generate significant savings of their own; they simply allow for the pooling of other people's savings. They do not invent new technologies, buy equipment, start businesses, or build houses; they simply lend to other people who perform these tasks. One might well ask why financial institutions are needed at all. Why do the people with excess funds, the savers, not simply lend directly to the people who need extra funds, the borrowers—and thereby avoid the expense and bother of the intermediary altogether?

The answer is that financial institutions provide significant services to savers that individual borrowers could not provide and significant services to the borrowers that the savers could not provide. Most savers are in no position to evaluate the creditworthiness of a loan applicant or make informed choices between different applicants. Few savers are prepared to assume the risk inherent in lending to a borrower. Instead, they deposit their funds in a financial institution where, in most cases, their savings are completely guaranteed and the rate of return is secure. The borrowers, for their part, would find it tedious and expensive in the extreme to approach a large number of small savers in order to put together a large loan. They would find it difficult to persuade savers to tie up their funds for the length of time the borrowers wish to keep the money. Instead, they approach a single financial intermediary, which is likely to provide all of the funds needed for a reasonable length of time. The intermediary builds up long-term assets (its loans) which are suitable to the borrowers, and balances them with short-term liabilities (its deposits) which are attractive to savers.

Financial institutions provide the important service, therefore, of connecting savers and borrowers. They are a channel through which a society's financial resources are converted to productive use. They are not the only channel. Governments amass funds through taxation and use them for purposes that are decided upon in the political process. But within the private sector of a capitalist, market economy such as the United States, banks and other financial institutions are the principal mechanism for gathering funds and directing them.

As a consequence, the financial sector has a great deal of power. Through its lending policies, it determines the uses to which a society's funds will be put. This is not to say that each individual financial institution has a great deal of power. Many thousands of banks, thrift institutions, and credit unions operate in competitive markets. If one of them decides not to engage in a particular kind of lending, that niche may be filled by another institu-

tion. But taken as a whole, the financial sector influences the sorts of investments and expenditures that will be undertaken and the overall direction of economic development. Some sectors, communities, and people are amply provided with funds while others are starved—whether because they lack productive investment opportunities, or because they appear untrustworthy to the lenders, or because of outright and arbitrary discrimination.

The failure of banks and other financial institutions to serve poor communities adequately is therefore a matter of great concern to those communities.

An Example on Chicago's South Side⁵

A testament to the importance of financial services in a poor community exists on the south side of Chicago in the contrast between two predominantly African American neighborhoods, South Shore and Woodlawn. In the mid 1970s, both were depressed, low-income areas with high unemployment and a decaying housing stock. Woodlawn was well known to the outside world as the area in which Saul Alinsky developed his techniques of grass-roots community organizing in the 1960s. The Woodlawn Organization (TWO) was a model of local people taking the issues that beset their neighborhood into their own hands, confronting the power structure, and working for constructive change. South Shore did not enjoy this kind of community organization.

By the 1990s, however, the contrast between the two areas was dramatic. Woodlawn was almost completely devastated, with block after block of abandoned apartment buildings and many vacant lots where buildings had burned. South Shore, on the other hand, was thriving, with block after block of rehabilitated housing and a viable commercial sector.

How did South Shore succeed and The Woodlawn Organization ultimately fail? The full answer is no doubt complicated, but one difference between the two neighborhoods stands out easily. In 1973, the South Shore Bank was formed to buy out a local bank and to direct funds into the local neighborhood for housing rehabilitation. South Shore Bank was a community development bank, a bank with stockholders and established to make a profit, but with the additional purpose of rescuing its neighborhood. Rather than drain funds from the neighborhood, it became a conduit for channeling outside funds into the neighborhood. The bank made local real estate loans on the express condition that the property be rehabilitated. These were properties that Chicago's banks had consistently declined to finance. South Shore

⁵ Much of the information in this section comes from the author's visit to South Shore Bank, along with other members of the National Federation of CDCUs, in May, 1992. For descriptions of South Shore Bank, and the associated financial institutions controlled by the holding company, Shorebank Corporation, see among others Satin, Quint, and Houghton.

Bank initially provided mortgages on single family units. Within a few years, it had demonstrated that such lending was profitable and other Chicago lenders moved in to compete. At that point, seeing no further need in the area of single family structure mortgages, South Shore began to finance the purchase and rehabilitation of apartment buildings. Between 1973 and 1991, it financed the rehabilitation of 30 percent of the neighborhood's rental housing units. Still later, it moved into small business lending.

South Shore Bank uses the deposits of community people for the development of the local area. It also serves as a vehicle for channeling outside funds into the local community; about half of the deposits come from outside South Shore, while almost all of the loans are made within the target area.

In Woodlawn, on the other hand, there was no institution devoted to development finance and consequently no way of directing capital into the community. The Woodlawn Organization was a marvelous example of community organizing but it lacked capital, and in the long run was therefore unable to prevent the deterioration and death of its community.

The South Shore Bank shows the power that a financial institution can have to promote development in its community. No other community development banks in the United States, however, have been successful for a sufficiently long period to make a real impact. At the beginning of the 1990s, several banks in other poor areas of the country were trying to replicate South Shore's success,⁶ but it was too early to evaluate them. Woodlawn is in some respects an extreme case, but it is more typical of poor communities, particularly in central cities: Woodlawn demonstrates that the absence of a financial institution that can collect and direct capital for economic development may go hand in hand with the social and economic deterioration of an area.

Home Mortgage Lending

A great deal is known about the home mortgage lending of banks and other financial institutions, far more than is known about other aspects of banking activity in poor neighborhoods. Mortgage lending patterns are well documented because of the passage in 1975 of the federal Home Mortgage Disclosure Act (HMDA), which required banks and other depository institutions to disclose publicly, by census tract, the dollar amount and number of their home mortgages and home improvement loans. In 1989, the HMDA reporting requirements were expanded significantly.⁷ The patterns that are

⁶ They included the Southern Development Bancorporation, a bank holding company founded in 1988 in Arkansas, sponsored by and modeled after South Shore Bank's holding company, Shorebank Corporation; Community Capital Bank, founded in 1990 in Brooklyn, New York; and Development Bank of Washington, D.C., which at the time of writing was being organized in the nation's capital.

⁷ The most recent data are fully described in Glenn B. Canner and Dolores S. Smith, from which much of the information in this section is taken.

revealed by the HMDA data are disturbing, partly for what they show directly about mortgage lending and partly because they hint at the uneven distribution of the other bank services that are not so well documented.

The pre-1990 HMDA data can be combined with information about personal income and racial composition from the census tracts. The resulting patterns are striking. Using rather reserved language, Glenn B. Canner and Dolores S. Smith of the Federal Reserve Board described the overall findings of a large number of studies of lending in individual cities and by individual banks:

For the most part, one basic lending pattern has stood out: Considerable differences exist in the levels of home lending activity across neighborhoods within local communities when the neighborhoods are grouped by median family income or racial composition....Overall the HMDA data show that a smaller proportion of home purchase loans made by reporting lenders are for properties in low or moderate-income neighborhoods (those where median family income is less than 80 percent of the median family income of their MSA).⁸

In other words, banks lend significantly less to the poor than to the middle class. According to the 1980 census, low-income areas contained 16 percent of the owner-occupied housing units in MSAs, and yet in the latter part of the 1980s they received only between 10 and 12 percent of the number of home purchase loans. Upper-income neighborhoods, in contrast (those whose median family income exceeded 120 percent of the median family income of their MSA), contained 23 percent of the units, and received roughly 33 percent of the home purchase loans. These figures refer to the number of home purchase mortgage loans, not the dollar amount of lending. No one would be surprised to discover that a disproportionate share of the money went to high-income areas; what these data reveal is a disproportion in the number of loans.

When the racial composition of the different neighborhoods is taken into account, the picture becomes more skewed. In 1988, newspapers in Atlanta and Detroit conducted studies comparing mortgage lending in predominantly white and predominantly minority communities of roughly comparable average incomes.⁹ The newspapers found the same pattern in both cities. Banks made three to four times more home purchase loans, per single family housing unit, in the predominantly white areas than in the

⁸ Ibid. MSA stands for metropolitan statistical area.

⁹ "The Color of Money," *Atlanta Journal-Constitution*, and "The Race for Money," *Detroit Free Press*.

predominantly minority areas. The principal conclusions of the Atlanta Journal Constitution were stated clearly:

Whites receive five times as many home loans from Atlanta's banks and savings and loans as blacks of the same income—and that gap has been widening each year, an Atlanta Journal-Constitution study of \$6.2 billion in lending shows.

Race—not home value or household income—consistently determines the lending patterns of metro Atlanta's largest financial institutions, according to the study, which examined six years of lender reports to the federal government.

Among stable neighborhoods of the same income, white neighborhoods always received the most bank loans per 1,000 single-family homes. Integrated neighborhoods always received fewer. Black neighborhoods—including the mayor's neighborhood—always received the fewest.

The same pattern was found in Atlanta area home mortgage loans purchased in the secondary market by the Federal National Mortgage Association (Fannie Mae) and other secondary market lenders.¹⁰ These institutions purchased twice as many home mortgages per 100 homeowners in predominantly white neighborhoods as in predominantly minority neighborhoods. In the period July 1, 1987 through June 30, 1989, the figures were 13.9 loans per 100 homeowners in white areas, as against 7.0 in the minority areas. The pre-1990 data, therefore, showed significant differences in mortgage lending by income levels and racial composition of different areas of cities.

The 1989 expansion of the HMDA allows a more detailed examination of the patterns of mortgage lending. Under the new requirements, reporting was extended beyond depository institutions to include independent mortgage companies. This is an important addition, since non-depository mortgage companies are particularly active in low-income areas. All home mortgage lending institutions are now required to report the number of loan applications and their disposition, not just the loans actually made. They are also required to report the race or national origin, gender, and annual income of the applicants.

At the time of writing, results from the expanded HMDA are just beginning to come in; within a few years, there will doubtless be many detailed

¹⁰ Ols, Jr.

Table 4.1
 (Percentages by Applicant Income and Race)

**Denial Rates for Applications for Mortgages to Purchase Homes
 1990**

Applicant Income and Race	Government-backed Mortgage	Conventional Mortgage
Less than 80% of median MSA income		
Native American	26.5	27.7
Asian/Pacific Islander	13.9	17.2
Black	29.4	40.1
Hispanic	22.4	31.1
White	14.7	23.1
Other	21.3	26.1
Joint (white/minority)	17.3	26.3
80% - 99% of median		
Native American	17.8	16.6
Asian/Pacific Islander	12.7	13.7
Black	24.8	29.3
Hispanic	17.0	21.5
White	10.6	13.7
Other	13.5	21.1
Joint (white/minority)	13.0	18.0
100% - 120% of median		
Native American	17.0	14.0
Asian/Pacific Islander	12.4	12.6
Black	23.1	26.3
Hispanic	14.7	19.1
White	9.5	11.2
Other	15.0	18.0
Joint (white/minority)	12.9	15.0
More than 120% of median		
Native American	15.6	12.8
Asian/Pacific Islander	11.2	11.2
Black	20.8	21.4
Hispanic	14.2	15.8
White	8.6	8.5
Other	17.1	15.8
Joint (white/minority)	10.6	10.5

Table 4.2
 (Percentages by Census Tract Characteristics)

Denial Rates for Applications for Mortgages to Purchase Homes
 1990

Census Tract Characteristic	Government-backed Mortgage	Conventional Mortgage
Racial composition (minorities as percentage of population)		
Less than 10	11.2	11.5
10-19	13.4	13.8
20-49	16.1	16.5
50-79	21.1	19.3
80-100	23.2	24.0
Income (median income as percentage of MSA median)		
Low (less than 80%)	17.8	20.2
Middle (80% - 120%)	13.0	13.9
Upper (more than 120%)	11.2	9.7
Income and racial composition (minorities as percentage of population)		
Low-income		
Less than 10	14.0	17.8
10-19	14.9	18.9
20-49	17.3	19.4
50-79	20.6	21.2
80-100	24.2	24.4
Middle-income		
Less than 10	11.3	12.7
10-19	13.5	14.5
20-49	15.8	16.3
50-79	22.2	18.1
80-100	21.5	23.7
Upper-income		
Less than 10	10.3	8.8
10-19	12.0	11.3
20-49	14.9	13.0
50-79	13.9	15.3
80-100	17.1	16.8

studies of mortgage lending in individual cities. The Board of Governors of the Federal Reserve System has published a few nationwide tabulations for 1990. While limited, they both confirm and extend the conclusions that were apparent in the earlier data.

In 1990, 6.4 million applications for mortgage loans were recorded. Since applications are included along with loans actually made, denial rates can be calculated. Tables 4.1 and 4.2 contain the denial rates for the country as a whole, 4.1 according to the income and race of the applicants, and 4.2 according to the average income and racial characteristics of the census tract.¹¹

The new HMDA data are revealing. Table 4.1 shows that lenders refuse a higher than average proportion of mortgage applications from poor people and from minorities. Both factors are important. Starting with income, for each racial group, low-income people are more likely to be denied mortgages than middle-income people are, and middle-income people are more likely to be denied than upper-income. For example, a lower-income white person is almost three times as likely to be rejected for a conventional mortgage as an upper-income white. Turning to race, within each income category, Blacks, Hispanics and Native Americans suffer more denials than whites do; for example, a Black person is about twice as likely to be rejected as a white.

Looking at the characteristics of the census tracts in Table 4.2, the findings are similar. Denial rates are higher the greater the minority proportion of a community's population and the lower the typical incomes in the neighborhoods. The first panel of Table 4.2 shows the patterns by race: the more non-white, the greater the likelihood that a mortgage loan application will be denied. The second panel shows the patterns by income: the poorer the neighborhood, the greater the likelihood of denial. The last three panels show that the racial composition of a neighborhood influences the denial rates, even when income is held constant. For example, looking only at low-income neighborhoods, the denial rates in predominantly minority neighborhoods are much higher than in predominantly white neighborhoods: 24 percent versus 14 percent in the case of government-backed mortgages.

The differences in denial rates in these tables are almost surely an understatement of the true differences in the mortgage markets in different areas of the country. In many cases, potential applications that are likely to be rejected are simply not filed. Realtors who are familiar with the lending policies of local financial institutions will decline to work with people or properties that are unlikely to receive a mortgage, and thus the loan application is

¹¹ Canner and Smith.

never made.¹² Sometimes informal inquiries are made to a loan officer and rejected out of hand, the consequence being that no formal loan application is made and no record is kept under the HMDA.

A narrower study of mortgage lending in the San Francisco Bay Area, using the expanded HMDA data for 1990, comes to much the same conclusions.¹³ For example, at the area's largest mortgage lender, Bank of America, an affluent African American was more likely to be denied a mortgage than a low-moderate income white: 31 percent denial rate versus 27 percent in Oakland, 45 percent versus 25 percent in San Francisco.

In an ambitious study sponsored by Ralph Nader's Essential Information, Inc., Jonathan Brown used computer techniques to map loans in 16 metropolitan areas made by both banks and mortgage companies in 1990 and 1991. He identified 49 lenders and 62 separate instances in which predominantly minority neighborhoods were either excluded or under-served.¹⁴

Thus the voluminous data on home mortgages that have been collected over the years show clear patterns. Fewer home purchase loans are made in poor and minority communities than elsewhere, in absolute terms and also per hundred units of owner-occupied housing. One of the explanations of this disparity is that mortgage applications from the poor and from minorities are disproportionately likely to be rejected.

Bank Services Besides Mortgage Lending

Home mortgage lending by financial institutions is exceptionally well documented; other aspects of bank activities in low- and moderate-income communities are hardly documented at all. Governments do not require reports on the geographic dispersion of other bank activities nor on the income and race of the people who engage in other types of business with the banks. No equivalent of the HMDA exists in such areas as consumer and small business lending, location of branches, services offered by branches, or deposits. A few state and local governments have passed commercial lending disclosure laws but the quality of the data that are generated is uneven.¹⁵

In order to assess the need for community development credit unions in

¹² See, for example, *Atlanta Journal-Constitution*, "The Color of Money," op. cit., for interviews with realtors in predominantly black areas who say that they generally steer their clients toward mortgage companies rather than banks or savings and loan associations because their experience is that the latter are unlikely to approve a loan in their neighborhood.

¹³ California Council of Urban Leagues.

¹⁴ Brown with Bennington.

¹⁵ See Flax-Hatch for a discussion of the data generated by Chicago's ordinance on the disclosure of commercial lending.

poor areas, one would like to have comprehensive information on all financial services, not just home mortgages. Credit unions, after all, are not exclusively home mortgage lenders. They are largely consumer lenders, and some of them lend to small businesses as well. In the absence of systematic data, however, one must make do with scattered, unsystematic information and inferences.

Looking first at personal loans, what evidence exists seems to indicate that low-income people seldom get them from conventional financial institutions such as banks, savings and loan associations, and credit unions. The poor are unlikely to turn to such institutions when they need advances for a vacation, a car, education, health care, or the purchase of major appliances. This type of lending is the niche in which mainstream credit unions do a great deal of their business, but seldom with the poor. While comprehensive data on this point are lacking, studies and interviews from widely scattered neighborhoods show a consistent picture.

Organizers of new CDCUs frequently survey the state of financial services in their neighborhoods as a part of the chartering process. One such survey, conducted by the Woodstock Institute in Chicago's Austin area in preparation for the founding of the Austin/West Garfield Federal Credit Union, showed that people in the neighborhood experienced a severe lack of credit for their personal needs. Summarizing the findings, Kathryn Tholin wrote that local leaders

felt strongly that there was a lack of affordable financial services in the community, particularly for low-income residents. The local banks were widely perceived as not making an effort to make loans within the community. Furthermore, experience had demonstrated that the local banks were also not interested in serving the deposit needs of local residents or of local organizations. Because local banks charged high fees for small accounts, lower income residents in the community did not have access to either banking services or credit from banks. Even middle income residents could not get small loans from local banks. Respondents cited consumer loans, home improvement loans and loans for purchase or repair of used cars as particular needs they felt were unmet in the community.¹⁶

It would not be surprising to find that financial institutions do an even less thorough job of lending in low-income neighborhoods for personal, consumer purposes than they do for home mortgages. In the case of mort-

¹⁶ Tholin, 4.

gages, after all, the collateral is substantial and verifiable and it does not necessarily lose value over time. A used automobile, on the other hand, is of more uncertain value and is certain to depreciate. In the case of debt consolidation, vacation, medical, and other sorts of personal lending, there may be no collateral at all that can be repossessed if the borrower fails in his or her repayment obligations. Thus a lender falls back to a large extent on an assessment of the income and assets of the borrower, and perhaps character as well. By definition, income is lower in low-income areas and certainly assets are lower too, and thus lenders have reason to be cautious. If racism and other forms of discrimination play a role in lending decisions, they are more likely to do so in consumer than in mortgage loans because the importance of character, as judged by the lender, is more central.

The many CDCU loan officers with whom the author has talked have said that their institutions are not in competition with other conventional financial institution when it comes to making personal loans to their low-income members. This is not to say that the poor members are unable to get credit, but the sources for the poor are likely to be a pawnshop, a finance company, or a loan shark. For example, in the mountains of eastern Kentucky, the principal alternatives were thought to be pawnshops and finance companies. On the Navajo reservation in Arizona people usually turn to pawnshops, and in several central cities, in addition to pawnshops and finance companies, they deal frequently with individual loan sharks. Small business borrowers in poor neighborhoods sometimes get credit from their suppliers, at high implicit rates of interest. A study in South Central Los Angeles shows this type of non-conventional lending increasing three-fold in the 1980s.¹⁷

The non-conventional lenders who do business with poor people are quite different from banks and other standard financial institutions. Their interest rates are generally much higher. Annual rates as high as 50 to 100 percent are common, and the rates sometimes go higher. Borrowers are sometimes unaware of the real rates; for example, Rosenthal and Schoder found people on the Lower East Side of Manhattan who referred to 10 percent per week payments to a loan shark as "ten percent interest."¹⁸ Non-conventional lenders sometimes use unscrupulous, even predatory, practices. The South Central Los Angeles study cited above shows, for example, that two of the largest finance companies in the area have been sued frequently for fraud and unfair business practices.¹⁹

¹⁷ Haas.

¹⁸ Rosenthal and Schoder.

¹⁹ Haas.

On the other hand, non-conventional lenders sometimes provide services that are not possible in more bureaucratic institutions. In comparison to the latter, they reduce transactions costs, namely the time and money costs of doing business. The informal sector lenders frequently have a much less complicated application process and a shorter waiting period. Because they are located closer to the borrowers, the borrowers waste less time traveling to and from appointments and time saved is time during which a low-income person can be earning money.²⁰ What this indicates is not so much that the non-conventional sector serves poor people well as that conventional institutions often serve them badly, even when loans are available. It also indicates that CDCUs would be well advised to focus not only on the explicit costs of their loans but also on the hidden costs, and to do what they can to minimize delays and bureaucratic procedures.

What is true of mortgage and consumer loans is also true of small business loans; poor people and racial minorities find them very difficult to obtain. A study of commercial lending in Chicago, conducted by the Woodstock Institute, showed that in 1986 and 1987, the city's principal banks directed just one-third of their commercial lending to the city, compared to two-thirds to the suburbs. Of the one-third in the city, three-quarters went to the downtown Loop area, leaving only one-quarter of one-third for the neighborhoods. It was not possible to show how poor neighborhoods fared in comparison to middle-class and prosperous neighborhoods, but one would be surprised to find that they did very well.²¹

As part of its larger study on redlining, the *Atlanta Journal-Constitution* examined small business lending in its area, and especially loans guaranteed by the Small Business Administration.²² The principal conclusion was summarized in an interview with a county planner: "Redlining is worse on the commercial side than in housing." The newspaper found that most banks would not consider a commercial loan for less than \$100,000. Using their normal underwriting rules, this implies that an entrepreneur would have to have \$25,000 to \$50,000 in start-up equity capital, a sum far beyond the reach of most low-income people. As in the case of mortgages, income was not the only determinant of the dispersion of loans; race also mattered considerably. The newspaper found that the largest three banks in Atlanta had a much smaller share of SBA loans in predominantly black areas than their

²⁰ I am grateful to Ginger McNally for her M.A. thesis, which refers to a study demonstrating the high opportunity costs of conventional loans as compared to informal sector loans in Latin America: Christen; McNally.

²¹ Flax-Hatch.

²² Op. cit.

share of deposits in those areas. The owner of a minority small business investment corporation was quoted as saying, "The bank is making these loans to white establishments. You don't want to think it's out and out racism, but you wonder." Whatever the reason, it is clear that commercial capital is scarce in poor neighborhoods.

Not only do banks lend less in poor than in middle-class communities, they provide fewer financial services of all kinds. During the 1980s, many banks reduced the number of their branches, and they did so disproportionately in low-income areas. A study commissioned by the City of Los Angeles revealed branch openings and closings from 1987 through 1990. In this period there were 27 openings and 416 closings, the latter concentrated in low-income areas.²³ Gilda Haas of Communities for Accountable Reinvestment studied the branch closures of two major banks in the Los Angeles area, Bank of America and Security Pacific. She reported:

During this period, Security Pacific closed 21 branches and Bank of America closed 30. 71 percent of Security Pacific closures and 67 percent of Bank of America's were in low and moderate income communities. None of Security Pacific's closures and only four of Bank of America's closures were in upper income neighborhoods. 52 percent of Security Pacific's branch closures and 30 percent of Bank of America's occurred in neighborhoods which are 80-100 percent minority, while only 10 percent and 7 percent respectively of Security Pacific and Bank of America's closures took place in communities that have less than 10 percent minority populations.²⁴

This pattern of bank branch closures, particularly in low-income neighborhoods, seems to be common throughout the country. A number of community development credit unions were formed during the 1980s specifically in response to branch closings that left a neighborhood with no standard banking services. When Manufacturers Hanover Trust Company closed the last bank branch in a 100-square block area of Manhattan's Lower East Side, it inadvertently created a movement that led to the chartering, in 1986, of the Lower East Side People's Federal Credit Union.²⁵ In Philadelphia, Southwest Germantown Association Federal Credit Union moved its

²³ "Taking it to the Bank: Poverty, Race, and Credit in Los Angeles," a report to the City of Los Angeles prepared by the Western Center on Law and Poverty, June 1991, cited in Haas.

²⁴ Haas.

²⁵ The story of the credit union is told in Rosenthal and Schoder.

operations into a branch building that was closed by Fidelity Bank.

As banks become scarcer in low-income communities, they are replaced by a variety of substitute institutions, including check cashing establishments or currency exchanges. The currency exchanges provide some essential financial services, but to a more limited degree and at a higher cost than do banks. Checks can be cashed, but at a discount that sometimes reaches as high as 10 percent. Money orders are sold, but for a higher fee than banks usually charge.²⁶ Furthermore, since the currency exchanges are not insured, poor people who buy money orders from them are at risk until the money orders clear. They are not depository institutions for poor people and they do not provide either interest or credit. So when currency exchanges replace banks, important financial services are lost. In South Central Los Angeles in 1991, a study found just 19 bank branches but 133 currency exchanges, a ratio of 1 to 7.²⁷

The Drain of Capital

Evidence exists that banks and other financial institutions do not provide capital to poor communities but instead drain capital out of them. The evidence is not conclusive since so much of it is hidden in the files of the institutions, but it is at least suggestive.

In order to test this proposition conclusively, one would like to know the deposits in each neighborhood or branch in comparison to the loans made in that neighborhood or by that branch. The larger the latter in comparison to the former, the more the bank is helping a community use its own resources for its own use. Even the balance sheet figures on these subjects would not be conclusive because of the complications caused by the banks' selling of loans on the secondary market, but they would be helpful. In their absence, we are left with inferences and a few case studies.

In Philadelphia, the Southwest Germantown Association Federal Credit Union gained access to the books of the Fidelity Bank branch it was replacing, to discover that the branch had only \$100,000 in loans on the books compared to \$15 million in deposits. Clearly, that branch was functioning like a great pump, sucking up the community's financial resources and draining them out somewhere else.

The *Atlanta Journal-Constitution* used nationwide estimates of savings by

²⁶ A Woodstock Institute survey of 18 currency exchanges in Chicago's Austin community in 1986 found these fees: For check cashing, 90 cents plus 1.2 percent of the amount of the check (for example, the fee for a \$125 check was \$2.40). For money orders, 75 cents plus 1 percent of the amount of money (for example, the fee for a \$120 money order was \$1.40). For utility bills, 50 cents; for state plates, \$3.50; for a book of stamps, 75 cents; and so forth. Tholin.

²⁷ Haas.

Black and white populations to estimate the bank deposits in predominantly Black and predominantly white areas of the city in 1986. Comparing these with the HMDA mortgage data for the same year, it calculated that Blacks received 9.1 cents in the form of mortgage loans on each dollar saved, while whites received 13.7 cents. The newspaper had no information on other types of lending, but if the same patterns exist in personal and commercial lending—as they probably do—then it is clear that the banks channel money out of Black areas at a much faster rate than they do out of white areas.

The most comprehensive study of the drain of capital from poor areas is by ACORN, the Association of Community Organizations for Reform Now, one of the principal groups lobbying for tighter controls on bank lending.²⁸ ACORN used information from the Federal Deposit Insurance Corporation on deposits by bank branch and compared it to HMDA information on mortgage lending by branch. The neighborhoods in which the branches were located were categorized by income level and by racial composition, using census tract data. Summarizing the study, the authors wrote:

Nationally, the study revealed that, for every dollar on deposit in predominantly minority neighborhoods, about 4 cents was loaned for mortgages in those same neighborhoods in 1989. By contrast, for every dollar on deposit in predominantly white neighborhoods, nearly 8 cents are reinvested in those same neighborhoods. . . .

The discrepancies were not materially reduced when comparing neighborhoods of comparable income, but different racial and ethnic profiles. For example, middle-income, predominantly minority neighborhoods received only two cents in loans for every dollar on deposit in those areas, while middle-income, predominantly white neighborhoods received nearly seven cents in loans for every dollar on deposit in those areas.

These findings are shown in Tables 4.3 and 4.4.²⁹ Philadelphia is the one exception where, the authors say, banks may have responded to community pressure to increase lending in the central city. In all the other cities studied, the ratio of mortgage lending to deposits was considerably lower in minority than in white communities.

²⁸ Association of Community Organizations for Reform Now (ACORN).

²⁹ Data from *ibid.*

Table 4.3

Loan-to-Deposit Ratios by Racial Composition of Neighborhoods

City	up to 25% Minority	>25% Minority	>75% Minority
Brooklyn	17.3%		11.8%
Chicago	7.6		2.4
Dallas	7.5		1.3
Detroit	—		0.4
New Orleans	14.5		1.0
Philadelphia	3.6		5.0
St. Louis	4.2		2.7
Washington DC	10.2		7.8
Boston	12.3	8.8%	
Kansas City	5.9	0.5	
Little Rock	9.8	2.0	
Milwaukee	3.0	0.5	
Minn-St. Paul	6.0	0.8	
Phoenix	8.6	1.8	

Table 4.4

Loan-to-Deposit Ratios in Middle-Income Neighborhoods by Racial Composition of Neighborhood

City	up to 25% Minority	>25% Minority	>75% Minority
Brooklyn	7.0%		4.8%
Chicago	21.7		2.1
Dallas	8.0		0.6
Philadelphia	3.1		1.2
Washington DC	20.1		3.3
Boston	9.6	0.4	
Kansas City	7.8	0.6	
Milwaukee	3.7	0.4	
Phoenix	3.3	1.5	

Because of the limited information that is available, the ACORN study looks only at mortgage lending in comparison to deposits. One would like to have data on all lending. As noted above, however, every reason exists to think that personal and commercial lending is just as skewed, and probably more so, as mortgage lending. If Tables 4.3 and 4.4 could be compiled to include all lending, they would probably show that the proportion of a community's savings that is returned to it in the form of loans is significantly higher for whites than for non-whites. On the basis of what is known, therefore, it is very likely that banks act to drain capital out of poor and minority

communities. This drain is both predictable and disturbing. It is predictable because, on the basis of all that is known about lending patterns in poor communities, it is clear that financial institutions do not regard such areas as good investment risks. They do not invest much money in them. The funds that are deposited by residents of poor communities become part of the resource base of the financial institution, and that institution is free to move those resources anywhere in the world that it deems prudent and profitable. Most financial institutions create no connection between the area that generates its resources and the area that absorbs those resources. One would be surprised to learn that the savings of poor communities are returned to those communities.

Yet the capital drain, if not surprising, is disturbing. Capital is a very important resource. A labor force, no matter how skilled, educated, and energetic, can make little progress in economic development without capital, without funds to make investments. The poorest areas of the country, both urban and rural, are the most needy, the areas where economic development could make the most impact on the lives of people. Ideally, at least some surplus funds from rich areas of the country would be redirected to the poor, to help repair some of the glaring gaps in living standards that mar the social landscape. At the very least, a poor community should be able to make use of its own financial resources to address its most pressing needs. But in fact what happens is that the financial resources of the poor are siphoned off into capital networks that for the most part benefit people who are better off than they are.

The need for community development credit unions is shown most dramatically by the outflow of funds from poor neighborhoods. Since a credit union is constrained to make loans only to its members, it provides a mechanism for a community to have access to its own resources. The mechanism is not airtight, since in some cases funds escape when the credit union is not fully loaned out and therefore makes investments with its surplus funds in financial institutions that lie outside its field of membership. But credit union managers always prefer to lend to members rather than make outside investments, if for no other reason than that the rate of interest on the former always exceeds the rate on the latter.³⁰ So while there may be some leakages of funds from the community, they are usually fairly small. In addition, the use of non-member deposits by a CDCU can promote a reverse flow of resources into the poor community.

The credit union structure is not essential to prevent the outflow of funds. The South Shore Bank in Chicago, by making loans only within its

³⁰ See, for example, Table 5.11, in the next chapter.

target community, and by accepting deposits from outside the community as well as from within, acts to create a positive flow of funds. It does this because of the social commitment it has undertaken, but it is almost unique in this respect. Most banks do not have this sort of commitment.

Legislation

For several decades, community groups and spokespeople for the poor have protested the actions of financial institutions, and have petitioned the government for redress. The focus has been largely, although not exclusively, on mortgage lending and the allegation of redlining. Among the protesters' allies in Congress was former Senator William Proxmire of Wisconsin, who wrote in 1976:

"Redlining" is a term that was scarcely known four years ago. But thanks to the painstaking efforts of community groups to preserve their neighborhoods, we now know that arbitrary refusal by lenders to invest in older urban neighborhoods dooms those neighborhoods to a premature death. That process, popularly called redlining, has been documented in scores of cities by community groups that labored in the basements of county court houses to produce statistics which show conclusively that many neighborhoods were not getting a fair share of mortgage money. And the community groups petitioned Congress for redress.³¹

Congress responded with a series of acts intended to promote urban development and end discrimination of various sorts.³²

The first major legislation was passed in 1968 as a part of President Johnson's Great Society program. Section 103 of the Housing and Urban Development Act specified certain older, poorer, and decaying sections of cities as worthy of special federal programs.

The first important anti-discrimination legislation in banking was the 1968 Civil Rights Act. Title VIII of that act is known as the Fair Housing Act. It prohibits discrimination in the sale, rental, financing, and marketing of housing on the basis of race, color, religion, national origin, or, after a 1988 amendment, handicapped or family status.

The prohibition against discrimination was extended beyond housing, to include all lending, by the Equal Credit Opportunity Act of 1974, which

³¹ Quoted in Bentson, Horsky, and Weingartner.

³² The highlights of the legislative history are reviewed in Calem.

specifically enjoined discrimination on the basis of race, color, religion, national origin, marital status, age, or welfare status.

The Home Mortgage Disclosure Act (HMDA) of 1975 required depository institutions to disclose by census tract the number and dollar amounts of their home mortgage and home improvement loans. As noted above, it was amended in 1989 to include all mortgage lenders, and to require disclosure of loan applications and of the race, gender, and annual income of the applicants. The HMDA was intended to open discriminatory practices to public view, to help enforcement of the Fair Housing Act, and to make redlining more difficult if not impossible.

Some legislation has been proposed at the state and local levels to expand HMDA reporting requirements. In California, for example, a bill that has been before the Assembly several times would require banks to report on all their lending, including commercial and consumer lending, not just on their mortgages. To date, none of this legislation has been adopted by states; a few cities, most notably Chicago, do have broader reporting requirements for financial institutions seeking deposits from the local government.

Finally, the Community Reinvestment Act (CRA) of 1977 called on all banks and savings and loan institutions to serve the credit needs of their entire communities, in particular low- and moderate-income areas and not just the wealthy areas. It requires the covered financial institutions to make a public record of their actions to comply with the Act, it invites the public to comment on that record, and it authorizes the government regulatory bodies to monitor compliance. In 1993, President Clinton called for a review of the CRA and its compliance regulations because of general dissatisfaction with the way it was working; this will be discussed in Chapter 7.

Taken together, these laws require that financial institutions be non-discriminatory in their provision of credit, and that they take affirmative steps to serve all parts of their communities. The HMDA is intended to provide the information by which outsiders can judge whether lenders are complying with the legislative requirements, at least in the area of mortgages.

In fact, however, the legislation has proven to be unsatisfactory to almost everyone concerned. Lending institutions generally regard it as a cumbersome intrusion on their business affairs, and completely unnecessary as well, since they claim to be not discriminatory in the first place. Community groups, on the other hand, say that they have seen little or no change in bank behavior as a consequence of the legislation.

To understand why the legislation of the last quarter century has had so little impact on the role of financial institutions in poor communities, one must consider the controversy over discrimination in lending.

Discrimination

There is no agreement as to whether financial institutions discriminate illegally against the poor and against racial minorities. The evidence presented in this chapter might seem to constitute overwhelming evidence of discrimination. The fact that non-whites receive fewer mortgage loans than whites, and that they are turned down more frequently than whites even when they have the same income, would seem definitive. Some people argue, however, that discrimination is not proven, that there may be perfectly equitable, rational, non-discriminatory reasons for these unequal results.

A sophisticated example of the latter sort of reasoning is contained in a statistical study of mortgage loans in Rochester in the mid 1970s by Benston, Horsky, and Weingartner.³³ They identified a central city area which community groups claimed was redlined and compared it to a suburban area. They found that mortgage loans were in fact made by banks in the central city; in other words, the most extreme form of the redlining hypothesis—that banks refused to lend in the central city—was transparently false. The authors explored a less extreme proposition, that banks set more stringent terms on the loans they make in the central city: higher interest rates, for example, or lower loan-to-value ratios or shorter terms. They found that some of the terms were less favorable in the central city, in particular that the number of months to maturity was smaller. Through a series of statistical tests, however, they demonstrated that most if not all of the difference in loan terms could be explained by the characteristics of the borrowers and of the property and were not associated with the area of the city.

A prudent lender must consider the creditworthiness of the applicants, and this can be divided into several dimensions. First, the lender must decide whether the applicant is likely to be able to make the payments on the loan. The main determinant is the applicant's income, but it is not the sole one; also relevant are the applicant's expenses, previous financial obligations, and credit history. Second, the lender must decide if the applicant has access to sufficient cash to cover all the immediate costs—in the case of a mortgage, these include the excess of the selling price over the loan, plus the various closing costs. And third, the lender must decide if the collateral on the loan is adequate, for example, if the house that is being bought with the loan has sufficient value, both currently and in the future, to cover the lender's exposure should the borrower default.

Bentson and his colleagues found that while the loan terms were somewhat less favorable in central Rochester than in the suburbs, this was a predictable consequence of the fact that the borrowers in the central city were

³³ *Op. cit.*

somewhat less creditworthy, according to the standard criteria of credit outlined in the last paragraph. There was almost no evidence that the lenders treated people in the two areas by unequal standards. The authors concluded that there was no evidence that redlining existed, that banks engaged in discrimination based on the area of the city in which the property or the borrower was located.

Some problems exist with the Rochester study, as with any study. While the authors chose two areas for comparison based upon community views about where redlining occurred, in fact the two areas chosen had almost exactly equal average family incomes, and the authors lacked information about the racial composition of the areas. It is not clear, therefore, that the study drew its data from an area that would be likely to show discrimination in lending, were it to exist.

At the very least, however, studies such as those of Bentson and his colleagues demonstrate that redlining and bias are complicated issues, not to be demonstrated by casual empiricism. The fact that banks lend less to the poor and to racial minorities does not by itself prove that they are violating the anti-discrimination laws.

A mountain of additional data has been generated by the HMDA since the time of the Rochester study, but they do not resolve the question of whether redlining exists and whether banks discriminate on the basis of race or geographical area.

One common complaint about the pre-1989 HMDA data is that they revealed nothing about the demand for mortgage loans. One reason why fewer mortgages are made in central cities, or to racial minorities, may be that there is less demand for loans. Perhaps suburban populations are more mobile, with more houses up for sale and consequently a higher demand for mortgages. It was because of concern about the issue of demand that applications as well as approved mortgages were covered in the most recent version of the HMDA, so that rejection rates could be calculated. As shown above, there are in fact significant differences in rejection rates, by race and income. It follows that differences in demand cannot be the sole explanation of differences in mortgage lending rates in different communities. Differences in demand may still, however, be part of the explanation.

In addition, since even the most recent version of the HMDA provides little information about the creditworthiness of the loan applicants, the data cannot be used to demonstrate illegal discrimination. The fact that fewer mortgages are extended to lower-income than to upper-income people—per unit of housing in a neighborhood or per number of applications—may indicate simply that lenders are doing a responsible job of weeding out people who lack the capacity to repay. Even the data showing lower lending rates

and higher denial rates to racial minorities, when income is held constant, may be consistent with non-discriminatory lending practices because of a lower level of net worth among minorities.³⁴

The strongest evidence that banks engage in mortgage lending practices that discriminate against minorities is contained in a 1992 study by the Federal Reserve Bank of Boston. It examined the economic characteristics of about 3,000 mortgage applicants in the Boston area in 1990. It found that for the most part banks used ordinary financial criteria in rejecting or accepting mortgage applications, but in addition that they discriminated against racial minorities. The study has been roundly criticized by economists at the University of Texas who have reexamined the Boston data, however. They assert that much of the reported information is obviously in error, and that even if it is not, the information does not support the study's conclusion of racial discrimination.³⁵

One of the factors that makes a determination of discrimination in lending difficult is that there are different concepts, different definitions of discrimination. Discrimination based on intent is quite different from discrimination based on impact, and the latter can exist in the absence of the former.³⁶ Federal Civil Rights legislation helpfully distinguishes between "intentional discrimination" and "disparate impact."

Intentional discrimination is clearly forbidden in many areas of commerce. For example, the Equal Employment Opportunity Act (Title VII of the 1964 Civil Rights Act) states:

It shall be an unlawful employment practice for an employer (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin. . . .

The 1968 Fair Housing Act similarly states that:

. . . it shall be unlawful for any bank . . . to deny a loan or other financial assistance to a person applying therefore . . . or to discriminate against him in the fixing of the amount, interest rate, duration or other

³⁴ A Federal Reserve survey in 1986 showed that Black families had on average 17 percent of the net worth and 9 percent of the financial assets of white families. See Canner and Smith.

³⁵ Liebowitz. For a rebuttal to the criticism, see the letter to the editor by Lynn Elaine Browne, Director of Research for the Federal Reserve Bank of Boston, *The Wall Street Journal* (September 21, 1993), A23.

³⁶ On intentional discrimination versus disparate impact, see Ayres.

terms or conditions of such loan . . . because of the race, color, religion or national origin of such person. . . .

In the area of employment discrimination, a series of court rulings established the doctrine of disparate impact, namely that unlawful discrimination could occur as a consequence of apparently neutral practices if those practices had the effect of disadvantaging a protected class of potential employees. In the late 1980s, however, several Supreme Court decisions, most notably *Wards Cove Packing Co. v. San Antonio*, weakened this basis for finding discrimination. As a consequence, the 1991 Civil Rights Act explicitly established disparate impact as a form of unlawful discrimination, in the area of employment, when:

a complaining party demonstrates that a respondent uses a particular employment practice that causes a disparate impact on the basis of race, color, religion, sex, or national origin and the respondent fails to demonstrate that the challenged practice is job related for the position in question and consistent with business necessity. . . .

Federal legislation does not formally establish disparate impact as a form of illegal discrimination in the areas of housing or lending, but only in employment. Nevertheless, the relevance of the concept extends well beyond employment. The question of discrimination by financial institutions, therefore, should be divided into two categories, relating to intention and impact.

The data are simply not sufficient to establish the existence of intentional discrimination in lending. Neither, however, are they sufficient to demonstrate that intentional discrimination does not exist.

A good argument can be made to reject the hypothesis of intentional discrimination but, on the other hand, a good argument can be made to embrace it. The argument supporting the view that there is little or no intentional discrimination is that there would be a financial cost to a lender of engaging in such discrimination. A lender faced with two equally attractive loan opportunities, one in a white suburb and one in a Black urban area, and who chose only the former, would be giving up on a perfectly sound business opportunity. Even if one supposes that the lender in question is prepared to forego this opportunity, the lender's competitor will likely see the missed opportunity and will fill the gap. Furthermore, in a competitive business environment, a firm that consistently passes up sound opportunities to make money is likely to be driven from the market, leaving only non-dis-

criminary firms in place.³⁷ It is a most logical, although not completely airtight, argument.³⁸

The argument supporting the existence of intentional discrimination and redlining is rather more historical than logical. The United States is a country whose origins are steeped in slavery. Until recently, in some areas its laws not only permitted but required discrimination in many aspects of public, private, and commercial life. Until the last few decades, most of its white leaders and indeed most of its white people were explicitly and unashamedly racist. More recently, while racist language is generally (not always) viewed as unacceptable, race and racism are at the forefront of many people's emotions. Income and social gaps between the rich and the poor, and between the white and the non-white, have been growing in recent decades. In such a society, financial institutions cannot be expected to be immune to the general malaise. When confronted with the clear evidence that poor people and non-whites have much less than their share of access to financial services, one can draw the obvious conclusion that these are the fruits of discrimination and racism.

This conflict in interpretation goes straight to the heart of Americans' consciences, and it is obviously beyond the scope of the present study, or my ability, to resolve it. I can report that the great majority of the people in the community development credit union movement with whom I have discussed the issue believe that the people in their communities are the victims of racial discrimination by financial institutions.

Turning to the other form of discrimination, there is no question but that disparate impact in bank lending is a fact. Disparate impact is exactly what the data show. What is not so clear is whether the disparate impact in lending would be judged by a court to be illegal, if there were a law in lending similar to the law in employment specifying disparate impact as grounds for a suit. In the area of employment, disparate impact is unlawful only if "the respondent fails to demonstrate that the challenged practice is job related for the position in question and related to business necessity." In the area of lending, the Community Reinvestment Act calls on banks to serve the credit needs of low- and moderate-income communities, but it requires them to do so in a manner consistent with safe and sound banking practices.

³⁷ For the seminal statement of this type of argument, see Gary S. Becker, 1957.

³⁸ The argument depends upon the existence of what economists call "perfect competition," in particular the assumption that there are so many firms in competition with each other that they drive the rate of economic profit (as opposed to accounting or financial profit) down to zero, even for the most efficient firm. Consequently a firm which is less than optimally efficient—for example, one that discriminates—will suffer losses over the long run and will eventually disappear. If financial markets are not perfectly competitive, however, and they may not be, then room exists both for efficient firms to make excess profits and for inefficient (discriminatory) firms to make sufficient income to stay in business.