For release on delivery
Expected about 10 a.m. EDT

Statement by

Nancy H. Teeters, Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

House Committee on Banking, Finance, and Urban Affairs

House of Representatives

May 29, 1980

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I appreciate this opportunity to present the views of the Board of Governors concerning steps that might be taken to help meet "the credit needs of inner-city minority communities". The Board commends the Subcommittee's efforts to develop means for encouraging an increased flow of credit to minority communities, but believes that use of the Federal Reserve discount window is not an appropriate device to accomplish this purpose. Among the alternatives that are available for promoting the Subcommittee's objectives are various proposals to establish special purpose development banks. A more modest but highly effective program with which the Board is especially familiar is the work of the Neighborhood Reinvestment Corporation. The Board recommends that consideration be given to expanding this latter program and through it the activities of local Neighborhood Housing Services corporations and Neighborhood Housing Services of America.

Before turning to a discussion of such proposals, however, I would first like to explain why use of the discount window is not an effective instrument for helping to meet the credit needs of inner-city minority communities. In your letter requesting the Board to testify, you alluded to the fact that the temporary seasonal credit program introduced by the Federal Reserve in April has not been helpful to such communities. This result is not surprising since the special credit program was designed for a different purpose.

As spring approached, the Board had been receiving reports that borrowers in some smaller communities were facing an especially severe financial bind because the local banks on which they depended for short-term credit were fully loaned-up. Since farm communities, in particular, were then moving into the part of the year when their seasonal credit needs were largest, there was some risk that lack of financing would curtail planting and subsequently aggravate the inflation of food prices. Although bankers'

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

concerns about loan risk were probably more responsible for their reluctance to meet loan demands than an exhaustion of fund availability, the Federal Reserve introduced the temporary seasonal program to make sure that smaller banks with high loan deposit ratios would have access to loanable funds if they needed them.

Banks serving inner-city communities do not generally fit the specifications of this temporary seasonal program. In particular, the average term of inner-city credit needs is usually a good deal longer than the 6 month maximum maturity allowed under the program. In addition, the primary banking outlets for inner-city areas are branches of banks that are larger than those eligible for the special program. Finally, even the smaller inner-city banks that do meet the size test for the program fall short on the loan-deposit ratio test because they face less pressing loan demands.

Looking to the future, the Federal Reserve has not yet completed its plans for administering the discount window after July 1 under the broader lending requirements of the new depository institutions act. While a program for providing seasonal credit will undoubtedly be continued, it is not likely that any practicable program of this type would be especially helpful to banks in inner-city communities, since it would need to be pegged to a fairly significant regular seasonal pattern of need for funds.

Looking beyond the question of temporary needs for funds, your letter also states that "ways must be found to assure that the continuing credit needs of minority communities are met." You do not indicate whether, or in what way, you believe the Federal Reserve discount window might help

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to meet such needs. But others have been less reticent in recommending Federal Reserve action. They have urged the Fed to lend to private financial institutions at below-market interest rates. Under this prescription funds provided by the Fed would then be relent to eligible inner-city borrowers--also at less than full market rates, but with an appropriate add-on to cover the private lender's servicing costs and loan risk. Over the years we have had many similar requests from other groups at times of cyclically high interest rates. For example, in the current year alone we have been approached with earnest requests of this type from highly vocal groups representing--in addition to those concerned about inner-city housing needs--groups urging Fed lending at subsidized rates to farmers, homebuilders, other small businesses, and businesses seeking funds for capital expansion.

The Federal Reserve has consistently opposed use of its discount window to provide government credit to special groups at subsidized interest rates. If this approach were adopted, the demand for subsidized Fed credit could be expected to mushroom dramatically. Unfortunately, the resulting heavy expansion of borrowing from the discount window would risk serious interference with the basic ability of the Federal Reserve to manage monetary policy and thus could prove to be highly inflationary. Moreover, the Fed would be drawn into the highly politicized process of allocating subsidized credit among competing interest groups. Choices of this type clearly should be the function of Congress working through the regular Federal budget process, and should not be delegated, through what would amount to a back-door deficit financing arrangement, to an appointive body like the Federal Reserve.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In contrast to credits advanced by other federal lending agencies, funds released to the economy through the Federal Reserve discount window are high-powered dollars. They add directly to the reserves of the banking system and provide the base for a multiple expansion of the supply of money and credit in the economy. Also, the initiative in deciding how many of these high-powered dollars are released through the discount window rests essentially with the borrowers, not with the Fed.

In the past the Fed generally has been able to use open-market sales to counter any unwanted fluctuations in the supply of bank reserves that developed from the demands of member bank borrowers at the discount window. But this success has reflected the rather stringent rules that now govern borrowing at the window. Generally, these rules require the borrower to repay the Fed within a short period. For large commercial banks, borrowings from the Fed typically run for only one day. While smaller banks may borrow for longer periods--particularly under the seasonal credit program--they too generally make repayments relatively quickly. As a result, both the size and volatility of reserves released to the banking system through the discount window have been kept within manageable bounds. Any program of long-term Fed lending at below-market rates, would risk a serious erosion in this ability to control the volume of bank reserves being released through the discount window. To the extent this happened, there would be an equally serious erosion in the Federal Reserve's capacity to work effectively against inflation.

Moreover, because of the fungibility of money, it would be virtually impossible for the Federal Reserve to monitor the subsidized funds provided

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

through the discount window to assure that they were being used to finance the social purpose for which they were intended. Any serious efforts to try to monitor such lending would require a substantial staff for surveillance and would create a heavy bureaucratic burden on both the conduit lenders and the ultimate credit users. Finally, the Federal Reserve does not now have the statutory leeway to establish a preferred discount rate below the basic rate. The Board, therefore, believes that it would be a mistake for it to mix responsibility for what might become a potentially diverse and sometimes conflicting array of special discount window programs with the broader and overriding Fed responsibility for the conduct of monetary policy.

Of course, a wide variety of federal and state government tax incentive and direct subsidy programs already exist that are designed expressly to allocate credit to high priority social purposes. Since these programs have expanded sharply over the years, they tend to exert pressure on scarce resources. Fortunately, in view of the longer-run need to bring U. S. inflation under better control, the new federal credit budget became operative in the current fiscal year. For the first time, it now sets a limit on total credit extended through federal programs and thus establishes the need to allocate scarce credit among alternative uses.

Within this allocation framework, it may now become more difficult to establish new lending programs for such things as urban development, since this may involve trimming an older more established program to make way for the new. Nevertheless, since the need for overall control of credit programs is clear, it is now simply more necessary to make clear that financing of urban development should have a high priority.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The nation's experience with various attempts to promote urban development, and more specifically, to reverse neighborhood decline indicates that neighborhood revitalization is indeed a complex problem. To be successful,a cornerstone of any such effort must clearly be the provision of a stable source of preferably low cost, long-term funds. In addition to those now pending in the Congress numerous proposals have been made in the past to create an urban or community development bank. The Board feels that these proposals merit special consideration. In addition, it would be willing to lend its expertise, if needed, to support the planning for such a facility, similar to the support for minority banks now being provided under the Minority Bank Development Program in conjunction with the FDIC, the OCC, and the Commerce Department. However, in addition to the ready availability of funds, experience indicates that successful community development efforts can be effective only with coordination, involvement and commitment of both time and resources by local residents, local governments, financial institutions and businesses. Such efforts require the identification of potentially viable programs and projects tailored to meet local needs. Special expertise and knowledge are needed to manage programs and projects to ensure their successful completion. Finally, continual monitoring of these programs is required to guarantee that the objectives are met.

For the past few years Board members have served on the Board of Directors of the Neighborhood Reinvestment Corporation (NRC) and its predecessor, the Urban Reinvestment Task Force. Our experience with this Corporation's activities and the local Neighborhood House Services (NHS) corporations it develops and assists suggest that they show considerable promise as tools to foster community reinvestment.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

One of Neighborhood Reinvestment's most successful activities to date has been to aid the formation of local NHS's which have embarked upon numerous activities to revitalize and refurbish intercity housing. At the heart of each NHS corporation are four key elements that have been pulled together, usually through the initial educational efforts of Neighborhood Reinvestment. These include a core of local residents willing and able to provide the leadership in forming the local NHS corporation; a responsive local government willing to play a role in the NHS activities; a group of financial institutions wishing to participate in supporting the NHS operating budget; and a revolving loan fund administered by the local NHS that is designed to help meet the credit needs of nonbankable NHS clients. Each NHS is run as a nonprofit corporation with a professionally trained staff experienced in running community development projects. They answer to the coalition of local residents, local governmental officials and lenders who sit on the board and participate in the oversight of the NHS's.

Neighborhood Reinvestment's NHS programs have been unique in that rather than relying on federal outlays to provide the bulk of the funds for reinvestment, they have secured most of the funds for reinvestment from private financial institutions, local governments and other sources. In this way, Neighborhood Reinvestment has been able to leverage substantially the federal outlays that have been used to get NRC programs started. Over the first 5 years Neighborhood Reinvestment's predecessor, the Urban Reinvestment Task Force, for example, with $19 million in appropriated federal funds

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

produced an estimated $32 million in support of local NHS activity and an excess of $119 million in private reinvestment. Many of the newer projects promise reinvestment leverage ratios substantially higher than this. Admittedly, the total reinvestment generated by Neighborhood Reinvestment activities to date is modest, but this reflects the early demonstration scale and the results of the pilot projects. Once many of the pilot projects enter the replication phase across other communities, it is expected that total reinvestment will accelerate substantially. To date, the Neighborhood Reinvestment Corporation has developed and assisted programs in more than 90 cities serving more than 112 neighborhoods.

Although formed under the auspices of the Neighborhood Reinvestment Corporation, local NHS corporations are not primarily financed by federal funds. They rely on local contributions and grants for their operating funds and for their revolving loan funds. This private support, along with the active involvement of lenders and neighborhood residents on the NHS boards, is the source of the programs' vitality. The local programs are assisted in obtaining financial institution involvement by the federal financial regulatory agencies. For instance, Federal Reserve Bank Presidents help convene the commercial banks in each new NHS development and encourage their participation in the program. They also assist operating NHS programs by convening bankers to hear annual progress reports and to encourage them to continue their annual contributions to the NHS operating budget. During coming months, the Board along with other federal financial regulators will continue their support through this period of economic uncertainty to ensure that the programs' neighborhood activities are not diminished just at the time of greatest need.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Recent high interest rates have placed growing pressure on the NHS revolving loan funds which serve "unbankable" homeowners. Neighborhood Housing Services of America operates a small secondary market for the NHS revolving loan funds. Grants for initial capitalization and interest subsidies provided by the Neighborhood Reinvestment Corporation are leveraged more than 2-1/2 times in sales to institutional investors of notes collateralized by NHS loans. Exploration of enhancing this secondary market would be particularly worthy of congressional attention.

Another critical area worthy of support is the training activity of Neighborhood Housing Services of America. It seeks, in conjunction with Neighborhood Reinvestment, to identify, recruit and train management to operate NHS's. As with any successful program competent management is always the key. To foster rapid expansion of NHS projects it is necessary to provide an ever increasing pool of qualified people to ensure success. For this reason, high priority should be given to supporting this function.

The Board expects in the wake of passage of the Community Reinvestment Act (CRA) that many more financial institutions will be participating in NHS and other Neighborhood Reinvestment Corporation projects. Certainly, expanded participation in these projects will be viewed favorably by the Board when assessing a bank's CRA performance. Furthermore, participation will be encouraged by our bank examiners when they perform their CRA examinations, since the CRA emphasizes that institutions are to make funds available to their local communities, consistent with safe and sound banking practices. NHS programs, to the extent that they employ revolving loan pools to make the nonbankable loans to reduce the risks to financial institutions

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

by engaging in tandem financing, are especially consistent with the objectives of the CRA. For this reason the Board believes that substantial untapped potential remains for additional leverage of federal funds to provide for further community reinvestment.

In summary, in addition to giving close consideration to the proposals to establish special purpose development banks, the Board would encourage continued support of the Neighborhood Reinvestment Corporation and consideration of methods to expand the availability of appropriated funds to support its development and assistance to local NHS's. Aid should also be provided to support expansion of the local and national revolving loan pools and secondary market activities as particularly effective ways to promote community development. This policy offers several advantages. The Neighborhood Reinvestment programs encourage private sector involvement of financial institutions to make the bankable loans rather than relying on straight federal subsidies. The programs provide for substantial leverage of federal funds as distinct from purely inflationary federal subsidies. The programs are easily targeted to specific projects and areas with the greatest need and prospects for success. The programs are carefully monitored. They typically involve projects that provide minimum displacement of local residents. Finally, because of the structure of the programs, they permit a cost-benefit assessment that is not possible with indirect subsidy programs such as those that might potentially be implemented by providing special access to the discount window.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis