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Statement of

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Mr. Chairman:

The urban crisis is as pressing a problem as any facing our nation. Financial institutions--whether existing or new--must play a major role in solving this problem. I welcome your Committee's decision to hold hearings on this critical topic and the opportunity of appearing today.

Financial institutions are the major source of investment funds. Yet they have barely touched poverty areas. A major characteristic of such areas is the minimum amount of new investment--whether in housing, plant and equipment, or public facilities. This lack of investment is reflected in a low standard of living. Jobs are short. Decent housing is lacking. Other facilities are poor. Any success your Committee can engender in making investments--whether in equities or debts in the inner cities--more possible would be reflected immediately in reduced poverty and a higher standard of living.

Public Policy to Aid Private Investment

Your Committee has asked a critical question. How can public policy aid the private sector in mobilizing its funds, its innovative ability, and its cost efficiency calculus, in order to get the job done? Clearly, inner cities have not proved an attractive investment area for private funds. Market forces even with public aid have not developed the institutional structure necessary to do the job. Since our enterprise system is exceedingly efficient in finding profitable outlets for its resources, something must be missing. You seek those methods by which public policy can aid in developing an institutional framework--with all the necessary rewards and penalties--that will shift the flow of funds into these vital areas.

Before proceeding to a more detailed analysis, let me state briefly my own views as to what paths appear most hopeful. These views probably owe more to my 20 years' experience as an urban economist than to my past three years on the Federal Reserve Board although both experiences are pertinent.

--- Public programs are necessary. There are logical reasons why private groups without government aid cannot solve the inner city problem.

--- Maximum use should be made of existing financial institutions. Greatest stress should be placed on activating the normal private economy to use its own techniques, methods, practices, and motivations.

--- Programs should not be limited to urban poverty areas. Rather they should be available, also, to those who want to leave such areas as well as in rural areas to keep migration down.

--- Specifically, the Government should develop a program of loan guarantees and subsidies. The programs should be at as wholesale a level as possible. The Government should avoid dealing at retail with individual loans. The programs should depend primarily on blanket guarantees such as those applicable to property improvement loans insured by the Federal Housing Administration under Title I of the National Housing Act and not on government agency analysis of individual loans such as carried out by the FHA under Title II of that Act. Aid, counseling, excess costs, and interest rates should all be eligible for subsidization.

--- While working mainly through existing institutions, the Government should welcome and utilize the wide variety of new institutions and firms being established by States and by groups of corporations, individuals, and localities. Rather than depending primarily upon governmental or non-profit institutions, the programs should utilize fully the profit motive. They should risk allowing seemingly high profits provided they are earned by high efficiency and productivity.

--- Consideration must also be given to the non-financial factors which lower the desirability of investment. The recently enacted special insurance programs and crime bills are examples of necessary improvements which must occur before private lending can expand rapidly.

Why Don't Existing Financial Institutions
Meet the Credit Needs of Inner Cities?

It is hard to accept the idea that certain credit demands cannot pay the free market price. However, the entire history of credit-short areas both urban and rural as well as our continuing attempts to deal with them show that such situations do exist. Because of high lending costs and low incomes, the amount of private credit made available falls far short of the amount of lending believed necessary on social grounds. A gap exists between community needs and the demand which private ability to pay can make economically effective. Any successful program to make additional funds available must recognize and bridge this gap.

High risks and high costs. The costs of making loans in the inner city are far above normal reflecting the abnormal risks and administrative charges involved. The factors which cause loans to have a high probability of loss are all highly concentrated in poverty areas. The lender must add charges to cover these costs to his usual rates if loans are to be made in substantial volume.

A considerable danger exists in these areas of a sharp fall in borrowers' incomes. These tend to be extremely volatile--"here today, gone tomorrow," and vice versa. Concern over the inner city recognizes the existence of marginal employment and low income. These in turn lead to a "last in, first out" job experience; sizable turnover; a lack of basic savings; and few more fortunate families or friends to borrow from. All these factors increase the risk of loan default.

A second major cause of loan defaults is sickness and family dissolutions. Again people who live in poverty areas are more prone to sickness and to the debilitating pathology of social and family disorganization. And, of course, they are less likely to possess the financial resources to deal adequately with these problems.

Financial inexperience is great. If credit is to flow into these areas, loans must be made to firms and individuals not used to borrowing in normal credit markets. Unfamiliarity with use of credit, lack of merchandising training, absence of records, and poor basic accounting ability raise costs per se. Firms are likely to be small and to trade in the lowest profit sections of the city. Such firms throughout the economy tend to be marginal with high turnover rates and large loss ratios. In the poverty areas, the usual poor experiences are multiplied.

The value of collateral based on property is less certain than in other areas. Again this is partly a vicious circle since property values fluctuate as a result of frequent financing difficulties.

In addition to high costs, there is a less-than-normal borrower's ability to pay even standard rates. This follows directly from the existence of poverty. Still worse, the high charges to cover risks and the existing poverty interact to create even greater probability of default. Asking a borrower in the poverty area to pay the costs of the additional risks reduces the likelihood that he can carry the burden successfully. This is a familiar cycle. Prices of goods and credit in the inner city are often extremely high. Yet profits, if anything, appear less than normal. The payment by families of a disproportionate share of their income to cover high costs increases their likelihood of default. This in turn raises costs still higher and lowers the sellers' or lenders' profits.

Institutional difficulties. Financial institutions have not been structured to deal with high-risk loans in the inner city. Part of the problem has been a lack of motivation. This can and is being changed. While there are reports of added funds flowing to these areas as a result of increased attention to this problem, it is extremely unlikely that such changes will serve to make adequate funds available. Why is this?

Private financial institutions are not usually prepared or able to accept high risks. They are primarily fiduciary institutions lending other people's money with a relatively low ratio of capital to risk assets. Their degree of risk exposure--whether by type of loan or area--is restricted by their capital. This has been a problem with some inner city banks. Experience has shown that aggressive neighborhood lending programs may lead to a high volume of sub-marginal loans. Loan policies large enough to have had only a minimal effect on their neighborhood problems have been sufficient to endanger such institutions' capital and at times depositors. Large city or State-wide banks could frequently accept an equivalent amount of risk, but they are unlikely to do so because it is unprofitable at the interest rates which can be charged. In contrast, the single institutions in poverty areas--without special protection--may find that they cannot even afford to invest the funds they themselves have collected from the area. For the area, they become a drain rather than a transfusion source for needed additional resources.

A further problem is the fear of social opprobrium or the risk of being considered usurious if a lender tries to cover his actual costs. While some still picture the hard-hearted mortgage lender twirling his moustaches as he forecloses on poor Nell, in actuality--as most of us are aware--most financial institutions act in completely the opposite manner. They avoid the image by avoiding whenever possible making loans that may lead to foreclosure, garnishment, or even seemingly hard collection efforts.

Most private financial institutions have more than an adequate demand for their funds in lower risk spheres. Potential battles and blackening of reputations can be avoided by refusing to make loans which carry a risk of future conflict with individuals or neighborhood groups. This is particularly true since the rate charged must cover the cost of money, of operations, and of risks. When stated as a rate of interest, such charges appear usurious and tend even without collection problems to be a source of conflict and loss of reputation.

Even if in times of easier credit institutions make such loans, this market is likely to have a low priority when money is harder to come by.

These factors are entirely aside from an institution's lack of expertise in lending in poverty areas. Institutions putting capital into the inner city must evaluate special risks, and they must spend more than a normal amount of time in counseling, advising, and explaining to borrowers both how to borrow and how to repay money. A different concept of estimating risks is required. The personnel factors and specialized handling leading to a successful loan may differ completely from those used in the organization's normal operations. In many cases efforts to develop these skills may not have been made simply through neglect. But many other institutions that have considered such efforts may have shied from them on economic grounds.

<u>External economies</u>. Another reason why private lending is limited in poverty areas is that no private firm can capture for its profit and loss statement the total economic and social gains which might arise from such loans. A problem of inadequate scale exists. Few private financial institutions can control a sufficiently large environment to profit from true externalities. An individual institution can profit only indirectly from potentially high social payoffs arising from enhanced individual and family welfare, lower municipal costs, higher land values, less crime and social disorganization.

Nor does any institution carry more than a minor burden of the community losses which arise if such loans are not made. The costs of poverty are borne by the economy as a whole and not by individual firms. Capital is fungible. It can flee from poverty areas.

A basic rationale for government intervention in markets exists when the net public costs of lending are less than the private costs, and the net social benefits exceed the private ones. This seems to be the case in this sphere.

Philanthropy. While the American tradition of philanthropy is renowned, I don't think it can solve the urban problem. Institutions do have a major stake in our country's future. They will suffer if the urban problem remains unsolved. The more intimate their relationship to the urban core because of location or prior investment, the greater their exposure. Nevertheless, depending on philanthropy alone is not enough.

The efficiency of business comes from its analysis of profits. A program based upon requests to institutions to take losses on what should be a major loan portfolio conflicts with our enterprise system. While an institution may be willing to make some charitable loans because of a recognition of self-interest in the solution of social problems, these will be insufficient for the needs. It is probably better if charitable contributions flow through normal channels rather than through lending policies.

There are also major disadvantages in asking the enlightened portion of society to bear an undue part of our total burden. Those who recognize a social problem should not be asked to pay a higher than normal percentage of the cost of solving it. National or local needs should be met by all. This is a major reason for governments.

Marginal improvements. Some institutional changes are occurring and are useful. They may be necessary for new programs to work. They should by themselves lead to some additional market loans. While improvements should occur, I don't think the results will be large enough to obviate the need for other public measures.

Financial institutions are in the process of recognizing how ill-prepared they have been to market their loans and render services in the ghettos. They are attempting to modify their lending practices. Many are seeking new ways of finding potential borrowers and of aiding the unskilled to improve their cost analysis so that prospects for repayments are enhanced. Additional services to inexperienced borrowers are necessary and are being developed.

If investments of a certain percentage of assets--say 2 or 5 per cent--in particular types of equities or riskier loans were authorized for all types of lenders, such actions might be hastened. The question of adequate charges and profitability would still be paramount, however, so the total results that can be expected from the new programs are probably slight.

Other possible inhibiting forces in making loans are the usury laws and the inability of some lenders to accept equity positions. When the Small Loan Act was passed, it was a great reform. It raised legal interest rates for legitimate lenders to allow the poor to borrow through other than illegal and truly usurious channels. Perhaps some such changes may again be needed to make other types of loans from major financial institutions more feasible.

Tax changes are always possible. However, subsidization through taxes is considered by many to be inefficient compared to direct assistance. It also has the great disadvantage that it primarily is useful for firms with taxable profits. Possibly, however, a careful comparison of subsidies made through taxes rather than directly would show increased efficiency for programs intended to obtain a wide diffusion of decision-making. Such programs as a result might accept what initially would appear to be theoretically less efficient methods than that of direct payments.

In one specific area, present tax laws may actually penalize institutions attempting to make more risky loans. Bad debt reserves are based on total experience rather than that with specific types of loans. Since poverty-area loans are much riskier than the average, an inability to sort them out and put aside larger reserves in advance for tax purposes may give them less than fair tax treatment.

While more liberal chartering of institutions has been suggested, such proposals do not attack the basic economic difficulties of making loans that will pay off. Since institutions with a high level of risky loans tend to have difficulties staying viable under present capital requirements, lowering such capital requirements would probably be a step backward. More institutions would be useful only if new chartering was part of a larger program that underwrote the risks and subsidized part of the costs including those necessary for a much broader type of service to borrowers of the new institutions.

The Example of the Housing Programs

The difficulties of increasing investment in problem areas of the city and of making loans to those attempting to leave their poverty status are so huge that unless all our knowledge and skills are used, progress will fall far short of needs. What is needed is a partnership between business and government. This Committee must seek methods which will properly structure the new relationships that are evolving. While statements praising and stressing such partnerships have become nearly platitudinous, the urgency of actually creating and perfecting adequate new techniques still remains. How can this Committee find the best possibilities? What sort of structure can the Government develop which so alters the basic market situation and potential profits and losses as to enlist to the maximum the skills, the flexibility, and the ability of the private sector to get things done?

In attempting to develop any new program, the record of the FHA and the public housing programs must be carefully examined. Congress is not entering the field of urban investment de novo. It has witnessed a long record of success and failure. The area of this experience--housing--will continue to require the largest share of urban funds. In nearly each of the past 20 years, the Government's housing programs have been the subject of Congressional debate and action. What institutional changes have resulted?

The continuing debate was sparked by the general dissatisfaction with these programs' achievements or rather lack of achievement in making investments possible in the inner city. The contrast between the FHA's suburban success and its near total flop in the center city has been a constant source of debate and dismay. As a result, the development of ideas of what is needed to make loans possible in the inner core has been nearly continuous. This year's Housing Act of 1968 (PL 90-448) breaks numerous new paths both in its approach to lending for housing, and also in broader spheres such as through the enactment of Title XII--the National Insurance Development Program. What lessons can be drawn from this prior experience?

The FHA has been most successful in four separate areas. It was able to establish new underwriting techniques to reduce prior incorrect risk estimates. It helped to change laws to make out-of-State lending more feasible. It made possible very low downpayments for inexpensive houses and longer amortization periods. It succeeded in using the Government's credit to reduce potential risks from economic disasters. In many cases, the real risks turned out to be so small that they could easily be paid for by the borrowers. This is one reason why the FHA has been supplanted in many local markets. It primarily remains a program for out-of-State lenders which face numerous other underwriting problems engendered when investments are made at a distance and for the lower price and low down-payment units.

By allowing sufficient profits, new institutions emerged to help develop, build, and finance housing. Some people claim that the FHA program created more millionaires than any other program in our history. Most observers believe that this was not bad public policy. The program has left us with a heritage of large suburban builders and developers; new mortgage lenders; FNMA; and a host of other institutions which succeeded in solving and are now holding under control our middle income suburban housing problem.

On the other hand, the FHA has had great difficulty in dealing with individual or out-of-the-ordinary cases. Loans based on new concepts, individual designs, central city land values, older buildings, all proved extremely difficult if not impossible to underwrite This arises because the FHA must of necessity use a fairly unskilled, mass-production, processing system. It can only indirectly and by fixed formulas estimate risks. The lack of progress and delays in inner city underwriting reflect both true complexities and also the problems facing a government agency when it attempts to consider each application on an individual basis.

The difficulty of inner city lending also, of course, has been increased by the inability of so many of the potential renters or buyers to pay the market price for inner city land or building construction. Also, because of possible falls in income, sickness, or other family problems, risks were high that these families could not meet payments as they came due.

As you are only too well aware, the FHA has been under constant pressure for administrative changes with the hope that such changes would lead to progress. The inability to obtain results through such pressure indicates at least to me the existence of basic underlying problems rather than administrative willfulness or lapses. The fact that this year's bill establishes many true structural changes in an attempt to speed up progress would appear to be a Congressional recognition of this fact.

The list of institutions altered in this bill is great. The bill authorizes a far wider program of subsidies to span the gap between income and market costs. It specifies FHA acceptance of additional risks with respect to properties, locations, and borrowers which the Congress previously considered unwise on a policy basis. It provides for direct aid in counseling poorer credit risks and seeks ways to insure the borrower against inability to meet payments. It allows for the development of new institutions for building, lending, owning, and renting. It authorizes the development of new property insurance procedures.

While it is still too early to say how successful these programs will be, I assume that they are based on a proper reading by Congress of the record of the type of changes needed to increase investment in the inner cities. Major difficulties of actually making the funds available, of implementation, of forging the new institutions, and particularly of blending private initiative and the profit motive with the Government's role still remain to be solved.

Future Legislation

If the prior analysis is correct, it seems clear that your Committee will be faced with the need to consider new programs and new legislation, particularly in the non-housing sphere. There will be institutional changes without your action. But they are unlikely to be either dramatic or sufficient. The problem is one of transferring possible loans which are now neither viable nor lendable into loans which both will work out successfully for the potential borrowers and at the same time make profits for the financial institutions who furnish the funds.

New institutions. A major question is whether new institutions are necessary or desirable and, if so, what form they should take. Proposals abound for new institutions at all levels--nationwide development banks; regional banks; local banks; and specialized lending and investing corporations. The forces which led to these suggestions should be carefully analyzed. Decisions are necessary as to their validity.

While many of the assumptions upon which they are based are implicit, they are usually rather obvious. A new organization--particularly if it has a glamorous aim--usually starts with drive and vigor. It focuses attention on a problem. It shows people are interested. On the other hand, it loses time, energy, and money in getting organized. It has to hire resources away from elsewhere. Skills are scarce. Why should successful ones leave existing organizations? It may go through many reorganizations. Typically, major accounting and record-keeping errors occur. There may be serious duplication with existing organizations and programs. Knowledge developed at great effort in existing organizations may have to be re-learned.

Another major assumption is that new institutions can raise money more easily. The costs of a new agency may not be obvious for a considerable period. They may run on borrowed money with a promise of future payments. Annual appropriations may not be necessary. While they pay more for funds than the Government, Federal agencies borrow at lower rates than private ones. Paying such higher rates from governmental funds may be considered worthwhile to avoid Congressional debates. On the whole, new organizations don't increase the funds available. Depending on what form of guarantees or subsidies are used, they mainly reshuffle existing funds.

New institutions may be given powers not available to existing ones. Examples would be: the right to make equity investments; the right to increase the ratio of risk to capital; tax exemptions; also subsidies for out-of-the-ordinary handling of more difficult lending cases. On the other hand, existing institutions could be granted similar powers.

Profits. A critical question which any new program must face is how to maintain private initiative, speed, and efficiency calculations while protecting the integrity of public funds. There is a trade-off in any joint governmental/private program between traditional government accounting and review procedures and the most complete use of private techniques and decision-making. How can government subsidies be kept out of the pockets of unscrupulous operators without suffocating the decision-makers in red tape?

Parenthetically, I would note that I have felt for most of these past 20 years that the Government, in its housing programs, has drawn the line too close to its traditional methods of operation. We would be far more advanced in our attack on slums if more firms could have received larger profits earned through greater efficiency. If programs in the inner core had allowed profits reflecting risks to the same degree as those in the suburbs, the resulting allocation of national funds and efforts would have been a better one for the national welfare.

Similarly, Congress' recent decision to allow lenders to charge competitive interest rates on FHA compared to other loans is clearly a plus factor. The ability to raise funds at less than market rates from institutions has necessarily been a limited one. Money is available on competitive terms. It disappears if competition cannot be met. This is also true in the hiring of managerial and entrepreneurial skills. Too many programs still require non-profit corporations. Those with the requisite skills are severely limited. In contrast, the supply of experts available in profit-making organizations is practically unlimited.

Loan guarantees. Among the many proposals advanced recently, careful attention should be paid to the concept of blanket loan insurance for loans of specified types made by any approved lenders. Under such proposals the Government would specify classes of borrowers and types and conditions of loans. It would also pre-certify lenders. It would not, however, attempt approval of individual loans. Guarantees to the lender would be available simply on the submission of a record of loans made.

Questions as to whether any charges should be made for such guarantees; the amount of the guarantee (90%, 95%, or 100%); and methods of spot-checking or auditing losses will also have to be decided. Partial, as opposed to complete, guarantees foster economic efficiency through better decision-making by lenders. Lenders will be willing to accept such risks, depending on rates they are allowed to earn, the lack of red tape, and potential government aid to the borrowers.

Subsidies. Congress will have to determine how far to expand the concept of direct subsidies to borrowers in and beyond the housing field. As this year's housing legislation recognized, there are at least two separate problems. One is the need to bridge the income gap between market interest rates and low incomes. The other is a payment for the high costs of loans which require advice, guidance, information and general consulting, high initial effort and larger than normal accounting and collection charges. The FHA record is probably pertinent to an estimate of the ability of a program to meet poverty-area needs without such specific subsidies.

Given such aids made available from the Government, consideration must be given to the availability of local financial institutions to make the loans. It would seem logical that most lending of the type required could be done through existing institutions. Banks, savings and loans, credit unions, all are available to meet programs that offer them normal profits. They have the requisite general management and lending skills and can tool up to meet these areas' specialized needs providing it does not have to be done on a charity or loss basis. The Small Business Administration and OEO are operating programs in this sphere. I assume their experience will indicate areas of success and failure and will also give an indication of the size of future programs needed to have a real impact.

At the same time, other experimental units are being established by States, local groups, and cooperating financial institutions. The need both for funds and for education in borrowing and using money is so great that the maximum degree of competition and experimentation among institutions should be welcomed. Again, the FHA experience may be pertinent. As the program developed, special mortgage banking institutions developed, initially specializing only in the government programs. These have since broadened their approach and many are now active in the entire market spectra.

In seeking new methods of channeling investment funds to poverty programs, consideration might be given to a program for simpler chartering of financial institutions which would initially be limited in their activities primarily to loans guaranteed under various government programs. With portfolios consisting mainly of guaranteed loans, ghetto banks or credit unions could run with a much higher than normal loan to capital ratio.

Adjustments of this type for guaranteed loans have traditionally been authorized by Congress for lending institutions.

To summarize, private investment in the inner city will take place in meaningful amounts only when it becomes profitable. It is not profitable now because it is too risky and too costly and because both lenders and potential borrowers lack the necessary skills. Federal programs are needed to reduce the risks through guarantees, and to pay part of the costs through subsidies. How successful the newly developed programs will be must be carefully measured. I would expect from prior experience a long learning process requiring constant legislative aid. Existing financial markets have demonstrated remarkable efficiency in seeking out profitable investments. They can be expected to respond to new incentives if they are provided on terms and conditions that allow latitude to investors in furnishing services and cutting costs.

Clearly, however, your task--and the task facing all of us--in developing an institutional structure which can channel funds into necessary and desirable investments is not simple. Any problem which has defied solution for over 100 years--and that is true of our cities' poverty areas--won't suddenly succumb to yet another try. Still each new effort does move us closer to our ultimate goal. Progress is being made. The task we all must share is to further its momentum.