dian borrower is better off. Do those institutions serve low-income people? Are they really community development credit unions?

They do serve low-income people and they are community development credit unions. Table 6.8 shows that about a third of the borrowers at each credit union earn less than $2,000 a month which, if not the poverty level, is a low income on the California coast. The two credit unions use a strategy that is different from the strategy of the other five.

Every financial institution that does business with low-income people faces difficulties. Chapter 4 showed that banks and other conventional lenders encounter such problems making a profit off the poor that they increasingly avoid the business, choosing not to make loans or to withdraw from poor neighborhoods altogether. Chapter 5 showed that community development credit unions, while viable, are less successful financially than mainstream credit unions operating with predominantly middle-class memberships.

In fact, while exceptions exist, most CDCUs need to find away of bringing outside resources into a partnership with the savings of poor people if they are to be successful in the long run. At least three ways exist of doing this: non-member deposits, grants, and a broad field of membership that includes middle-income people. Most of the credit unions studied in this chapter have pursued one or more of these strategies.

The Appalachian credit union has attracted both non-member deposits and grant money from the outside. In 1991, about half of its deposits, or $900,000, came from outside its field of membership. Depositors included the Campaign for Human Development and the National Federation of CDCUs. The credit union qualified for a $200,000 loan from the NCUA Revolving Loan Program.[12] It has experienced no difficulty in attracting non-member deposits. The only limit is the cap imposed by the NCUA; while the agency has relaxed its usual 20 percent limit, it has not been willing to allow the credit union to increase these funds beyond the current level.

First American is less dependent upon outside resources. It has often sought non-member deposits, but the reason has been not so much to generate the income needed for survival as to permit continued lending when loan demand has outstripped savings.

Mission Area has made heavy use of both non-member deposits and grants. It was virtually rescued, early in 1981, by an NCUA $200,000 loan. At that time, its assets stood at just $100,000, so the outside loan tripled the

[12] According to federal regulations, a loan from the NCUA does not technically count as a "non-member deposit" when calculating the 20 percent limit, nor do deposits from outside the field of membership that are solicited to match the NCUA loan.

size of the credit union and transformed it. It has secured grants from the Vanguard Foundation and the San Francisco Foundation, and outside deposits from many foundations and other socially responsible investors.

NEJA has had little help from the outside, and perhaps for this reason it remains small. It has, however, received deposits from Presbyterian churches and from the National Federation of CDCUs, and in 1991 it received an NCUA loan.

Watts United was founded after the 1965 uprising with outside money, and many of its expenses were covered in the early years by a community agency, the Westminster Association. It has been largely on its own in more recent years, but it has qualified for an NCUA loan. Watts United has addressed the problem of solvency, in the absence of much outside help, by its pricing strategy; of the credit unions studied in this chapter, it charges the highest interest on loans and pays the lowest dividend on savings.

All of the five unambiguously low-income credit unions have found ways of bringing outside resources into their communities, to a greater or lesser extent. The other two credit unions, Northeast Community and Santa Cruz Community, have also made use of both grants and non-member deposits, and in addition they have attracted higher-income people into their membership.

Northeast Community has received a waiver from the NCUA to exceed the 20 percent limit on non-member deposits. In addition to such deposits, it participates in a guarantee program for business loans to Southeast Asian refugees, and it has received several grants. Santa Cruz Community does not currently have non-member deposits, but it has had a few of them in the past, in addition to an NCUA loan and a major grant in its early years from the John Hay Whitney Foundation. It also participates in a guarantee program for business loans to low-income people and minorities.

Both Northeast Community and Santa Cruz Community are fortunate to have a mixed-income membership. The reasons for their fortune are interesting. They are located in areas with both middle-class and low-income people, but geography alone is not enough to explain the mixture. Both credit unions began with a clear mission of social change from which they have not wavered: Northeast Community to help the Asian immigrant community, and Santa Cruz Community to help low-income people in the county of Santa Cruz. That mission proved attractive enough to many middle-income people that they were willing to join. In San Francisco it was largely ethnic loyalty that pulled the more prosperous people in. In Santa Cruz there was a strong progressive political movement, which came to see the credit union as its financial institution.

The middle-income people who joined these two credit unions did so at a certain cost to themselves. Chapter 5 showed that the rates offered by CDCUs are not quite competitive with those offered by other credit unions, and the same is true at Northeast Community and Santa Cruz Community. In many cases, middle-income people would be unwilling to accept the sacrifice, however small, that is involved in belonging to an institution that focuses on the needs of the poor, and therefore this model cannot be replicated everywhere.

It is not a coincidence that Northeast Community and Santa Cruz Community concentrate on business lending more than the other CDCUs do. Many of the business loans go to people who are not themselves poor, but who provide employment for people who otherwise would be. For example, Santa Cruz Community has provided agricultural loans for many years to a Chicano farming couple who are successful and have a comfortable income, and who each year provide stable employment, at an average annual wage of $14,800, to 70 Mexican and Mexican-American farmworkers who previously were low-income migrants. Hundreds of other employees of businesses that borrow from the credit union—motels, grocery stores, print shops, flower stalls, restaurants, etc.—are people who have been poor but who now have decent, moderately-paid jobs.

The strategy of bringing people who are better off into the membership of the credit union, along with low-income people, would not work in Watts, since the neighborhood is almost exclusively low-income, or at NEJA, because of the cultural divide between the African Americans and the whites, or in many other areas. But where it is feasible, it works. The middle-class people treat the institution as their own, as it in fact is. They deposit their savings, conduct transactions, and borrow from the credit union. In so doing, they effectively subsidize the credit union's dealings with its low-income members.

Conclusion

The typical loan purpose varies considerably between CDCUs. Some CDCUs concentrate on personal lending, including auto and debt consolidation loans, while others emphasize small business lending.

In spite of skepticism from regulators about the appropriateness of credit unions' lending to businesses, many CDCUs find ways to contribute to local economic development by making a significant number of business and community development loans.

Leaders in the CDCU movement have sometimes indulged themselves in a bit of a dispute about whether personal lending or business lending was

the most appropriate use of their institutions' resources. Different credit unions have made different choices. Many do no business lending at all. At least one, Self-Help Credit Union in North Carolina, does only business and housing lending. Some do a mixture of both. The case studies in this chapter show, in the author's opinion, the importance of both kinds of lending. Business loans can help to transform a community by providing decent jobs to low-income people and by giving people an ownership stake. But it would be a mistake to regard the personal loans as somehow less important. When a CDCU allows an Appalachian family to celebrate Christmas, or a Navajo family to send their daughter to school, or an African American family in Watts to buy a used car, it is performing a very important function.

The ethnic composition of the credit unions' membership varies widely, including concentrations among Hispanics, African Americans, Native Americans and whites.

Five of the seven CDCUs studied in this chapter operate in communities that are marked by relatively low incomes and high poverty rates. Their borrowers are on average quite poor. Two operate in mixed-income communities, where low-income borrowers are balanced by middle-income; this mixture is part of a strategy that allows the credit unions to remain commercially successful while at the same time serving poor people.

The borrowers' incomes are much lower in the rural CDCUs than in the urban. When adjustments are made for differences in the cost of living and the age distribution of the borrowers, however, the typical borrower incomes in the rural CDCUs are roughly equivalent to the incomes in the poorer urban CDCUs. The incomes of male borrowers are significantly higher than those of female borrowers in each CDCU.

Appendix: The Data

The data were gathered by the author and several research assistants. A random selection was made of approximately 200 loans in each credit union, disbursed during 1990. Because NEJA is a small credit union, with few loans each month, the period was extended from 1989 through mid-1991, and even so only 103 files were available. At Santa Cruz the sample consisted of about 400 files, which provides a sufficient number of credit card and business loans, as well as personal loans.

The material in the loan files is not uniform from credit union to credit union, and even within a single credit union's files pieces of information are sometimes missing. In the comparisons between credit unions, therefore, the usable variables were restricted, and not all of the files could be used.

The information comes from different documents in the loan files. A

loan file always contains an application, filled out by the member, and a promissory note, filled out by the credit union and signed by the member. Some, but not all, credit unions also have a worksheet containing relevant information and calculations, filled out by a loan officer.

Some arbitrary decisions were necessary. The first had to do with the income of the borrower. Wherever possible, the figure used was the gross monthly income of the principal borrower. Taxes and other paycheck deductions were not subtracted. In the case of the self-employed, the attempt was made to deduct expenses related to the generation of income, although this was not always possible. Note that individual income, not household income, was used, even when several incomes in a household were required to make the borrowers eligible for a loan. There were two reasons for using individual rather than household income: because the study was attempting to discover the characteristics of the borrowers, not to assess the decision-making process of the credit union, and because in some of the communities the concept of "household" was ambiguous. In the great majority of cases, the borrower's income was by a large margin the highest income in the household.

Each loan was assigned to a single borrower, even when the loan was legally made to a couple. In these cases, an attempt was made to decide, from looking at the complete file, who the principal borrower was, and to gather information about that person. This seemed the wisest choice, since otherwise the information would not be comparable between loans.

Some of the information in the files is certainly inaccurate. A person seeking a loan may have an incentive either to overrepresent or to underrepresent his or her income. The tendency to overrepresent comes from a desire to appear more creditworthy than the person actually is, while the tendency to underrepresent may come from people on public assistance who wish to conceal some of their income from the authorities. In some files, figures are confirmed by employers or by tax returns, but this does not happen in every case. Some credit union loan officers have said that they are particularly suspicious of income reported from self-employment, since the figures they are shown may not be net of income-related expenses. Errors such as these are unfortunate, but since they affect all of the credit unions, they are unlikely (with one exception) to influence the comparison between the credit unions. The one exception is NEJA Federal Credit Union in Florida, where many of the members are self-employed farmers, and where the overstatement of income may therefore be somewhat greater than in the other credit unions.

POLICY

Mr. Chairperson, I understand the political climate existing here in Washington, D.C. following the savings and loan and bank crises. I know that laws were passed giving regulators expanded supervisory powers and that Congress clearly signaled the federal regulators to step up their enforcement activities and to look under every rock for threats to the insurance fund. Despite the fact that credit unions were doing very well, the NCUA apparently felt it was also given the signal to dramatically increase its regulatory pressure. In my judgment, they may have gone too far. I agree that we need a top priority of safety and soundness, but at what expense? Certainly not at the expense of curtailing the fundamental mission of providing credit to those who desperately need it.

—Jeff Wells, Board member of the National Federation of CDCUs[1]

A public-purpose banking system cannot be created by an act of Congress. It must grow from a network of well-organized citizens capable of articulating a vision for community renewal.

—Martin Paul Trimble, National Association of Community Development Loan Funds[2]

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1 Testimony before the Subcommittee on Policy Research and Insurance and the Subcommittee on Economic Stabilization of the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs (July 22, 1992).

2 Trimble.

Today I am sending to Congress an innovative program that will bring new life and new opportunity and new directions to communities all over America that lack capital and credit.

—President Bill Clinton[3]

This chapter considers public policy towards community development credit unions. It concentrates on legislation and regulation at the level of the federal government.

CDCUs, like all credit unions and like almost all financial institutions, are private, non-governmental entities. Their success or failure is determined primarily by the extent to which they meet a market test, the extent to which they provide services that individuals are willing to use and support. They are not public agencies.

Nevertheless, governments have a great deal of influence over them. Credit unions are chartered, regulated, and examined by agencies of either the federal or a state government. They are required to carry deposit insurance which is provided by a federal agency, and they therefore have to meet the performance standards of the public insurer. To a certain extent they serve a public purpose, and consequently public bodies frequently show an interest in them.

The Regulation of Financial Institutions

In the United States in the late twentieth century, and in all other industrialized countries, governments regulate and constrain the activities of virtually all private businesses. They tax them, establish accounting standards, restrict their environmental impact, impose fair labor standards—including minimum wages, health and safety regulations, and collective bargaining rights—and in some cases test and regulate the goods and services that the businesses offer on the market. No sector of the private economy is regulated more closely, however, than the financial sector, the country's banks, thrift institutions, and credit unions. Financial institutions are subject to all of the regulations imposed on other businesses. In addition, they must subject their business practices to detailed examination and often control by public agencies. Public agencies have the authority to tell financial institutions how to allocate their assets, to forbid them from making certain loans, to require them to reserve funds to back up risky loans, and much more. They have the authority to liquidate or merge them.

This level of public control occurs because of a peculiar distinction be-

3 Statement introducing the Community Development Banking and Financial Institutions Act of 1993 (July 15, 1993).

tween financial institutions and other businesses. All businesses have liabilities, but the liabilities of financial institutions are unique in that they constitute the largest part of the country's money supply. Most money that people have is held not in the form of paper notes or coins, but of deposits at a financial institution.[4] In the nineteenth and early twentieth centuries, when banks were largely unregulated, they grew rapidly during boom periods, but often went bankrupt during a downturn of the business cycle. When banks failed, their liabilities disappeared, and consequently the country's money supply fell, and thousands of people were ruined by the loss of their life savings. Both consequences were important. On the macroeconomic level, research has shown that the money supply, the amount of money in circulation in a society, is a principal determinant of the level of business activity; when the money supply falls, businesses fail and people are thrown out of work. On the individual level, the disappearance of a person's savings can be a tragedy.

The twentieth century response to this problem has been for the government to regulate financial institutions closely, in order to increase the chances that they will be operated prudently, and to insure their deposits. The two responses fit together. The federal government's deposit insurance means that a person's savings are protected, even if the financial institution should fail. By itself, deposit insurance helps to protect the institutions against failure because, since they have insurance, depositors are less likely to withdraw their funds when they suspect their institution is in trouble and thus less likely to provoke the very crisis they fear by starting a bank run. In addition, federal insurance brings government regulation to bear in a new way. As the insurer, the government has a strong interest in seeing that the financial institutions are operated safely, so that the insurance funds will not have to be paid out. Thus, for the financial institutions to get insurance for their deposits, they must meet the rigorous standards of the insurer. In return for providing the insurance, the government has the authority to examine the business practices of the financial institutions in detail, and to require many policies and behaviors in order to reduce risk.

None of this regulation and insurance eliminates risk or guarantees that the financial institutions will survive. In the 1980s, a large number of thrift institutions went bankrupt, principally because of imprudent business practices that the regulators did not prevent. While fewer banks failed, many of them too found themselves in grave difficulty, often because of unwise loans

[4] There are different definitions of the money supply. The narrowest one, called M1, is restricted to coins, notes, and checking deposits at commercial banks and a few other items, and it excludes deposits at credit unions entirely. But broader definitions of the money supply include many other types of deposits, including deposits at credit unions.

made to foreign countries. The credit unions were actually the soundest of the three types of financial institutions during this period.

Government regulation and insurance cannot eliminate risk, nor should they. Risk is the essence of banking. If there were no risk there would be no need for financial intermediaries like banks and credit unions. Individual savers would simply lend their funds to individual and business borrowers, secure in the knowledge that their assets were safe. But the risk that loans will not be paid back exists, and individual savers would like to avoid that risk to the maximum extent possible. They therefore pool their savings in financial institutions. The institutions in turn make many loans, and in a sense "manage" the risk. They place their loans in such a way that while they expect a few of them to go into default, they are reasonably sure that these few mistakes will be balanced by a much larger number of performing loans. The principal purpose of government regulation, therefore, is not to eliminate the risk, but to require financial institutions to manage it prudently.

At some times and in some circumstances, governments regulate financial institutions for a second purpose, namely, in order to direct credit in particular ways. They decide that the private market is not supplying sufficient loans to specific sectors of the economy, and they intervene to increase the flow of funds in those directions. They do this sometimes in response to perceived discrimination in lending. At other times no discrimination is alleged, but the government takes the position that the public would nevertheless benefit from more funds going to an area than the private sector is likely to provide on its own. Sometimes constraints are placed on private financial institutions to increase the loans to a sector of the economy; in other cases the government establishes publicly controlled banks to perform the task.

Many examples exist of this latter sort of government intervention. The Community Reinvestment Act requires banks to show that they are meeting the credit needs of their local communities. The Home Mortgage Disclosure Act requires financial institutions to report their mortgage lending performance in detail. Both pieces of legislation were passed in response to allegations of redlining, or discrimination in lending against minorities and poor communities. An example of a public bank that directs credit to a particular sector is the National Consumer Cooperative Bank, which lends only to cooperatives. It was established in response not so much to charges of discrimination as to the recognition that the ownership structure of a cooperative tends to make it relatively unattractive to a private-sector lender.

The Regulation of Credit Unions

Federally chartered credit unions are regulated by the National Credit

Union Administration (NCUA), an independent federal agency whose three board members are appointed by the President for six-year terms. State chartered credit unions are regulated by a variety of state agencies. The deposits of the great majority of credit unions are insured by a branch of NCUA,the National Credit Union Share Insurance Fund (NCUSIF). Members' deposits in a credit union are now insured to a level of $100,000, the same insurance level as is provided by the government to depositors in banks and thrift institutions.

The provision of share insurance gives NCUA the right to examine and regulate not only the federal credit unions but also the federally insured state chartered credit unions in order to protect the soundness of the insurance fund. As a consequence, virtually all of the country's almost 14,000 credit unions, whether or not they are federally chartered, are subject to the rules and regulations established by NCUA.

Federal supervision of credit unions was begun in 1934, with the passage of the Federal Credit Union Act.[5] Initially, the Credit Union Division was located in the Farm Credit Administration. Over the years it was moved around, first to the Federal Deposit Insurance Corporation and then to the Federal Security Administration. From 1952 through 1970, the Bureau of Federal Credit Unions was a section of the Department of Health, Education and Welfare; it was this bureau that was responsible for chartering the OEO credit unions. In 1970, NCUA was established as an independent agency.

The purpose of federal regulation has undergone fundamental changes since 1934. The Federal Credit Union Act was a part of President Roosevelt's New Deal legislation. Its explicit purpose was to encourage the growth of credit unions in order to promote both personal savings and also loans for "provident and productive purposes." During the later years of the Great Depression, the principal activity of the Credit Union Division was to organize new credit unions. The government organized many more credit unions than did the newly formed Credit Union National Association (CUNA), the private trade association of the credit unions. The Credit Union Division did not provide share insurance, nor did it impose strenuous restrictions on the activities of credit unions.

Again in the 1960s, the federal government took the lead in promoting credit union development, this time specifically in poor communities. As described in Chapter 3, the Office of Economic Opportunity helped to charter about 400 CDCUs in both rural and urban areas.

In later years, however, the federal government took the position that it was an inappropriate conflict of interest for it both to promote credit unions

[5] For the history of federal credit union regulation, see Moody and Fite.

and to regulate them. It ceased to be a promoter of credit unions, and gradually adopted the more orthodox regulatory stance of protecting the public against possible abuses by credit unions.

An important milestone in this evolution was the establishment of NCUA in 1970. The new agency took over all the functions of the Bureau of Federal Credit Unions, and within a few months it added the task of insuring the share deposits of the country's credit unions. Since it now had the responsibility of protecting the assets of the insurance fund, it began to take a much more aggressive stance in regulation, holding credit unions to strict financial standards, forcing the closure of many small and financially weak credit unions, and tightening the requirements for new charters. Regulations were further tightened in the late 1980s as a response to the fiasco in the savings and loan industry and to the weaknesses that were revealed in the banks. NCUA took the almost explicit position that new credit unions should not be chartered, and that existing large credit unions should instead expand to incorporate wider fields of membership.

Community development credit unions were particularly vulnerable to this tightening of regulatory standards. While in some cases the tightening helped CDCUs by encouraging them to adopt sounder business practices, in many other cases it was their downfall. A CDCU with high delinquencies on loan repayments, with low levels of reserves relative to its deposits, or with losses on its income statement was vulnerable to the recommendations of the federal examiners to close it. Even CDCUs with fairly acceptable financial ratios were sometimes at risk when the examiners did not want to incur what they regarded as the expense and inefficiency of regulating small institutions.

No doubt some of the liquidations were inevitable; some credit unions had been formed without sufficient community support or expertise and they could not sustain themselves on an ongoing basis. But experienced observers in the CDCU movement believed that many of the liquidations could have been avoided had the NCUA examiners taken the trouble to understand the importance and the unique circumstances of the low-income credit unions. Clifford Rosenthal, Executive Director of the National Federation of CDCUs, told the author that he believed the federal examiners were often insensitive to the special features of minority communities and low-income institutions, and that had they chosen to work more positively with the CDCUs, many more of the institutions could have been turned around and saved. Ernest Johnson, of the Federation of Southern Cooperatives, spoke sadly of the credit unions he had advised, nurtured, and almost, but not quite, rescued.

In some respects, NCUA did recognize the special needs of poor communities and their CDCUs. In response to a directive from Congress in 1974, the agency recognized certain "limited income credit unions," which it permitted to accept non-member deposits and to participate in a revolving loan fund. The Democratic board member, Robert H. Swann (appointed in 1990), and his assistant, Christopher Kerecman, took a fresh look at CDCUs and attempted to redesign the regulations with an eye to their impact on the CDCUs. With the coming of the Clinton administration, the agency accelerated some of its attempts to be helpful to CDCUs. These most recent regulatory changes of the 1990s are described in the next section.

But in other respects, the NCUA regulators did not acknowledge that poor communities were different from middle-class communities, that their financial institutions faced problems that were systematically different, and that the application of rules and regulations should be appropriately modified for them. CDCUs, as generally the smallest and most vulnerable of the country's credit unions, frequently experienced federal examination and regulation as hostile. In 1990, Robert Loftus, director of public and congressional affairs for NCUA, told an interviewer:

> *In our testimony to Congress [throughout the savings and loan crisis] we made the point several times that, in some instances we try to be extra helpful or bend over backward for a CDCU because of the type of institution it is. Our comments didn't get a very favorable response from senators and members of Congress. As a result, I would have to say we've become less lenient with CDCUs.*[6]

The Changing Response of NCUA to CDCUs

In the 1990s, and especially with the election of President Clinton in 1992, the regulatory hostility began to dissipate. For the first time since the OEO period of the 1960s, the federal government began to assert that it was a policy goal to promote banking services for economic development in poor communities. The President introduced the Community Development Banking and Financial Institutions Act of 1993. NCUA took a number of new initiatives to support CDCUs. The government was returning to the dual view of its proper role: on the one hand, regulate and examine in order to increase the safety and soundness of the credit unions and their share insurance fund, but, on the other hand, encourage the flow of finance towards poor communities in order to promote economic development.

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[6] "Low Income Credit Unions Survive Amid Turmoil." *Credit Union Magazine* (Madison: Credit Union National Association, October 1990), 50.

In July of 1992 NCUA undertook a major reconsideration of its regulatory stance towards low-income credit unions—thanks, in considerable degree, to advocacy by the National Federation of CDCUs. It established a committee charged to consider all aspects of its regulation, including the limited-income designation, non-member deposits, participation in the Revolving Loan Program, chartering policies, and the examination and supervision of CDCUs. It undertook to prepare a detailed information base in order to analyze key factors among CDCUs.[7] The committee went on the road, holding hearings in Newark, New York, Philadelphia, Washington, Atlanta, and Chicago. As a consequence of this reconsideration, it changed a number of its policies.

To begin, it changed the criteria that it uses for identifying credit unions working within low-income communities. These credit unions, first recognized in response to federal legislation in 1974, are eligible to accept non-member deposits, to participate in the low-interest Community Development Revolving Loan Program, and to receive federally funded technical assistance.[8] It is likely that federal financial assistance to credit unions under President Clinton's community development banking initiative will be restricted to this group.

At the end of 1992, 139 credit unions were certified by NCUA as falling within this category. The number is low in comparison to the 180 CDCUs whose financial statements were analyzed in Chapter 5, or in comparison with the figures the National Federation of CDCUs sometimes uses of be-

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7 The terms of what the NCUA called its "Pilot Program - Community Development Credit Unions" are outlined in a memorandum to the NCUA board dated July 7, 1992. For the information base, see the two papers by Neunlist.

8 In this era of enhanced sensitivity to verbal labels, NCUA has dealt with the nomenclature of these credit unions is a way so charming as to be worth quoting in its entirety. In the Federal Register 58 (April 23, 1993), in which the agency promulgates the final rules for the Community Development Revolving Loan Program, it reviews the question:

> NCUA requested comment on whether the term "low income credit union" found in Section 705.3 should be changed to either "economic development credit union" or "community development union." Two of these commenters believe this wording is more accurate than the alternatives. One commenter believes confusion will result if the name is changed to "community development credit union." Three commenters suggest the use of "economic development credit union" to avoid negative connotations and possible confusion. Six commenters recommend using the term "community development credit union." Those commenters believe this term avoids the negative connotation some associate with the term "low-income credit union." NCUA believes that the term "low-income credit union" may have negative connotations in the credit union community. Furthermore, NCUA believes the term "community development credit union" may cause confusion due to the fact that many credit unions that have not participated in the Program are members of a trade association called the National Federation of Community Development Credit Unions. The term "economic development credit union" may be misleading since the purpose of the Program is to assist credit unions serving low-income members. Therefore the final rule deletes the reference to "low-income credit unions" in Section 705.3 without replacing it with any of the suggested terms. Instead credit unions taking part in the Program will simply be referred to in the final regulation as "participating credit unions" as defined in Section 705.3(b).

tween 300 and 400 CDCUs. When NCUA took over the administration of the Revolving Loan Program in 1987, it inherited a list of over 300 designated low-income credit unions, which it cut drastically. Some of the cuts were appropriate, but some seemed arbitrary. After reconsideration, the NCUA board agreed that the current criteria were excessively restrictive, and therefore it expanded them in April of 1993.[9]

Under the new rules, participating credit unions are ones that serve a "predominantly" "low-income membership." "Predominantly" means at least 50 percent, and "low-income" means below 80 percent of the country's average personal income, with some allowance for regional differences in the cost of living. The principal change in the new rules is the 80 percent standard, which was raised from a much more restrictive 70 percent. Credit unions can demonstrate that they qualify for inclusion by surveying the incomes of their members or, if that is too onerous a task, they can now do so by showing that they operate in a neighborhood which is predominantly low-income. NCUA states that a credit union can use this latter method, even if its field of membership is not geographical. As another new possibility, credit unions that do not meet the 80 percent test exactly, but which "serve and benefit low-income residents of a community and whose mission and goals are identical to those set out in the purpose section of the regulation"[10] can petition the NCUA board for inclusion. As in the previous regulations, student credit unions may meet these criteria, but they are not eligible to participate in the programs for low-income credit unions.

NCUA estimates that an additional 100 credit unions will qualify for participation under these more relaxed criteria. The actual number may well be greater. The changes are welcome ones. They will permit more poor communities to be helped by government assistance, while still insuring that the assistance is actually targeted to the poor, and not dissipated among higher income groups whose credit unions are capable of flourishing on their own.

At the same time that it relaxed its criteria for participation in programs relating to low-income members, NCUA expanded its Community Development Revolving Loan Program. The program was first begun in 1979 with a Congressional appropriation of $6 million. The funds were lent to community development credit unions in amounts of $200,000, at 2 percent annual interest, for a term of 5 years. The recipient credit unions were required to match the loan by raising their share deposits, from either members or nonmembers, during the loan period. After one round of funding, the program was cancelled by the new Reagan administration as a part of its reduction of

[9] See the Federal Register, op. cit.

[10] Ibid. Santa Cruz Community Credit Union, among others, is hoping to qualify under this provision.

domestic spending. The funds were not confiscated by the administration, however, and consequently they were available for a new round of lending in 1985. This time, though, the interest rate was set at 7.5 percent, a rate that put it out of reach of most CDCUs.

The program was turned over to NCUA in 1986, but not activated again until 1990. In three annual rounds, NCUA lent out $6.6 million (the original appropriation plus the accrued interest), in amounts up to $200,000. After the first round, most of the CDCUs that applied for the loans were approved. While the program was received positively by the CDCUs, there were a few negative notes. In some cases, the agency descended into a curiously detailed level of micromanagement by placing what seemed to be unnecessary restrictions on the use of the borrowed funds, by ruling that a CDCU could not use the federal money, or the matching funds that came from non-members, for loans but only for investments in other financial institutions. In other cases, it also ruled that the net income on those investments could not be used to meet the credit union's expenses, but had to be put straight into reserves. One credit union, PA FCU in Louisiana, actually declined the loan after learning of NCUA's conditions.[11] While the agency was no doubt wise to place restrictions on some credit unions, the actual restrictions were onerous and unnecessary in a number of credit unions that were completely capable of making responsible decisions themselves.

In 1993, NCUA announced new rules for the Revolving Loan Fund. Henceforth, loan requests of up to $300,000 would be entertained, the paperwork and bureaucratic requirements involved in applying for the loans would be reduced, and the availability of technical assistance from NCUA would be separated from participation in the loan program.

In spite of its erratic history, the Revolving Loan Program has been a useful tool for moving CDCUs towards self-sufficiency. In some cases, the recipient CDCUs used the borrowed funds to lend to their members, thereby increasing their impact on their communities, while at the same time improving their financial status by virtue of the spread between the interest paid by their members and the interest owed to the government. When the funds were not lent out, either because of NCUA restrictions or because of the credit union's choice, they nevertheless have been invested in such a way as to improve the financial standing of the credit union. The quantitative impact of the loans has often been substantial. Some of the CDCUs that received the loans in 1979—for example, Santa Cruz Community and Near Eastside Community in Indianapolis—used them as springboards to develop into multi-million dollar institutions. More recently, NEJA Federal

[11] National Federation of Community Development Credit Unions, *CDCU Report* (New York, Fall, 1991), 3.

Credit Union, the rural African American credit union in the Florida panhandle whose lending was analyzed in Chapter 6, received a $200,000 loan in 1991, thereby raising its assets by almost 50 percent, from $450,000 to $650,000. The changes made by NCUA in expanding and streamlining the program are likely to be quite positive.

Nevertheless, a number of people in the CDCU movement came to believe that an expanded low-interest loan program was not the most effective way in which the federal government could stimulate the growth of credit in low-income areas in the future. As was shown in Chapter 5, in the early 1990s, the typical CDCU, like the typical American credit union, was only 50 to 60 percent loaned out. It had plenty of funds to lend, and did not face a liquidity problem. Moreover, a prospective increase in the size of its asset basis was a mixed blessing, at least in the short run, because such an increase made its reserves-to-assets ratio goal more difficult to reach. What the CDCUs really needed was an increase in their reserves, their equity capital, and to achieve this they needed grants from the federal government, not loans. They began to advocate, therefore, for what became President Clinton's 1993 initiative on community development banking, to be described later in this chapter.

A third change made by NCUA in 1993 was that it began to deal with the attitudes and training of its staff who examine low-income credit unions. A common complaint from CDCUs over the years has been that the NCUA examiners treat them rudely, in a manner insensitive to cultural and class differences, and lack sufficient understanding of the problems that they face. Since the examiners are predominantly white, and the CDCU staff predominantly non-white, the question of racism, whether subconscious or overt, is frequently present. Federal examiners have a great deal of power over credit unions, including the power to liquidate them or to dictate their business practices in detail. Under these circumstances, the encounter between a small credit union in a poor, non-white neighborhood and its examiner is often fraught with tension, and it has considerable potential for miscommunication. Regional directors of NCUA have sometimes exacerbated the problem by using the examination of a small CDCU essentially as a training exercise, assigning the least experienced people to do the job.

The National Federation of CDCUs has asked NCUA to revise its Examiner's Guide in order to remove some offensive language relating to low-income credit unions and also to add a section on CDCUs in its training program for examiners. Without accepting all of the Federation's requests, NCUA has at least recognized the problem. It has set up a training session to help its examiners deal more sensitively and professionally with the CDCUs, and it is making attempts to recruit more people of color into the ranks of its

examiners. It has agreed to review the Examiner's Guide. Whether any of this will make a difference to the quality of the examinations is still an open question.

While welcome, these improvements in the regulatory stance of NCUA do not exhaust the areas in which CDCUs have concerns. One of the most important areas of contention between the CDCUs and their regulators is the question of non-member deposits.

Chapter 2 discussed the use of the equivalent of non-member deposits in the early German cooperative banks, and Chapter 5 showed their quantitative importance in today's CDCUs. Non-member deposits (except deposits from the public sector) are forbidden in most credit unions, but allowed in those credit unions identified by NCUA as serving low-income people. They are an important mechanism in some CDCUs for promoting growth and financial self-sufficiency by attracting the participation of socially responsible investors such as churches and foundations.

The exception for low-income credit unions to accept non-member deposits is critical. For example, Tholin and Pogge describe how the Austin-West Garfield Community Credit Union, a CDCU in Chicago, opened for business with two $100,000 non-member deposits from local banks; without that start-off boost, the credit union might never have gotten going.[12] Another example is the Central Appalachian People's Federal Credit Union in eastern Kentucky, described earlier, where non-member deposits account for roughly 50 percent of the $2 million asset base.

Consequently, the CDCU movement suffered a major blow when NCUA decided in December 1988 to restrict non-member deposits to 20 percent of total shares. The decision was taken in response to serious fraud and the subsequent liquidation of the Franklin Community Credit Union in Omaha, Nebraska, a credit union which had made heavy use of non-member deposits. The decision to limit non-member deposits represented a curious response to the problem, however. The cause of the problem was fraud, not non-member deposits. One would have thought the proper response was to rethink the examination procedures which had allowed the fraud to go undetected until it was too late to save the credit union. Instead, NCUA decided to restrict the amount of non-member deposits. Faced with numerous protests from credit unions, it did relax the new rule somewhat, to allow regional NCUA directors to make exceptions in some cases if they deemed fit. Currently, therefore, most CDCUs are restricted to 20 percent non-member deposits, and even those which have exceptions must negotiate them separately, with no guarantee of success, for each new deposit.

12 Tholin and Pogge.

Non-member deposits can represent a risk to CDCUs. Ordinary member share deposits are usually so numerous, and so small, that a credit union can count on the probability that withdrawals over a short period will be balanced, more or less, by new deposits, and that therefore while there may be a lot of in-and-out movement of funds, the overall size of the deposit base will not collapse. Non-member deposits, on the other hand, tend to be few and large. A decision by one or two non-member depositors to withdraw their funds on short notice could cause a liquidity problem for a credit union, that is to say, a shortage of cash that could threaten the solvency of the institution.

Still, the seriousness of the potential liquidity problem should not be overstated. Just as the Federal Reserve System functions as a "lender of last resort" for the nation's banks, so too NCUA operates a Central Liquidity Facility which is available to meet short-term liquidity crises faced by credit unions. Furthermore, liquidity was not the problem in Omaha; the problem there was fraud. Nor have non-member deposits caused liquidity problems for any CDCU of which the author is aware.

If NCUA is genuinely worried about the instability of non-member deposits, it could establish some regulations to increase stability. For example, it could rule that beyond some level, such as 20 percent, non-member deposits would have to be made for a specific term, so that the credit union could plan well in advance for their disappearance. It could require that non-members give notice of their intent to withdraw, the length of the notice depending upon the size of the deposit. Or it could require that non-member deposits, beyond a certain level, be matched to loans of the same maturity as the deposit. Regulations such as these would go a long way towards reducing the possible threat to CDCUs caused by non-member deposits without killing them off. NCUA's stance should be to encourage non-member deposits in order to increase the flow of funds into poor neighborhoods, while at the same structuring them to control the risk. In late 1992, in response to criticism from CDCUs and from the National Federation of CDCUs, NCUA agreed to reconsider its policy on non-member deposits and the process for requesting waivers from the 20 percent rule, but there has been no indication that the agency is willing to change the policy in any fundamental way.

A second area in which NCUA regulation has been harmful has been its member business loan regulations. The root of the problem in this case is that most American credit unions view themselves as consumer lenders, not business lenders, and so does NCUA. While the nineteenth-century German cooperative peoples' banks lent only for business purposes, most of their modern American counterparts do no business lending. In 1991, only 1,360 of 13,007 federally insured credit unions, or about 10 percent, held any

member business loans at all.[13] At the end of that year, member business loans accounted for only 1.2 percent of the dollar volume of all credit union loans outstanding.[14] Consequently the regulators of credit unions tend to view business lending suspiciously, as being outside the normal and safe sphere of credit union activity. Since business loans carry particular risks of non-repayment, they would prefer that credit unions not make them, or at least restrict them severely.

NCUA has taken a strong stance against business lending. In its 1991 Annual Report, it referred to business lending as "speculative" and blamed most of the financial problems of credit unions upon an over-dependence on business loans. "Although less than 2 percent of all lending," the Report stated, "business lending accounted for 81 percent of insurance losses in 1991, almost twice the 1990 ratio. Although only 10 percent of federally insured credit unions make business loans, poorly reserved and problem credit unions hold a disproportionate share of business loans."[15]

What worried NCUA were some spectacular failures of credit unions in the late 1980s and early 1990s where there was evidence of reckless speculation in commercial ventures. The agency has not, however, presented evidence that business lending, properly carried out, is necessarily excessively risky. The President of the Credit Union National Association (CUNA), Ralph Swoboda, has criticized NCUA's position, questioning why a third automobile or a vacation is regarded by the regulators as a provident purpose, while capital for a small business is seen as speculative.[16]

NCUA's attitude on business loans runs into conflict with the basic purpose of at least some CDCUs. These credit unions view their principal impact upon their communities as being the encouragement of business and housing development for the benefit of low-income residents. While they offer personal loans in most cases, they tend to see those loans as making a shorter run, less permanent contribution to their communities. Among the CDCUs studied in Chapter 6, NEJA, Northeast Community, and Santa Cruz Community have a major commitment to business lending, and they are not alone.

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[13] Federal Register 56 (September 25, 1991). A definitional problem exists here. For several years, loans made for a business purpose were not classified by NCUA as "member business loans" if the sum of such loans to a single borrower did not exceed $25,000. In 1993, the cutoff was raised to $50,000. Therefore, the number of credit unions doing business lending, broadly conceived, and the proportion of business lending, is probably somewhat greater than these figures indicate.

[14] Credit Union National Association. *Operating Ratios and Spreads, Year-End 1991*, Table 3.

[15] National Credit Union Administration, 1991 Annual Report (Washington: 1992), 7.

[16] Speech at the annual meeting of the National Federation of Community Development Credit Unions (Chicago: May 8, 1992).

Member business loan regulations were first adopted by the NCUA board in 1987 and then tightened at the end of 1991. NCUA's intention at the beginning of 1991 was to impose even more restrictive rules, but an overwhelmingly negative response in the public comment period persuaded it to back off somewhat. The new regulations are lengthy and complex. The most constraining rule is that no one member may receive a business loan exceeding 15 percent of the credit union's reserves, or $75,000, whichever is greater. NCUA had originally intended to restrict total business lending of a credit union to 100 percent of reserves; while in the end it did not impose this rule, it did require credit unions with business loans exceeding reserves to report all business loans to the examiner in considerable detail.

The effect of the member business loan regulations can be seen in a credit union such as Santa Cruz Community which emphasizes business lending. The size of its reserves restrict it to a maximum business loan to any one member of about $100,000. This limit does not represent much of a problem in the case of start-up loans. The failure rate in start-ups is relatively high, and the credit union therefore prefers to begin with a fairly small loan that is well-protected by collateral. The problem arises with continuing loans to successful businesses. These loans tend to be safer because the businesses have a proven track record. But as they grow, the businesses have larger needs for capital, often exceeding the $100,000 limit. One of the most successful businesses started by Santa Cruz Community, a producer of natural fruit juices, wanted to continue to borrow from the credit union but needed more than $100,000. Since the credit union was prevented from making the loan, the business approached a local bank which was happy to provide the funds. In this case, it is hard to see how NCUA's member business loan regulation improved the financial condition of the credit union, protected its members, or promoted the safety and soundness of the Share Insurance Fund.

As in the case of non-member deposits, NCUA has identified a legitimate area of concern but has used the wrong tools to deal with it. There is no doubt that business lending can be risky. Some businesses fail and are unable to pay back their loans. But this does not mean that financial institutions in general turn their backs on business lending. On the contrary, banks and other institutions lend enormous sums to businesses. Rather than reject business lending, they learn how to do it prudently. They require business plans, they insist upon the personal experience and qualifications of the borrowers, they are careful to take liens on collateral that are adequate to protect the loans, and they compensate for risk by charging higher interest rates. Of course, credit unions should not stumble into business lending blindly, but if

they take these sorts of precautions there is every reason to think that they can be successful. The delinquency and default rates on business loans at NEJA, Northeast Community, and Santa Cruz Community are low, indicating that credit unions wanting to do business lending can be successful.

Rather than restrict the size of a member business loan so severely, NCUA would have been better advised to instruct its examiners to pay particular attention to the quality of business loans and to insist that the sorts of precautions noted above be taken. With this sort of policy, the agency could have helped CDCUs respond to the most pressing needs in their communities—the lack of employment and economic development—while also helping them to increase the safety of their assets.

One of the consequences of NCUA's restrictions on business lending by credit unions has been to increase the importance of another kind of lending institution in poor neighborhoods, community development loan funds. The loan funds accept below-market-rate, uninsured deposits from socially responsible investors, and in turn make loans for affordable housing and also for small businesses and non-profits. Because the deposits are not insured, the funds are not closely regulated by the government and few restrictions are placed on the lending. The principal restrictions are imposed by the loan funds themselves since they need to stay solvent.

Some CDCUs have developed working relationships with loan funds, or have even sponsored loan funds, as a way of doing business lending without falling under NCUA restrictions. The most successful example of this is the Center for Community Self-Help in North Carolina which sponsors two institutions, a credit union and a loan fund. The same staff operates both institutions and can decide easily whether to make a loan from the credit union or from the loan fund, depending upon whether it fits within NCUA's regulations.[17] In 1993, the Central Appalachian People's Federal Credit Union took control of the loan fund that had previously been its sponsor. And in Santa Cruz, the credit union sponsors a non-profit institution which accepts grants and in turn deposits those funds in the credit union to secure business loans made by the credit union. This procedure has a result that is similar to a community loan fund, since share-secured loans in a credit union are exempt from NCUA's member business regulations.

The community development loan funds represent a way to get around NCUA's restrictions on business lending and also its restrictions on non-

[17] The NCUA business loan regulations have proven to be so restrictive that, at least in early 1993, almost all the business lending was done through the loan fund. In the first four months of 1993, Self-Help made only $86,000 in member business loans through the credit union, while channeling $1.5 million in business loans through the loan fund, because of the restrictions on credit union lending. Private communication from Davis McGrady of Self-Help to Jeff Wells, May, 1993.

member deposits. It is not an optimal solution, however, since deposits in the loan funds are not insured. The absence of insurance places a burden on the depositors, and it results in less money being available for lending than would be the case if insurance were provided. The use of a loan fund makes community development lending completely dependent on loans from outsiders. Furthermore, most CDCUs neither sponsor nor have a working relationship with a loan fund. Consequently, the NCUA member business loan regulations impose serious burdens on poor communities.

A third way in which NCUA has stifled CDCU development is its policy on new charters. Table 7.1 shows the number of charters issued and cancelled, and total outstanding, for federal credit unions in selected years.[18]

Table 7.1

Federal Credit Unions, Selected Years, 1935-1992

Year	Charters Issued	Charters Canceled	Net Change	Total
1935	828	—	828	906
1940	666	76	590	3,855
1945	96	185	-89	3,959
1950	565	83	482	5,128
1955	777	188	589	8,175
1960	685	274	411	10,374
1965	584	270	324	11,978
1970	653	412	151	13,555
1975	373	334	39	13,011
1980	170	368	-198	12,802
1985	55	575	-520	10,247
1990	3	3410	-377	8,629
1991	14	291	-277	8,352
1992	33	341	-308	8,044

The table shows that new charters exceeded cancellations of charters, and the number of federal credit unions grew, until the 1970s. Thereafter, new charters fell dramatically, cancellations increased (although irregularly), and as a result the number of federal credit unions fell. Similar data are not available for state chartered credit unions, but in the period since 1980 the number of federally insured state credit unions fell slightly.[19]

[18] National Credit Union Administration, 1992 Annual Report (Washington: 1993), 30-31.
[19] Ibid., 33.

These figures do not imply that credit union activity fell; credit union members, assets, and loans continued to grow. But the number of credit unions fell as small credit unions were liquidated or merged with larger institutions.

It is difficult to assign responsibility for the decline in the number of credit unions, how much of it has been due to market forces and how much to regulation. To a large extent, the cause must be economies of scale as shown in Table 5.13, the fact that costs tend to increase less than proportionately when a credit union expands, with the result that large credit unions can offer services cheaper and more efficiently than small credit unions can. However, NCUA has done nothing to slow down the trend. At various times, NCUA spokespeople have said that they welcome the decline in the number of credit unions since it is not cost effective for the agency to devote resources to examining small credit unions. Their view has been that members can be as well or better served in large credit unions. Over the last decades the agency has frequently increased the barriers to groups seeking new charters.

This position may be defensible in the case of most mainstream credit unions serving a middle-class membership, although even here the decline in the number of credit unions means less member participation and less genuinely democratic control. It is not defensible, however, in the case of CDCUs serving low-income neighborhoods. Many CDCUs have disappeared, and their members have not been well served in the aftermath.

Chapter 4 discussed the reasons why CDCUs are needed. As banks pull out, many poor communities have no conventional financial institutions, and residents are forced into the hands of check cashers, liquor stores, pawnshops, and loan sharks. Even when bank branches are present, they tend not to lend very much in the local area, and therefore serve to funnel resources out of the community.

When a small mainstream credit union with a middle-class membership closes its doors, most of its members can find another credit union which they are eligible to join. In the case of mergers, the charter of the new credit union is explicitly changed to include the members of the closed institution. But in a poor neighborhood, when the CDCU closes, there is usually no other credit union nearby, and no credit union for which the members could qualify.

The question of whether large mainstream credit unions can operate effectively, and produce needed services, in poor communities is one which is unclear and in need of further research. Certainly there are obstacles. As Chapter 5 showed, CDCUs suffer higher loan losses and higher expenses than do mainstream credit unions, and they therefore charge somewhat

higher interest rates on their loans and offer lower dividend rates on savings. Under these circumstances, it is not necessarily to the advantage of a middle-class credit union to expand into a poor neighborhood. There may be sound economic reasons for the relative absence of large credit unions in poor areas. Therefore, the premise behind NCUA's view is faulty: When a CDCU closes, its members probably cannot be picked up by an existing credit union.

Even if they can join a larger credit union, that credit union may not provide the same level of services. Chapter 4 showed that branches of banks in poor areas typically accept deposits and provide other customer services, but they do not make very many loans. They find it more profitable and less risky to lend in middle-class communities. Consequently, they siphon funds away from the area. No studies exist on the question of whether mainstream credit unions with branches in poor neighborhoods operate in the same way as banks do, but until the case is proven otherwise, one ought to be suspicious. When a CDCU closes, its members might be able to find a new credit union, but one cannot be certain that the new credit union will be as predisposed to lend to them as the old CDCU was.

It follows that the NCUA policy of permitting and encouraging a decline in the number of small credit unions, including CDCUs, operates to the detriment of low-income people in a way quite different from the way it affects more affluent groups.

It is possible that NCUA is changing its policy on new charters. As Table 7.1 shows, new charters of federal credit unions almost disappeared in 1991, but they rebounded somewhat in 1992. The 33 new charters in 1992 included 7 CDCUs. Nevertheless, the number of liquidations continues to be high, and these include CDCUs. In May of 1992, the NCUA board met with the National Federation of CDCUs and heard its Executive Director, Clifford Rosenthal, propose a program of 10 new CDCU charters a year for three years, plus a temporary moratorium on CDCU liquidations. While the agency has not accepted the second part of the proposal, it may have been influenced by the first part.

New Federal Legislation

CDCU leaders argued for years that new federal legislation was needed if the promise of banking in poor communities was to reach its full potential. They prepared numerous position papers and draft bills and argued their case strenuously in Washington. In 1993, their persistence was rewarded when President Clinton proposed the Community Development Banking and Financial Institutions Act. While the exact terms of the legislation were

likely to change, the importance of the President's action was that it restored the federal government's initiative in the development of financial services for the poor.

The President came into office with a commitment to what he called "community development banking" as a strategy to improve living conditions and combat poverty in low-income areas of the country. In a series of speeches and interviews, both during the campaign and after taking office, he praised small, private-sector financial institutions that made credit available to poor people for housing and business development.

The inclusion of credit unions in the President's policy was a victory for the efforts of the National Federation of CDCUs. Although Clinton was aware of CDCUs—as a presidential candidate he had visited one in Texas—he did not talk much about them in his speeches on community development banking. Instead, he focused on two models of low-income financial institutions, the Grameen microenterprise lenders in Bangladesh and the South Shore Bank in Chicago (with, not incidentally, an affiliate in Arkansas).

The microenterprise lenders were described in Chapter 3. First developed in Bangladesh, they identify a group of people, typically five women, to form a "circle" for the purpose of planning small business ventures. The group picks one of its members to take the first small loan from the bank. When that loan is paid back, or partially paid back, the next woman can qualify for a loan to start her business, and so forth until all the members are engaged in new activities. The achievements of South Shore Bank were described in Chapter 4. Owned by an inter-racial group of civic minded activists and bankers, with considerable capital from foundations and churches, it exists for the twin purposes of making a profit and promoting community economic development. Over a twenty year period, it has brought sufficient capital into its neighborhood on the south side of Chicago and made enough mortgage loans to transform what was once a nearly destroyed area of the city into a thriving, lower-middle-class residential and business community.

Upon assuming office, the Clinton administration initially proposed that the federal government help establish 1,000 microenterprise lenders on the Grameen model and 100 development banks like South Shore. As the proposal was debated in Washington in the first few months of the administration, however, it was criticized from several different perspectives, and as a consequence changes were made in the program.

The first criticism came from the existing community development credit unions and loan funds, from institutions and people who already had a track record of providing financial services for economic development in poor areas. They objected to the exclusive focus of the program upon new

institutions, and argued that the government should reinforce successes that had already been achieved in the field. As early as 1985-86, the National Federation of CDCUs had developed a proposal for a public "National Neighborhood Banking Corporation" that would provide equity funding for CDCUs, and in 1991 the National Association of Community Development Loan Funds had joined the proposal as a cosponsor.[20] The two national organizations now argued that something like this neighborhood banking corporation should be incorporated into the President's proposal.

The second principal criticism came from people who thought that the focus on small, alternative financial institutions was counterproductive and harmful; the real emphasis should be on the large banks and thrifts, the institutions that controlled most of the country's money. Interestingly, this criticism came from both the right and the left of the political spectrum. From the right, Republicans argued that banks should be given incentives to encourage them to lend in low-income neighborhoods. From the left, organizations such as ACORN (Association of Community Organizations for Reform Now), argued for much tougher provisions and enforcement of the Community Reinvestment Act (CRA). Currently, they argued, CRA was toothless and ineffective; even banks that did little lending to low- and moderate-income people in their local communities received high ratings. The Act needed both amendment and tough enforcement in order to force the banks into a constructive relationship with central cities and other poor areas.

The criticism from the left represented a danger to the interests of the CDCUs and the loan funds. At their most extreme, the proponents of a tougher CRA seemed to argue that the very existence of small alternative lenders was harmful because it allowed the banks to back off from their responsibilities. The issue was brought into the open at a meeting of bank critics with the board of the National Federation of CDCUs in February of 1993.

The CDCUs' representatives responded to the bank critics that there was no necessary conflict between the two groups, and that if there were to be an open fight on the issue, the likelihood of defeat for both sides would be increased. There was no need to choose, they said, between a CDCU strategy and a strong CRA strategy. They are compatible and even mutually supportive. The argument seems persuasive. In fact, CDCUs have been among the strongest supporters of CRA enforcement in their cities. In numerous cases—for example at Austin/West Garfield FCU in Chicago and at the Lower East Side People's FCU in New York—credit union organizers have

[20] National Federation of Community Development Credit Unions, "The Neighborhood Banking Corporation."

used the leverage provided by the CRA to persuade, cajole, or even force banks that were in the neighborhood, or banks that were departing from the neighborhood, to make contributions to them. The contributions have included buildings, technical assistance, staff, deposits, and grants. But CDCUs and their spokespeople at the National Federation have been careful not to argue that banks could meet their CRA responsibilities solely by contributing to alternative financial institutions; the main responsibility of the banks, they maintain, is to lend. CDCUs have frequently protested the lax enforcement of CRA requirements, and have spoken out in favor of making the requirements more explicit.

In any case, the administration took account of some of these criticisms as it developed its policy for investment in low-income communities. In July, 1993, the President announced a two-part program, the first part dealing with public investment in community development financial institutions, and the second with the Community Reinvestment Act. He proposed $382 million over four years to be given to community financial institutions in the form of seed money and equity grants. Referring to CRA, he asked government regulators to draft a new set of rules that would reduce paperwork but tighten the standards for compliance.

The administration refused, therefore, to accept the argument that a conflict exists between encouraging small community lenders on the one hand, and requiring larger banks to do business in poverty areas on the other. It took the position that the two thrusts were compatible, that they were twin components of the same initiative.

Whether because government officials had studied the history of the OEO credit unions in the 1960s, or because they simply had good sense, they structured the new program to avoid some of the problems of the earlier period. As Chapter 3 showed, one of the mistakes made in the OEO period was that the government subsidized salary and other expenses, encouraging the credit unions to increase their expenses beyond a sustainable level. Then when the funding was cut off, the credit unions could not meet their budgets, and many failed. Under the terms of the new legislation, federal support will be in the form of grants, equity investments, deposits, loans, and shares, but not subsidies for expenses.

Equity grants will be of the most help to CDCUs. They will improve the financial condition of the credit unions by increasing their reserve ratios, and at the same time, under NCUA's member business loan regulations, will increase the size of business loans that can be made. But capital grants will not entice the credit unions into thinking that they can operate beyond their means. Describing the importance of this sort of funding, the National Fed-

eration of CDCUs wrote:

> *Our greatest need is for equity capital, i.e., reserves. For a number of years, low-income credit unions have been limited by NCUA in their ability to do community development lending (especially, housing and small business lending) because they are, by NCUA standards, insufficiently capitalized . . .*
>
> *We don't necessarily agree with NCUA's policies in this regard. But we do recognize for a fact that financial institutions with below-peer capital ratios will always encounter regulatory difficulties when they conduct lending perceived as 'high risk'—e.g., lending to low-income people, lending for small businesses, nonconforming mortgage lending. This kind of lending is absolutely essential to our mission as CDCUs.*
>
> *. . . It is extremely difficult for CDCUs to generate internally an 'adequate' level of capital (peer-level or higher) to carry on community development lending without intense regulatory scrutiny. There are several reasons for this. By nature, serving the poor is very labor-intensive and costly. Loan losses do tend to be higher than in non-CDCU credit unions. Also, CDCUs are often constrained from making the larger, more profitable loans (e.g., mortgage lending) either because of regulatory pressure or because of our asset size. To make a quantum leap in capacity, we believe CDCUs need an external infusion of capital.*[21]

The President's proposal was the most ambitious federal government initiative in the area of community development finance since the Depression. If successful, it will stabilize community development credit unions and other similar institutions, and promote their growth both in number and size, so that they will be capable of making a much greater impact on poor communities throughout the country. At the same time, the CDCUs will remain private sector cooperatives, still under the control of their members.

A Community Reinvestment Act for Credit Unions?

Closely related to the issue of whether the Community Reinvestment Act should be tightened for banks is the question of whether the CRA, or something like it, should be applied to the country's credit unions. At present it is not, and credit unions are therefore not required to show to a public agency that they are making a contribution to the needs of the poor

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[21] National Federation of Community Development Credit Unions. "Response of the National Federation of CDCUs to NAFCU's 'A 12-Point Plan for Community Development Credit Unions.' "

and other groups within their communities. Representative Henry Gonzalez of Texas, Chairman of the House Banking Committee, said in August, 1993, that the CRA should be expanded to include credit unions and also nonbank financial entities such as mortgage and insurance companies.[22]

Spokespeople of the mainstream credit union industry would prefer that the question not be raised. They have long argued that it would be inappropriate to apply the CRA to credit unions, since credit unions are constrained by their charters to lend only to people who have a common bond within their field of membership. Credit unions simply cannot be held to a standard that would require them to do business with people outside their charter. Credit union representatives also argue that CRA regulations are unnecessary for them since they are member-owned, non-profit cooperatives, and as such they voluntarily meet the most pressing needs of their members.

The credit unions' argument about not being allowed to do business outside their field of membership is valid, as far as it goes, but it ignores the fact that charters can be amended, and that fields of membership are in fact being expanded substantially. Many credit unions which began with a limited, well-defined field of membership have expanded that field so much that almost anyone who lives close to the credit union or one of its branches can find a way to qualify. In some cases, associational fields have been converted to geographical fields, meaning that absolutely everyone in a defined area is eligible to join. The expansion in the field of membership has gone together with other changes in credit union regulations and practices which have had the effect of making credit unions functionally much more like banks than they used to be. Since many credit unions operate like banks, the question arises with increasing force, why they should not be held to CRA standards, as banks are.

Similarly, with respect to the cooperative structure of mainstream credit unions, it is no longer clear that this ensures a socially responsible attitude on the part of credit union managers. As Chapter 3 showed, over time credit union members in the United States have become more affluent and comfortable, and credit union staffs have become larger and more professionalized. The sense of a "movement" that once pervaded credit unions has been converted gradually into one of an "industry."

Under these circumstances, it would seem appropriate for the government to require credit unions to show that they are providing financial services to the less fortunate within their fields of membership. Without new legislation, NCUA could impose something like CRA requirements on credit unions, in a tailored, individualized way. The broader and more inclusive the

[22] *Credit Union Newswatch* (August 30, 1993).

field of membership, the stronger the requirements should be. Credit unions which have charters that give them the opportunity to serve poor people would need to show to NCUA that they have made good faith efforts to do exactly that. Under such a standard, community development credit unions would be subject to CRA-type requirements, since most of them have geographic fields of membership that certainly include poor people. They would have no trouble demonstrating compliance. Difficulties might arise, however, for credit unions which have broad charters but which concentrate upon their more affluent potential members.

Recent research by *Credit Union Magazine*[23] shows that many credit unions have a great deal of opportunity to respond to the needs of poor people. Although the majority of credit union members in the country are reasonably well-off, a survey of 1,200 credit unions showed that 29 percent of member households had less than $20,000 annual income. Some credit unions have seized this opportunity, in some cases by developing programs that are designed specifically for low-income people. Some, for example, grant loans of very small amounts. But some credit unions do little or nothing to respond to the particular needs of their low-income members, and for these credit unions a little public accountability for their actions might go a long way.

The question becomes more pointed in the case of credit unions asking for expanded charters specifically in order to draw low-income communities into their fields of membership. In early 1993, the Governmental Affairs Committee of CUNA passed a resolution asking that NCUA facilitate such charter amendments. The Board of Directors of the National Federation of CDCUs responded rather negatively to the proposal, and scheduled a major panel on the issue several months later at its annual meeting. The lack of enthusiasm from the CDCUs is a reflection of their skepticism that large credit unions will operate in their communities in any way differently from the banks. As has been seen, banks in poor neighborhoods tend to provide a place for people to deposit their money, earn interest, cash checks, and buy money orders, but they are reluctant to lend money in the local community. CDCUs are particularly worried that large credit unions might squeeze them out of local communities and then refuse to supply the local people with adequate lending.

If NCUA is to permit mainstream credit unions to expand their charters into low-income neighborhoods, therefore, it should require performance standards of them that bear some relationship to the CRA. It is not enough for the credit unions simply to set up shop, accept deposits, and cash checks.

[23] Reported in *Credit Union Magazine* (May 3, 1993).

They should show that they can make loans in the neighborhood, even if this requires some adjustment in their normal underwriting policies. Otherwise they will just be a conduit drawing funds out of the area. They should show that they have assessed the financial needs of the area and are capable of making the appropriate contributions. Furthermore, in the spirit of a cooperative, they should show that they are drawing neighborhood people into the organization in positions of responsibility, on the staff, committees, and board of directors. Credit unions that expand into low-income areas in this manner would likely be welcomed enthusiastically by the local communities. They can bring both financial and technical resources that are needed. If their intent is to operate like typical banks, however, NCUA would be well-justified in denying their applications for charter expansion.

Policy at Other Levels

Not all policy that affects community development credit unions is formulated at the level of the federal government.[24] State and local governments have an influence, as do a multitude of private sector groups.

The principal influence that state governments have on CDCUs is through their authority to charter, examine, and regulate credit unions. Most states do not have a specialized regulatory agency that parallels NCUA, but rather embed their credit union oversight within a more general department or agency that regulates all types of businesses. In California, for example, state-chartered credit unions are supervised by the Department of Corporations. The states do, however, have separate laws providing for credit union charters. Many CDCUs have chosen a state rather than a federal charter for a variety of reasons, including the fact that personal associations have sometimes been closer with state officials than with federal ones. Typical is the Vermont Development Credit Union in Burlington, which chose a state charter in 1989 because some of the credit union's organizers had worked for years with people in the state government and trusted them. Even when credit unions have state charters, however, they must comply with most of the NCUA regulations because this is a condition of insuring their deposits with the National Credit Union Share Insurance Fund.

In recent years, most of the states have been no more active in chartering credit unions in general, and CDCUs in particular, than has NCUA. There is no reason, however, that states cannot follow and cooperate with President Clinton's community development banking initiative, reinforcing it on their own. They can actively solicit CDCU charters, and they can find ways of assisting them with infusions of capital to promote their stability if the fed-

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[24] Tholin and Pogge have a particularly strong section on policy towards CDCUs at the non-federal level.

eral funding is not sufficient.

State and local governments can contribute to community economic development by depositing funds in CDCUs. Public deposits throughout the country in private financial institutions are enormous, and a small portion of these funds directed towards CDCUs can make an important difference to the ability of those institutions to lend and to make ends meet. It must be recognized, however, that several barriers often stand in the way of this type of partnership. From the public side, state and local governments are often constrained by law, or by constitution or charter, to place their funds where they receive the highest possible rate of return. They are often not able to offer deposits to CDCUs at concessionary rates, and the high market rates they must hold out for are unattractive to the credit unions. The credit unions in turn may not wish to deal with large blocks of money that flow in and out quickly, as government deposits often do. Furthermore, they may not be able to accept the funds because of the NCUA limit on non-member deposits. Several examples exist, however, of public bodies making below-market-rate deposits in CDCUs, which in turn permit below-market-rate loans to members for economic development purposes.

Private as well as public sector bodies can make deposits in and grants to CDCUs. A large number of socially responsible investors want to place their funds where they will get a reasonable return and at the same time will contribute to human welfare and social change. Many churches find themselves in this position, as do some foundations, educational institutions, and even corporations. They can make deposits in individual CDCUs directly, or they can lend money to the National Federation of CDCUs which packages deposits to individual credit unions.

Finally, and importantly, is the role that the rest of the country's credit unions can play in nurturing the growth of CDCUs. Historically, a certain tension has frequently existed between CDCUs and their more established sisters. As explained in Chapter 3, however, that tension was dissipated, at least somewhat, in the early 1990s. At the national level, the National Federation of CDCUs joined the Credit Union National Association, for reasons of advantage to both groups. The Federation benefited by having access to the technical resources and financial support of CUNA; CUNA in turn benefited by being able to represent itself publicly as embracing those credit unions most committed to the welfare of poor people and to social change.

CDCUs have a testier relationship to the other principal trade association of credit unions, the National Association of Federal Credit Unions. NAFCU is an association of the largest federally chartered credit unions. As such it has had little to do with CDCUs, but in late 1992 and 1993 it began

promoting a 12-point program regarding CDCUs and community development banking. While some of the points were supportive of CDCUs (for example, point 10: "Urge the Clinton Administration to support CDCUs as the key to financial self-help and the cornerstone of community development initiatives"), others were hostile or self-serving. Point 1, for example, was hostile: "Urge the NCUA to conduct a study and issue a report on why CDCUs have failed in the past."[25] Number 6, among others, was self-serving: "Establish a mentor credit union program; mentor credit unions will receive credit towards their NCUA operating fee for active participation (fees could be derived from technical assistance funds.)" While leaving the door open for future discussion, the National Federation of CDCUs in effect responded that if this was NAFCU's idea of help, they could keep it to themselves.

The picture varies at the state level. A few states' credit union leagues (the trade associations of the credit unions, which are organized by state) have been very helpful to CDCUs, providing technical assistance and welcoming them into the credit union family. The CDCUs in some states report, however, that their leagues have been unhelpful, even hostile.

One of the main projects ahead of CUNA over the next decade, Operation Moonshot, has a goal of increasing the number of credit union members in the country from the existing level of a little over 60 million to 100 million. It is an ambitious goal, and it is unlikely to be achieved unless the credit unions can attract a substantial number of new members from low-income parts of the country. This may occur in part through the expansion of mainstream credit unions into central cities and other poverty areas, but as noted earlier, some obstacles lie in the way of such expansion. Middle-income people may not choose to join in a financial institution with the poor, since they would have to bear some of the burden of the higher loan default and expense ratios associated with banking among the poor. In turn, the low-income communities may not welcome the outside credit unions if those institutions do not demonstrate a commitment to lending in the area and supporting the local people in other ways. So at least in part, the success of

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[25] In its rejoinder, the National Federation of CDCUs noted:

> Certainly there have been failures among CDCUs. But it is not at all clear that failures among CDCUs have exceeded those of other credit unions. Since 1980, we have witnessed a sharp decline in the number of credit unions of all kinds. Among 'mainstream' credit unions, there have been large-scale failures resulting from fraud and insider dealing. There have been failures at the level of corporate credit unions. Moreover, there has been a steady 'upscaling' of the credit union industry, so that median credit union household income in fact exceeds the median for all US households. Yet, we have not called for a study of the 'failures' of the credit union industry at large, nor of the industry's failure to serve low-income people.

Op. cit., "Response of the National Federation of CDCUs."

Operation Moonshot will depend upon the success and growth of CDCUs, institutions nurtured within low-income communities and intended principally for the welfare of the poor. It is strongly in the interest of the credit union industry as a whole, therefore, to support CDCUs.

The possible types of support are almost endless and have only begun to be explored. While cooperation has become quite close at the national level, a great deal more remains to be done at the state level and at the level of individual credit unions. CDCU staff members are often in urgent need of training and technical assistance; these can be provided by state leagues or even by single, more-established credit unions that are located nearby. Leagues can develop marketing material for CDCUs, advocate for CDCUs with state governments, and encourage brother/sister credit union relationships. Large credit unions can place below-market-rate deposits in CDCUs.[26] A most encouraging example of this sort of cooperation occurred at the South Central People's Federal Credit Union in Los Angeles, chartered in 1993, where credit unions pledged $5 million in deposits even before the institution opened its doors to the public.

Conclusion

Whether consciously or not, the community development credit union movement is returning credit unions to the roots of cooperative banking. While rejecting the racism and other reactionary ideas that sometimes characterized the early German people's banks, they have breathed new life into some of the basic ideas of those institutions. Like the Schulze-Delitzsch and Raiffeisen societies, they have shown that disadvantaged people can band together to support each other, that they can attract resources from outside their communities, and that they can use funds for productive business investments that create jobs and provide people with an ownership stake in their own neighborhoods. Like the early American credit unions, they have shown that credit unions can make personal loans that help struggling, marginalized people get out of debt traps and claim more control over their lives. Like all of the early credit unions, the CDCUs rely on volunteer and low-paid work by people who are dedicated to a cause that is greater than themselves. While most American credit unions have moved away from these commitments as their memberships have become increasingly affluent, CDCUs have stayed true to their goal of trying to provide a way for low-income communities to revitalize their economic structures, and for low-income people to transform their lives.

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[26] Ideas such as these are explored in more detail in Tholin and Pogge.

As the middle years of the 1990s approach, a new sense of optimism is creeping at least slowly through the community development credit union movement. Five or ten years earlier, a disinterested observer could have been forgiven for wondering whether CDCUs were not an idea whose time had come and gone. Most of the OEO credit unions had failed, liquidations and mergers of low-income credit unions were proceeding regularly, surviving CDCUs were growing only slowly, they were burdened with serious financial problems, and few new CDCUs were appearing. CDCUs are a good idea in the abstract, such an observer might have concluded, but not one which is going to make much of a contribution to the resolution of America's great poverty problem.

Both questions and obstacles still remain, and much of this book has been concerned with documenting them in detail. But they are balanced by a renewed faith in the future. New CDCUs are appearing in somewhat larger numbers, and because of NCUA's increasingly rigorous chartering requirements, they are on the whole better prepared to conduct business successfully than their predecessors had been. Existing CDCUs are improving their balance sheets, increasing their memberships, and expanding into new areas such as business and mortgage lending. Non-member deposits in CDCUs are growing, as churches and foundations learn more about this way of contributing to human welfare. NCUA has taken a new interest in encouraging CDCUs. The Clinton administration has proposed a major initiative in community development banking which holds the promise of injecting significant capital into CDCUs. And the Credit Union National Association has forged a new partnership with the CDCU movement.

More important than all the national changes is the spirit of confidence in the individual community development credit unions. It cannot be documented or measured with precision, but it can be felt. Attendance at the annual meetings of the National Federation and at regional meetings has risen sharply; the people new to these meetings are just as committed as the old-timers, and often more enthusiastic. No one embodies the new spirit of the CDCU movement better than Mark Griffith, the 30-year-old organizer of Central Brooklyn Federal Credit Union, chartered in January 1993 in the African American Bedford Stuyvesant area of New York. Griffith is a poet as well as an activist. "People in the traditional banking community question our background," he says, "but I am convinced it has helped. We do not represent business as usual, and we bring a certain freshness....There is a new generational consciousness."[27]

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[27] Lueck.

Individual credit unions and the movement as a whole are sure to face setbacks in the years to come, but there is every reason to believe that the CDCUs will grow, that they will draw more people into the cooperative saving and lending process, and that they will make increasingly important contributions to their communities.

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is the first comprehensive study of the community development credit union (CDCU) movement in the United States. CDCUs are cooperative financial institutions that provide basic financial services in low-income communities throughout the country — in central cities and rural areas, on Native American reservations, and in racially segregated housing projects. At a time when the gap between rich and poor Americans is growing, when poverty rates are increasing and racial tensions are simmering, sometimes exploding, CDCUs are part of a strategy for change. *Thin Cats* documents the history, role, and accomplishments of CDCUs, providing an insider's view of why they are needed, how they operate, and suggestions for policies that can promote their growth and success.

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