Wealth Creation

Discussion Comments
Peter Chinloy
American University

Introduction

An issue for social and economic policy is the degree to which all of the citizenry participates in the financial sector. The financial sector, particularly depository financial institutions, hold the medium of exchange and allow for the processing of transactions. Even if some of these transactions are migrating to electronic media such as the Internet, if there is a digital divide there will remain an underserved group. At the same time, technology may hold out the promise of a reduction in cost for dealing with the underserved.

Depository financial institutions also face regulations on making loans in areas where they take deposits or where there is a restriction in the debt capital market. If there are opportunities to invest in inner-city or majority-minority areas, then commercial firms would take advantage of them. Such business operations rarely exist, other than small retail stores. There are few job-producing activities, obliging residents to travel to other areas to work. Porter (1998) has identified inner cities as an untapped frontier for business opportunities, with estimates of disposable income and demand for consumer goods. Despite these opportunities, there appears to be a market failure, since firms continue to shun these areas. Lenders are afraid of default.

A response is to encourage debt and equity investment through a targeted mechanism. In an examination of such programs, **Bates** (2001) provides a series of strategic lessons. First, loans that are successful require collateral support, whether in a valued asset such as a taxi medallion or in cross-collateralization using a house. Second, the successful borrowers tend to be immigrants rather than the native born. While loan programs clearly cannot favor one group over another, this evidence raises questions about who should be targeted.

The process of making a loan, particularly when businesses are difficult to evaluate, may require informal networks and contacts. Again, technology such as the Internet may arguably reduce the cost of the

informal network. Smart systems can simulate the interaction between a loan officer and customer, but these may only go so far, and computers will never be able to make a site visit. It is in this area that **Uzzi** (2001) investigates connections and closeness between borrowers and lenders. The results here are that the stronger the degree of relationship and connectedness, the more successful the lending arrangement. This provides some modest comfort for smaller and community banks in an era where economies of scale and technology are becoming more predominant.

The lending side is half of what banks do; the other half is the deposit side. Apart from the paucity of depository financial institutions in inner-city areas, an issue is whether such can develop indigenous sources of capital. Banks serve as mobilizing forces for pools of capital, whether on the debt or equity side. On the aggregate level, the United States during the 1990s has exhibited a negligible and sometimes negative savings rate. Some discussion indicates that the situation is not as severe as it appears since capital gains on assets are excluded from the definition of saving. Expenditures on consumer durables are sometimes counted as consumption as opposed to investment. But a relevant question remains as to whether low-income households are willing to save, and whether their savings rates might exceed those of high-income households. That is an important policy question in an environment where tax policy might suggest that some people will save and invest a reduction in the take from the government.

Another side of the savings and investment issue is the widespread presence of middle-class entitlements such as retirement and pension accounts. Typically these are matched accounts either by employers in the case of 401(k) or 403(b) accounts, and implicitly by the government, since the contributions are made from before-tax income. Other retirement accounts provide for matches by the government if the individual contributes, such as individual retirement accounts. The match is *de facto*, in that before-tax income is contributed. All these programs require an individual to work and have a job that either has a formal pension program or provides sufficient income so that the individual can make a contribution. For the underclass, these conditions are not always in place.

The Loan Side

On the asset side, banks and other lenders are seeking, partly through regulatory prompting, lending opportunities in inner-city and under-

served markets. Deregulatory efforts that have removed the distinction between debt and equity markets, such as repeal of the Glass-Steagall provisions, imply that lenders and others can source capital in different ways.

Bates (2001) examines the Minority Enterprise Small Business Investment Company (MESBIC) program. These are private firms that finance inner-city and minority-owned businesses. The financing takes the form of debt and equity. There is a sample of 199 firms that were operating in 1987. Of these, 61 were still operating in 1994; 58 went out of business. An analysis is also presented about what makes for the successful survivors.

There are two industries that are success stories. The first is in the taxi medallion industry. About half of all the firms receiving support from the program are in one industry; taxi medallions in New York City. Medallions are highly regulated: the price is in excess of $500,000. The medallion holders are protected against competition by the police, and most holders rent the cabs to others. These are all mechanisms by which medallion holders have their property rights protected. Medallion Funding is an organization that funds the taxi operators, and has been identified by Porter (1998) as a firm that has achieved success in the inner city. The taxi operators pay the medallion holder a daily fee to operate the cab. This situation is then exactly analogous to an asset-backed security. This is similar to a mortgage, auto loan, or credit-card receivable. There is an asset price and a cash flow. As long as security of the asset remains, the prospect for securitization is possible.

The second is in small businesses that are located in inner-city areas. This type of business includes restaurants, laundries, and grocery stores. Some of these firms are in New York City. There are two keys to success. The first is loan size. Small loans, typically less than $50,000, are inefficient to process and require monitoring against agency and moral hazard costs. The second is having collateral. Loans that are cross-collateralized with the mortgage on a house tend to default less frequently. The conclusions are that larger-sized loans backed by collateral are less likely to default. Loans without these provisions have extremely high default rates, and typically lose all the principal.

Another finding is that a majority of the participants in these loan programs are immigrants, whether they be taxi or small business entrepreneurs. The number of domestic entrepreneurs is limited. The immigrants may be self-selected, in that only the more motivated ones

immigrate to the United States in the first place. The ability to wade through a regulatory set of forms and programs is daunting to only the very entrepreneurial, not to mention the language barrier. It is not clear whether these are unintended consequences of the programs. Particularly since this program has "minority" written in the title, it is an issue whether the original intention was to help immigrants or the domestic-born. The latter are unsuccessful in this program, suggesting that modification of the terms and conditions may be appropriate if the intention is to facilitate domestic minorities entering business.

Another reason why some loans are successful and remain performing is because of a tie between lenders and borrowers. Informal and formal networks to obtain consumer loans are compared by **Uzzi** (2001). The paper discusses how formal networks, such as with a bank, involve specific governance issues such as contracts, including guarantees and other recourse. Other informal lending mechanisms are widely prevalent but receive less attention, yet are important in financing small business. Examples are *kye*, *susu*, or *partner* arrangements, where there is rotating financing. The paper contains some challenging results in a probit specification. The argument and hypothesis is that informal governance networks can be strong and tight motivators.

In arrangements there is a sense of trust and reciprocity. The social embeddedness allows banks to evaluate loans to otherwise risky customers. Social customs such as playing golf substitute for formal pricing, such as interest-rate premiums and the requirement for additional collateral.

One of the issues that emerges in the gradual takeover of smaller banks by larger ones is whether these trust and reciprocity arrangements can survive. Some larger lenders have mechanized and automated loan processing, partly to establish neutral standards that can survive legal challenges on discrimination grounds. Another reason is to take advantage of economies of scale. Ties and reciprocity rely on community banking and close touch. There is a technological possibility that the Internet and other mechanisms can simulate some of the tie arrangements.

If ties are important and difficult to manage at large institutions, there are some predictions as to the evolution of the banking system. Larger firms will discount the value of ties in purchasing smaller ones, since they cannot easily continue the informal arrangements within standardized corporate structures. There could be a two-tiered system of lending, where national lenders use automated procedures and local lenders exploit more informal arrangements. Since national lenders

have no or negative value to these arrangements if they create liability problems, customers may sort themselves. Those with close ties will seek them elsewhere in medium-sized or smaller banks and a clientele effect operates.

An issue is one of agency and management supervision. Pricing of arrangements is difficult, and the bank management wants to be assured that investments on the golf course are proving to have payoffs. There are conflicts between those whose rainmaking capability brings in business and others left at the office. The compensation scheme could be the rewarding influence, with loan officers paid on commission for bringing in business. With banks allowed to enter the securities business, and increasingly a financial advisor and stock salesperson available in each branch, this is only another progression in the banking industry.

Possibly because of these agency issues, banks have come to rely on commissioned salespeople to generate leads in commercial loans and mortgages. These individuals, frequently not employees of the bank, act as intermediaries. Then the management does not have to worry about the morale and other issues of one employee claiming to be working on the golf course. An outsourcing of the loan origination function within a bank is already a development that has occurred in the mortgage market and is spreading to other loans. **Uzzi** (2001) defines embedded ties by the duration of the relationship and the multiplexity of it. The conclusion is that the stronger and longer the tie, the better the loan performance. Another issue is whether customers have embedded ties with larger, faceless banks because of inertia or the high transaction costs of switching banks. A challenge for the banking industry is to preserve this capability in the face of increasing consolidation.

The Deposit Side

A first step in wealth creation is the ability to have deposit accounts. Such accounts are already a challenge in inner-city areas. While nobody will become rich on a checking or savings account because of the interest paid, opening and having such an account available is a starter in wealth creation. Moreover, such accounts can generate wealth if fostered by matching programs.

When consumers are faced with the prospect of their savings being matched, they respond positively. Evidence from the Survey of Consumer Finances on overall wealth indicates that for the median household, most financial assets are held in pension and insurance

accounts. Pension accounts such as 401(k) plans at private employers and 403(b) plans at nonprofits provide a double match. If the employee agrees to have a portion of the paycheck withheld, the employer will make a contribution. The employee is able to make the contribution from before-tax income, so effectively the tax authorities are a second contributor. For an employee in the 15 percent income tax bracket with no state income tax and an employer matching dollar-for-dollar, on a $2 contribution to the fund the employer is contributing $1, the tax authority 15 cents, and the employee 85 cents. Individual Retirement Accounts have a single match, with the contribution deductible. Roth IRA plans and insurance accounts have the feature of protecting the income tax-free. Evidence is that individuals will save when allowed to have matches, although some of the funds are transfers from other accounts.

What of those who either do not have an employer offering a full benefits package, as many underclass members do not, or want to have additional savings? An answer is an Individual Development Account, as studied by **Schreiner**, **Sherraden**, **Clancy**, **Johnson**, **Curley**, **Zhun**, **Beverly**, and **Grinstein-Weiss** (2001).

This program offers matches for underserved individuals willing to make savings efforts themselves. The matches are provided by foundations and other grantors, and contain incentives to save. Individuals can receive matches of up to $3 for each dollar saved, providing incentives comparable to those in the middle and upper classes. The requirements are that participants receive financial education and that any withdrawals be for prescribed uses such as home purchase, postsecondary education, or a small business.

The study is of a demonstration program, the American Dream experiment. In the sample, the average accumulation after a 2:1 match is $900 per year. This amount implies that households are saving on average $25 per month into these accounts. The accounts then allow individuals to unlock barriers to other lumpy purchases in a constrained capital market. The results are promising. Since the overall savings rate for the United States since 1998 has been negative, the presence of any savings is an incentive for the economy. Even if some wealthier households are dissaving because of actual or unrealized capital gains on assets, someone has to provide the internal pool of capital in the economy. It could be the case that within certain income and wealth ranges, the marginal propensity to save is decreasing in income and wealth. The evidence here seems to be supportive.

Concluding Remarks

There are policy initiatives to increase the amount of loans and deposits in underserved areas. Banks and other regulated depository institutions find themselves sometimes obliged to comply under terms of legislation such as the Community Reinvestment Act. In the other case, entrepreneurial banks are seeking opportunities. Two themes recur through these papers. The first is the clientele that takes advantage of targeted programs to increase loans and deposits. If that clientele is self-selected, having inherently extreme values of the talent being encouraged, then the programs might be seen to be successful where they otherwise might not be. Nevertheless, there are success stories on the loan and deposit side. There are opportunities for profitable lending in inner-city neighborhoods, with the appropriate loan size and collateral. There are opportunities to take profitable deposits, and the average size is comparable to the overall liquid wealth in the population.

The second is that informal ties strengthen loan arrangements. Increasing use of expert systems, and their migration to the Internet, suggests that the ties and arrangements could be priced. A community bank can be simulated on the Internet. This would be bad news for golf courses.

Peter Chinloy is on the faculty at American University and is a visiting professor at Cornell University. His areas of interest include mortgage finance, commercial real estate, and equity structuring in real estate. He is a member of the editorial boards of four journals, including Real Estate Economics and the Journal of Real Estate Finance and Economics. Chinloy has been on the faculty of the University of British Columbia and the University of Southern California. He received an undergraduate degree in accounting and economics from McGill University and master's and doctoral degrees from Harvard University.

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