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Community Lending and Economic Development

by Jerry L. Jordan

In a recent speech at the Federal Reserve Bank of Cleveland's Community Reinvestment Forum in Columbus, Ohio, President Jerry L. Jordan urged lenders to reconsider the problems associated with improving credit access in America's inner cities. According to Jordan, although eliminating lending discrimination clearly deserves a high priority among banking regulators, minority communities also stand to benefit tremendously from public policies that recognize solutions predicated on economic development. The following is excerpted from his remarks.

Improving access to credit by minority and low-income communities represents a serious challenge to lenders, community residents, and government officials. Hardly a day goes by without a story in a major newspaper or in a trade publication dealing with some aspect of this issue. My own view is that most discussions about community investment and lending discrimination ignore some fundamental lessons from economic theory and practical experience.

One of the most pressing problems we face in the United States is the disgraceful condition of our minority neighborhoods. The solution to this problem is economic development, an indispensable component of which is an effective banking system. I think that if we can bring ourselves to consider the problem and its solution from this perspective, we will have a much better framework for productive action than is often found in the community lending process today.

■ Lessons from Developing Countries

The deplorable condition of a lot of our neighborhoods in major cities across this country is clear evidence that something is terribly wrong. I have even heard some foreign visitors characterize the situation as if we have a third-world nation existing within our own borders. So it is useful, I think, to reflect on what we have learned from developing countries about the role of credit and economic development. When I consider this process, I am impressed by how imperative it is for people to have an intuitive grasp of the operation of a market economy, and by how often that foundation is lacking.

I truly believe that in the United States, part of our underlying problem is that too few people have an adequate understanding of how to use our financial system, how to budget, how to plan, or how to save. In my view, the whole idea of asset accumulation in preparing for the future—of having a time horizon in one's life as well as in one's financial affairs—turns out to be an important component to the solution we are all seeking.

Elsewhere in the world, there is even less general understanding about the operations of a financial economy. Recently, I had the opportunity to sit down with several people from the Eastern Bloc countries of Europe. Not surprisingly, they want the same things that most consumers in the United States seek: car loans, mortgage loans, and other forms of household credit. These people clearly recognize what we call the *asset side* of a banker's balance sheet, but I have learned that a crucial aspect of our accounting system is alien to them.

When I was in Bratislava, a city in what is now the Slovak Republic, my host pulled me aside. "I've got one question, something I've never understood," he said. "How do checks work?"

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It always puzzled him that people could write an amount on a piece of paper, sign their name to it, and give it to another party as payment for a good or service. I tried to explain the system to him, but I soon realized that he did not understand the mechanics of double-entry bookkeeping.

He, like most others in these developing economies, had no concept of debits and credits. Not ever having been exposed to a financial economy that uses credit, he could not get over that hurdle of understanding the way checking accounts operate. His economic transactions had been restricted to currency. Interestingly, people in these developing countries are suddenly being faced with learning how to function in market-oriented economies that now include the possibility of credit. The adjustments are not easily made, as it turns out, because of the links between assets and liabilities. Just as we shouldn't take for granted that credit flows will occur smoothly in these countries, neither should we assume that residents of our own cities will understand what it takes to make credit function in their local economies.

■ Banking Relationships

It's often said that what residents of the depressed inner cities need more than anything else is credit—home loans and small business loans. Of course they do. However, that is an incomplete analysis of the situation. It would be a serious mistake to think that inner-city neighborhoods would be quickly transformed through legislation requiring lenders to extend credit *into* those communities if they are not *a part of* those communities. As a nation, we saw in the 1970s and the 1980s that long-distance lending to less-developed places (especially in the case of Latin America and Poland) simply does not work for the most part. Treating our inner-city neighborhoods as if they are some far-off, third-world country that we are going to lend into will not work. Credit extensions in the absence of the conditions necessary to generate the income to service such debt generally tend to end in disaster.

Instead, it is essential that the individuals living in, and conducting business in, a community have a long-term stake in that community. Centuries-old experience has shown that it makes sense for people predominantly to own their homes, and public policy in this country has promoted home ownership for a long time. Communities, in turn, have recognized the importance of attracting and nourishing their own businesses. It seems to me that the success of these endeavors depends importantly on the strength of banking relationships in our nation's communities as well.

Here is where the concept of double-entry bookkeeping comes into play. Banking relationships require communities as a whole to be both depositors and borrowers. In fact, the relationship actually requires saving to *precede* borrowing. A discouraging aspect of financial service provision in many inner-city neighborhoods is the striking number of people who don't have any connection to a bank whatsoever. Instead, many of them turn to money changers for the various financial services they need. Although these companies are clearly providing a valuable service, if people have little reason to be in a bank at all, and make no use of banks for conducting transactions or for accumulating financial assets, then the idea that we are going to make borrowers out of them is not quite starting at the right place. For potential borrowers to appreciate how the banking system operates, banks must have a presence. Above anything else, banking offices have to be friendly, familiar members of the community.

The situation is the same in Brooklyn or in Bratislava. A bank is simply an intermediary. It's an institution that connects the ultimate savers with the ultimate borrowers—and both parties are important. Just as a bank has to pay attention to both sides of its balance sheet, I think that businesses and households must be participants on both sides of the bank's balance sheet, which means that people have to be depositors in order to be good borrowers.

Without the benefit of understanding what it really means for an intermediary to use a double-entry balance sheet, people who want to obtain credit or pay by check are going to form the wrong view about what it takes to be a good borrower—that is, what it means to have a bankable loan. Across the financial spectrum, what individuals really want is more ability to consume, now and in the future. They seek to hold onto whatever wealth they already have and to be able to accumulate more. They also would like to understand what's involved in wealth accumulation. They want to build equity in their homes and in their businesses. At the root of it all, they want to give their children a better start than they had.

■ Two Mistakes

We can learn some important lessons by looking at lending to less-developed countries—to Eastern Europe, to the former Soviet republics—that are now trying to create banking institutions and encourage market growth. In these countries (and sometimes in our own) politicians often make a couple of elementary mistakes. One is that when people say, "We need more money," politicians say, "Well, that's easy, we'll have the central bank print some more. Now, what else do you need?" That reaction, of course, is a disaster. Look at the inflation and attendant problems that are taking place in Russia today. One recent news account stated that the problem with the central bank in Russia is that there are no central bankers working there.

The other mistake that is often made is more sophisticated. Sometimes politicians recognize the fallacy of printing too much money—they understand that when inflation takes off, the country is not better off. Instead, politicians are implored to make use of someone else's savings through legislation, giving one group access to what others have accumulated. That, too, ends in disaster when the extension of credit does not result in the generation of greater income. Just as a bank's assets must equal its liabilities, a society can support investment only up to the amount of savings it can generate and attract.

Savings depend on people's expectations of a better tomorrow, which in turn depend on a host of cultural and political factors. But, to collect the savings and deploy them safely, effectively, and efficiently, there must be banks. The history of global economic development has made it abundantly clear that the pace of progress depends crucially on the efficiency of the banking system.

■ Local Solutions

Federal law requires depository financial institutions and, indirectly, their supervisors, to actively promote equal credit availability in the nation's housing markets. None of us can simply step aside and declare that this is not our problem. But there are choices available in searching for solutions.

It has become fashionable in this aspect of social policy to concentrate exclusively on finding and eliminating discrimination in lending at financial institutions. Enforcement of applicable laws and regulations is important. I am convinced, however, that Federal Reserve Banks can also contribute by demonstrating strong leadership in our respective cities across this country. We can develop working relationships with the entire housing industry in trying to solve the problem. These efforts may not garner quick and sensational newspaper headlines, but they can go a long way toward bringing understanding and results to this urgent national issue.

It is often said that if you are not part of the solution, you are part of the problem. I've been in my present job for nearly two years now, and it certainly does not appear to me that the Federal Reserve Banks have traditionally been accepted by all of the participants as part of the solution. I don't like thinking of myself as being part of any problem, and certainly not this one.

I make the same argument to commercial bankers. If a part of the market area served includes these shamefully depressed neighborhoods, then bankers have no choice but to become part of the solution. These are unacceptable conditions to all of us, either as individuals or as businesspeople. We acknowledge that the fundamental problems are national in scope and that we need to "think globally"—to borrow from environmentalists—but when we start seeking solutions, we need to "act locally." Naturally, there are bound to be some common elements in whatever solutions are found to reverse the dismal economic conditions in our inner cities. But what is *not* called for is some sort of national cookie-cutter program designed in Washington that is supposed to be implemented from Toledo to Tucson.

There is a strong message in my remarks for bankers. For banks to obtain "bankable loans" from all segments of their markets, they must have a broad presence in those markets. For credit to be available to people in a community, lenders have to understand the needs and economic circumstances of that community. Not only can lenders better assess the creditworthiness of their borrowers when their saving habits are transparent, but the borrowers themselves are arguably more responsible about repayment when they have also established a track record for managing their own finances.

Counseling individuals about the basics of household or small business finance is one of the most valuable activities that lenders could sponsor. How to budget, how to plan, how to save; the whole idea of accumulation in preparing for the future; having a time horizon in one's life as well as in one's financial affairs—all of these are very important, maybe *more* important than how to fill out a loan application. If potential borrowers do not understand what happens on both sides of the bank's balance sheet, they will not grasp why it is so critical for them and others in the community to be successful depositors.

■ Strong Banks

We're blessed here, in the Fourth Federal Reserve District, to have some of the best banks in the country. Our District includes all of the state of Ohio, the western third of Pennsylvania, the northern panhandle of West Virginia, and the eastern half of Kentucky. Commercial banks in this part of the country, whether in the small communities or in our major cities, are really extraordinary. Levels of capitalization, returns on assets, returns on equity, loan loss reserves—all of the ways we measure banking performance—are the best in the country and maybe among the very best in the world.

Currently, the earnings of the banking companies headquartered in the Fourth District are the strongest in the nation, and their aggregate market capital ranks second. What we need to do is make sure this strong banking presence not only supports our region—and I do think it is a big asset to our regional economy—but also benefits the minority communities in our cities.

Banks clearly must be a part of the solution, but they cannot be the entire solution. If they are not joined by other participants in the economic redevelopment of our cities, they would be wasting their stockholders' and depositors' funds, and perhaps even taxpayers' money. I think that a successful transformation of depressed neighborhoods requires more than criticism of the banking industry, and more than banking legislation or regulation. Unfortunately, some of our national leaders seem to think banks can solve these fundamental problems by themselves. One congressman recently was asked why he advocated some of the banking regulation that he does, and he said, "This is a way of doing good without it costing anything." That attitude not only is naive and wrong, but it's dangerous to allow to prevail.

■ Conclusion

We don't need research studies to tell us that we have a problem with minority and low-income lending, though studies may eventually prove to be helpful in understanding how the various parts of the housing market operate to yield the results we so desperately seek. The upsetting condition of many minority neighborhoods is something we cannot ignore; we cannot accept it, and we all need to address it. It is simply too systematic across the whole country to be an accident. We must start working *now* to attack this problem, and we are going to need a lot of energy to do so.

Two things are certain. One is that eliminating bias in lending to minorities will not solve all of the problems in minority neighborhoods. At the same time, failure to produce an environment where there is equal access to credit would inhibit, if not totally frustrate, all of the other efforts that will be necessary to improve living conditions for all citizens.

As we join forces to press for change, however, let's not forget what we have recognized about the situations in Asia, Africa, Latin America, and the former Soviet republics. For nations in those regions to consume more, resources have to be organized so that their citizens can produce more. What's true for a country is also true for a state, a city, or even a neighborhood. To foster more production, there must be capital formation. Investment is needed in both physical and human capital. To encourage investment, we must have savings. And, to the point of my observations today, to collect the savings and deploy them safely, efficiently, and effectively, there must be banks.

Although banks have a necessary role in economic development and redevelopment in the neighborhoods, they must be joined by nonbank businesses, by political authorities, by regulators, by educators, as well as—very importantly—by neighborhood and community leaders.

Federal Reserve Banks, with head offices and branches across the country, have a natural capacity to facilitate a dialogue among diverse groups in metropolitan areas, to get them working together at the local level to formulate actions, not just plans or proposals or ideas. We are fortunate in our District to have a number of banks that are deeply involved with others in their communities in trying to make a difference. We have been learning from them, and we intend to become more centrally involved in the process of fostering these kinds of working partnerships.

Jerry L. Jordan is president and chief executive officer of the Federal Reserve Bank of Cleveland. The text of this Economic Commentary *was excerpted from a speech that President Jordan presented at the Bank's Community Reinvestment Forum in Columbus, Ohio, on September 23, 1993.*

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