NATIONAL
COMMUNITY CAPITAL
ASSOCIATION

Statement of

Mark Pinsky, Executive Director
National Community Capital Association

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On Travelers Group, Inc.'s Proposed Acquisition of Citicorp

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Federal Reserve Bank
Of New York

CAPITAL FOR SOCIAL, ECONOMIC, AND POLITICAL JUSTICE

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My name is Mark Pinsky and I am the Executive Director of the National Community Capital Association—a national membership organization representing more than 210 organizations and individuals engaged in community development finance, including 50 Member community development financial institutions (CDFIs).

National Community Capital believes that every financial institution that derives benefits at public expense should provide a commensurate public return. Through its performance and its practices, Citibank has proven to National Community Capital that it is committed to providing a public return more than commensurate with the benefits it receives at taxpayer expense.

Over the past six years Citibank has been a key player in building and expanding the CDFI industry in the U.S. In particular, Citibank has:

- Embraced community development finance as integral to its core business,
- Invested invaluable expertise as well as capital in its community development finance work,
- Treated CDFIs as customers rather than as applicants, and
- Supported the expanding CDFI industry without regard to geographic boundaries. Citibank has never required National Community Capital to limit the use of its equity, debt, or operating support to Citibank's service area. Citibank understands that building a strong CDFI industry requires National Community Capital to pursue market opportunities.

About National Community Capital

National Community Capital works to give people the resources and capacity they need to act in their own economic and social self-interest. Two core strategies drive this work:

1. First, we strive to build and support a national network of performance-driven, nonprofit community development financial institutions (CDFIs). To achieve this goal, National Community Capital provides financing, training, and technical assistance to its Member CDFIs.
2. Second, we leverage our performance as lenders and investors in many of the nation's most distressed communities to influence the behavior of mainstream institutions, including banks, other financial service companies, and government.

CDFIs work with one foot in the world of the poor and the other in the world of financial services. We are bridge institutions that link unconventional consumers to conventional financial products and services. For that reason, CDFIs must shape and respond to changes in the financial services world as well as those in the communities we serve.

Two key principles guide National Community Capital's community investment strategy. We believe that they should guide Citigroup's and every other community investment work, as well:

- Community investment must help poor people gain the capacity and resources to engage economically, socially, and politically so that they can and will act in their own self-interests, and
- It must do so in a way that ensures the sustainability of the institutions that seek to serve that market.

NATIONAL COMMUNITY CAPITAL'S PARTNERSHIP WITH CITIBANK

Citibank has worked closely with National Community Capital and many other CDFIs. It consistently has sought to help CDFIs develop the capacity and resources to carry out their work effectively.

Citibank's willingness to innovate, to pioneer, and to lead in community development finance has helped create a national distribution system for critically important community development capital. In its work with CDFIs, Citibank has exceeded every reasonable expectation.

The National Equity Grants Program

National Community Capital's relationship with Citibank began in 1992 when Citibank made a $1.1 million grant to launch our National Equity Grants Program. Citibank understood that CDFIs need high levels of equity to borrow debt that they, in turn, re-lend in distressed and disinvested communities. Through its National Equity Grants Program, National Community Capital makes net worth grants to CDFIs to help build their financial strength and ensure their long-term sustainability. By year-end 1998, National Community Capital will have awarded more than $3.3 million in equity grants to nonprofit CDFIs, including Citibank's catalytic contribution to this effort.

The success of this program influenced three other important initiatives. First, National Community Capital's experience providing equity grants helped shape the federal Community Development Financial Institutions Fund's (CDFI Fund) awards program. Through its first two award rounds, the CDFI Fund has committed more than $60 million in equity grants and investments. Second, National Community Capital's success paved the way for Citibank's $1.25 million grant to the National Federation of Community

Development Credit Unions for an Equity Grants program modeled on ours. Finally, in 1997 Citibank made equity grants directly to 17 CDFIs nationwide.

The Equity Equivalent Product

National Community Capital and Citibank partnered again in 1996 to develop an innovative financing product for nonprofit CDFIs—the Equity Equivalent, or EQ2. This revolutionary product is a long-term, deeply subordinated loan with characteristics that make it function like equity for a nonprofit CDFI. It is the nonprofit equivalent of convertible preferred stock with a coupon, enabling nonprofit CDFIs to raise more debt for re-lending.

The EQ2 is a win-win-win product.

- Banks win because they make high-risk equity investments in CDFIs that promise to return their principle and because they receive multiplied Community Reinvestment Act credit for making these investments. An EQ2-investing bank can receive lending test credit equal to the pro rata share of the CDFI's lending over the life of the EQ2 investment. The share is based on the bank's percentage of total equity in the CDFI. In the alternative, the bank can receive investment test credit.

- CDFIs win because the EQ2 leverages debt to fuel the CDFI's lending and investing activities; and

- Low-income and low-wealth communities benefit because more financing is available to them through CDFIs.

In late 1996, Citibank made a $2 million Equity Equivalent investment in National Community Capital to put this ambitious concept into practice. Since then, Citibank has provided technical assistance to numerous banks and CDFIs replicating the EQ2.

As important as its financial commitment is Citibank's commitment of expertise. In developing the EQ2, Citibank committed staff resources at the highest level of the corporation to help work out complex regulatory, accounting, and financial management issues. Like National Community Capital, Citibank was committed to producing a replicable product, rather than a one-time transaction. Citibank went several extra miles to make sure that the EQ2 is an investment product that will help disinvested communities again and again.

Citibank's Support for CDFI Human Capital

In addition to equity, the CDFI industry's greatest need is human capital. The industry has experienced consistently aggressive growth over the past six years, fueled by the federal CDFI Fund, the Community Reinvestment Act, bank support for CDFI expansion, and government's declining support for low-income and low-wealth communities in general. As CDFIs' capital under management has increased sharply, their staff capacity has barely kept pace.

Citibank has provided substantial financial support for National Community Capital's human capital-building efforts, including technical assistance programs, Targeted Training sessions, and our Annual Training Conference. In addition to funding, Citibank has provided top quality trainers.

Citibank has provided core support for National Community Capital's Annual Training Conference—the premier CDFI training event—in 1996, 1997, and this year. In two of those three years, the conference has been or will be outside of Citibank's market.

In 1996, Citibank provided the seed capital to National Community Capital to launch our Targeted Training series, which offers one-day and two-day courses on select topics in different locations across the nation. This year, National Community Capital is offering nine Targeted Trainings on seven topics in six locations.

CONCLUSION

The ultimate goal for CDFIs is to link economically poor people to the financial products and services they need to act in their own self-interest. To do this, CDFIs need to recognize change and respond with creative, innovative solutions. We will not succeed if we get caught up perpetuating CDFIs for their own sake, defending the Community Reinvestment Act without acknowledging the revolutionary changes in the financial services industry, or justifying the behavior of financial services companies without regard to their performance in serving low-income and low-wealth people and communities.

We need a community investment strategy that builds on the strengths of the financial services industry as it is, not as we want it to be. The industry is in the midst of a major and rapid transformation that is reshaping how poor people—like most people—use financial services. The proposed Citibank-Travelers merger is now the cutting edge of this transformation.

The merger we are talking about today is different than most other mergers, of course, because it involves a bank and a parallel banking institution. It and other acquisitions such as First Union's purchase of The Money Store fall outside the current regulatory environment. It is driven not by regulatory or legislative mandates but by the commercial imperatives of operating in a financial system that is increasingly cross-functional and global in nature. The Citibank-Travelers merger will not involve job cuts and branch closings like bank-bank mergers. It expands the range of products and services Citigroup can provide to customers.

The question before us today is whether the proposed Citigroup can lead the way on community development finance in the financial services marketplace of the future. Given Citibank's past performance and practice—particularly its vision in helping to develop the CDFI industry as a distribution system that bridges gaps between poor people and conventional capital and financial services—National Community Capital is confident that Citigroup will continue Citibank's leadership in community development finance.

Thank you for this opportunity to share my views. I would be pleased to answer any questions you might have.

The Parallel Banking System & Community Reinvestment

Mark A. Pinsky
Valerie L. Threlfall
November 1996

NATIONAL
COMMUNITY CAPITAL
ASSOCIATION

Note:
In November 1997, Members of the National Association of Community Development Loan Funds (NACDLF) voted to change the organization's name to National Community Capital Association. This paper, "The Parallel Banking System & Community Reinvestment," was written prior to the name change, and thus "NACDLF" is used throughout the document.

The Parallel Banking System & Community Reinvestment

by Mark A. Pinsky and Valerie L. Threlfall

On October 4, 1996, a federal agency intervened to arrest an impending solvency crisis at a small but significant financial institution holding almost $425 million of 77,000 Americans' retirement savings. With lingering memories of the savings and loans crisis of the 1980s, which left thousands of anxious Americans without access to their savings, the federal government decided to act before the crisis hit. The agency was not one of the four bank regulatory agencies but the Pension Benefit Guarantee Corporation (PBGC), and the financial institution was not a bank or a thrift but a pension fund serving the men's suit industry[1].

This federal intervention was just a hint of one of the most important twentieth-century shifts in the financial services industry, the shift of dominance from the banking industry to the parallel banking industry. Contrary to the common wisdom, the rise of the parallel banking industry would not have occurred without significant federal and state assistance, such as the "lender of last resort" protection the PBGC is now providing. This paper explores the structural shift in the banking industry, the role government has played in abetting this shift, and the implications the transition creates for low-income and a growing number of moderate-income communities around the country. It raises important questions about the public and civic responsibilities of a multi-trillion dollar industry that derives substantial, critical benefits from taxpayers yet operates without a commensurate obligation to return benefits back to the American people.

Introduction

The U.S. financial industry has changed in dramatic and significant ways over the past thirty years as nonbank financial intermediaries have taken over many of the functions depository institutions traditionally considered their province. Notably, more than two-thirds of Americans' long-term savings and investments now reside in non-bank intermediaries, compared to less than one-third in the mid-1970s. Moreover, these nonbank intermediaries, known as parallel banks, now serve as the primary source of credit for many American households and businesses.

The parallel banking industry consists primarily of mutual funds, pension funds, insurance companies, and corporate finance companies. Over the past three decades, the rapid growth in assets and influence of non-bank institutions has changed the role banks play in addressing the financial services needs of local individuals and institutions and altered the relationship between the financial services industry, broadly defined, and its users (investors, lenders, borrowers). On a macro level, the U.S. financial system is no longer characterized by locally based intermediary institutions but rather by sophisticated institutional savings arrangements, fee-generating bank activities, and global financial instruments. The resulting dislocation of capital and place—as local savings flow out of local communities into regional, national, and international markets—has effectively widened the credit and capital gaps that plague many communities struggling to gain or retain their social, economic, and political vitality. Moreover, the old system that linked wealth to place, that kept savings in communities, is now in danger of disappearing. Low-income residents in particular lack access to modern financial services as they do not have the capital and expertise necessary to take advantage of institutional savings arrangements and technology-driven banking. If the traditional system is allowed to erode any further, conventional credit access may become virtually obsolete for larger segments of the population.

Credit is key for the development of a healthy community for two primary reasons—it provides liquidity and it signals confidence in the future of that community. In *Money of the Mind*, a history of American credit since the Civil War, author James Grant describes credit as a "financial transaction with a moral lineage"[2]. Extending credit assumes repayment, and is a vote of confidence in a borrower's future. At the community level, the extension of credit and capital can have a profound, albeit intangible, positive effect on a community. In contrast, the absence of capital can be extremely corrosive.

This paper explains that the parallel banking system would not have emerged as it has and could not continue to function without the indirect and direct government (taxpayer) financial support and regulatory forbearance it receives. In light of this substantial subsidy, NACDLF contends that a reasonable and meaningful public policy would require the parallel banking industry to reinvest in its market service area in a manner comparable to that which conventional banks do under the Community Reinvestment Act. NACDLF has a strong interest in promoting reinvestment by nonbank institutions because its Members witness and experience the effects of community disinvestment on a daily basis.

The overwhelming shifts in the financial industry have caused long-standing structural changes in the financial services industry as well as demographic changes in many communities. Most important, from the perspective of community development finance, as the parallel banking industry has swelled with American savings and the conventional banking industry has lost market share, key federal financial regulatory agencies have relinquished much of their ability to ensure that taxpayer support for the financial services industry carries with it commensurate public responsibilities. For those communities where NACDLF's Member community development financial institutions (CDFIs) work, the truncated reach of the Community Reinvestment Act, in particular, is an ominous trend. More broadly, the decreased ability of the Federal Reserve to influence monetary or regulatory policy coupled with the de-insurance of much of America's savings, has promoted a precarious state of affairs in which financial safety has been sacrificed for growing market power.

The patchwork of United States bank and non-bank regulatory systems is inconsistent. Most conventional depository institutions benefit from a myriad of federally backed programs ranging from deposit insurance (a basic credit enhancement) to the Federal Reserve's safety net to end all safety nets—its "too big to fail" policy. The price banks pay for these essential taxpayer-funded supports is that they must give something back to the public at large in the form of an affirmative community reinvestment commitment, as codified in the Community Reinvestment Act.

In marked contrast, nonbank financial institutions have gained access to many of the same federal protections but operate with no comparable reinvestment responsibility. In particular, parallel banks have direct access to many federal guarantee programs and state guarantee associations as well as indirect access to back-up credit and liquidity provisions from the conventional bank system. Parallel banks also enjoy the competitive advantage of regulatory forbearance. While parallel banks must comply with some regulatory requirements and protections specific to their individual industries, their regulatory burden is significantly less than that carried by conventional banks. This is particularly troubling since the parallel banking system has paid little or no attention to local markets and community credit needs, especially in the distressed and disinvested communities in which CDFIs work. By permitting parallel banks to benefit from government supports in the current regulatory framework, the government and the public are fueling the expansion of a financial services system that profits from the taxpayer's dollar but avoids its corresponding civic responsibilities at the expense of the conventional banking industry and local communities.

Sustainable change in distressed local economies requires a meaningful financial commitment to community reinvestment by the full spectrum of financial institutions. Because NACDLF's Members see in the communities where they work the problems of disinvestment, NACDLF is prepared to take a leadership role in fostering a national discussion on the reinvestment responsibilities of the parallel banking system. This discussion should focus on the roles financial institutions and governments can and should play in fostering community economic revitalization and economic, social, and political justice, and should strive to produce comprehensive, concrete recommendations for extending community reinvestment responsibilities to all financial institutions that benefit from government support.

A. The Changing Financial Market

The growth of the parallel banking industry has permanently altered the financial landscape by fostering the development of new savings and lending vehicles that are inaccessible for many households and businesses. By specializing in many of the financial services that banks have historically provided, parallel banks have created substantial market niches for themselves and have in many ways supplanted the conventional banking industry. The rapid growth of pooled mutual and pension funds during the late 1960s and through the 1970s created alternative savings vehicles for individuals that generally produced higher yields than the returns typically guaranteed by conventional banks. As a result, people increasingly switched from savings accounts to investment vehicles to build their household savings, causing the percentage of U.S. financial sector assets held by mutual funds and pension funds to more than double from 20% to 42% between 1978 and 1994. In 1986, approximately 1,800 mutual funds controlled 716 billion dollars in investment income; by 1996, the number of active mutual funds operating in the United States has reached over 7,000 and the funds now control at least 3 trillion dollars in investment income[3].

Conventional financial institutions have also experienced declines in their market share of business and commercial lending as many medium and large businesses increasingly utilize nonbank institutions as intermediaries or sell commercial paper directly in the money market. As a result, banks' share of short-term business credit has decreased more than 21% over the past twenty five years such that banks now finance just over half of the nation's credit debt. Finance companies that grew as subsidiaries of large manufacturing firms in particular have grown to rival the conventional banks' lending position, increasing their market share of outstanding domestic credit debt from 26% to 37% between 1983 and 1993[4].

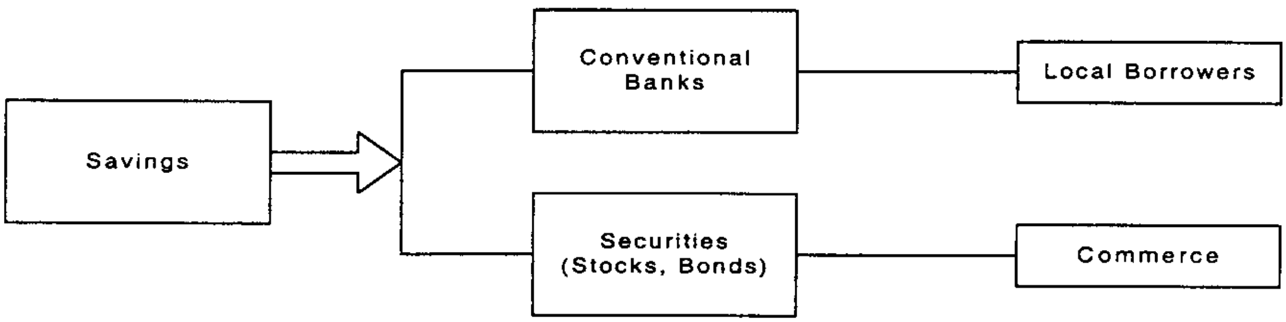
In addition, the banking industry has undergone numerous internal transformations as extensive deregulation has shifted the overall focus of the field away from local lending. In order to compete with growing nonbank competitors for limited market share in the global economy, conventional banks have increasingly lobbied for loosened regulatory constraints. The lifting of interstate branching restrictions in 1994 and ongoing efforts to dismantle longstanding prohibitory regulations that limit the securities activities banks are able to pursue (Glass-Steagall restrictions) are obvious examples of the banking industry's efforts to equalize the regulatory pressures facing diverse financial market players and to promote increased access to market opportunities. Earlier this year, the Federal Reserve gave the banking industry a major boost when it proposed regulations lifting limits on banks' nonbank activities.

The overwhelming number of mergers and consolidations within the banking system has only reinforced the industry's shift away from local finance needs as the number of U.S. banks with less than $100 million in assets has dropped by at least 5% every year since 1985[5]. Bank industry analysts further predict that more than half of the nation's bank branches will close or be consolidated over the next ten years[6]. The primary result of these changes is that the banking industry has not only lost its role as the primary source of savings and credit in the United States but has also fundamentally reoriented its focus away from place-based financing toward global activity.

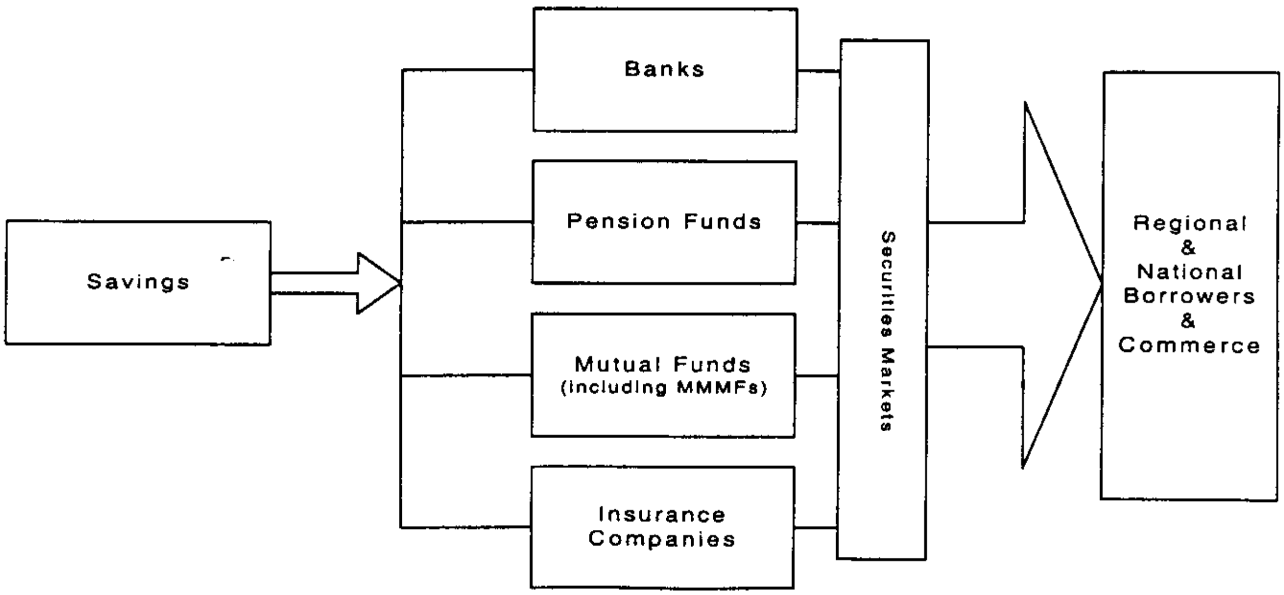
As recently as twenty-five years ago, most Americans walked or drove their savings to neighborhood banks or thrifts which, by regulation, put most of that money back into the local economy. Today, a growing number of Americans deposit their earnings in large super-regional banks or invest their money in money market mutual fund or pension fund companies outside their local communities that direct their funds throughout the world. (Chart A illustrates just one dimension of how traditional financial intermediation has changed over the past thirty years). As a result of cumulative institutional changes, capital no longer remains within local communities. Rather, it tends to flow away from the majority of American communities into larger wealth-based national and international financial markets.

Chart A

Bank-Centered Financial Intermediation



Modern-Day Financial Intermediation



The transition away from bank-centered financial intermediation has had major repercussions in both the financial industry as well as within society at large. First, the number of financial institutions that operate with comprehensive safety and soundness requirements has decreased—a move which has effectively de-insured a bulk of America's savings. While banks must comply with significant soundness requirements, nonbank institutions benefit from an extremely fragmented and weak regulatory system; as more Americans' savings flow into these structures, therefore, the overall safety of the global financial system has become more precarious. Second, the importance of the Community Reinvestment Act and other fair lending standards has declined as fewer and fewer institutions are covered by the regulations while the credit and investment needs of many local communities continue to be under-served. This has especially constrained low-income communities which are historically characterized by inadequate credit access.

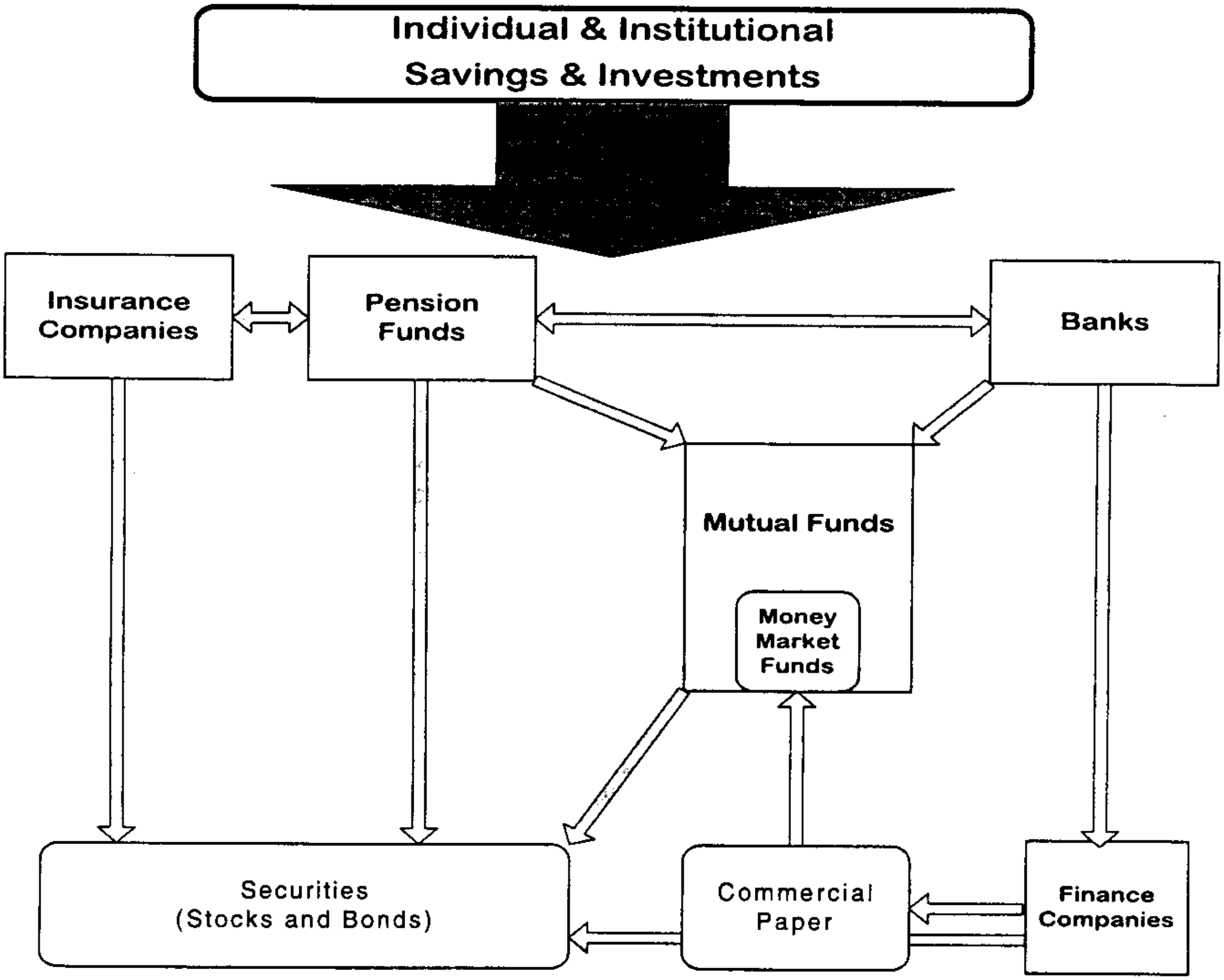
B. What are Parallel Banks?

The parallel banking system comprises four major types of non-bank institutions: mutual funds, pension funds, insurance firms, and finance companies. Mutual funds, pension funds, and insurance companies have all developed into important intermediaries for household and commercial businesses' investments and savings. Finance companies, on the other hand, rival the conventional banking system as a source of credit for larger businesses and local consumers. While all of the parallel banking institutions serve specific purposes (for example, pension funds are primarily used as vehicles for building retirement savings), they remain closely interrelated and dependent upon one another and conventional banks for their continued existence. (Chart B on page 6 highlights some of these interrelationships). For example, banks routinely invest significant portions of their portfolios in institutional mutual fund arrangements while they compete with these same mutual funds for customers. Similarly, pension funds are responsible for a growing share of mutual fund inflows. Thus, while the institutions that make up the parallel banking system may each have specific niches in the financial industry, the financial system as it exists today operates as a complex web of both rival and dependent institutions.

Mutual funds function as alternate savings and investment mechanisms for both households and large corporations. By pooling the funds of individual accounts into large-scale investments, mutual funds purchase large volumes of both short and long-term securities and distribute their earnings among fund shareholders. Most mutual funds tend to invest in long-term securities such as corporate stocks in the capital market. More specialized money market mutual funds (MMMFs) developed in the 1970s, however, as an avenue for middle-class savers who wanted to enter into the expanding securities market. MMMFs specifically invest in shorter-term securities such as government bonds and unsecured corporate commercial paper (short-term promissory notes). The advantages to targeting investments towards short-term instruments are numerous. Most important, money market instruments are very liquid—the average maturity on their investments is less than 70 days; this in turn means that the credit and interest rate risks borne by the investment remain quite low. In addition, MMMFs offer well-diversified and relatively safe portfolios, investing in a range of securities with short-term maturities.

While mutual funds developed initially as high-yield savings vehicles for wealth investors, they have increasingly come to resemble conventional bank accounts. For example, most mutual funds now offer limited payment services such as the ability to write checks against existing fund balances. This has propelled the funds into growing public favor for they offer both savings and payment services—just like a bank. As James Pierce describes in *The Future of Banking*, "money market funds offer accounts to the public that are technically shares in a mutual fund, but they look and work like a bank account ... both money market funds and

Chart B



banks offer accounts that are payable on demand, and they invest the funds deposited with them in assets that customers typically could not or would not acquire on their own. Money market funds are in essence banks that fell outside the legal definition"[7]. While the access mutual funds provide to savings is slightly more limited than that of banks, many people prefer mutual funds because they promise higher returns.

Mutual funds remain significantly different from banks, however, in terms of the regulations that govern their activities and the explicit consumer protections they are able to offer. Mutual funds (including money market mutual funds) are regulated by the Securities Exchange Commission (SEC), which mandates that all funds must meet strict diversification and disclosure requirements. For example, a money market fund may not have more than 5% of its portfolio held up in commercial paper that has less than the highest rating. In addition, funds must limit the amount of securities they hold from any issuer that has less than the highest credit rating to less than one million dollars or one percent of their total asset base whichever is smaller. While these diversification requirements do protect consumers to some extent, these safety regulations are far less stringent than the requirements under which banks operate.

Moreover, the contributions individuals make to their money market and mutual funds are inherently riskier than bank deposits because fund investments are not protected by federal deposit insurance. Until very recently, mutual funds have not incorporated self-insurance because the contagion effects of a mutual fund default are more limited than in the case of a bank default[8]. If a mutual fund approaches insolvency, the value of all investors' shares decreases simultaneously giving individuals little incentive to be the first to withdraw their savings. Moreover, in the event of an economic downturn, mutual funds will generally forgo some of their profits to ensure adequate investor returns. According to Pierce, "Banks' primary advantage over [money market mutual funds] is that money market funds do not enjoy federal insurance. But unlike banks, which back their liabilities with relatively illiquid and risky loans, money market funds are backed by highly liquid, low-risk market securities"[9]. The returns promised by mutual funds are also generally higher-yielding relative to deposit returns because the funds operate with low delivery and regulatory costs and pass some of these savings on to investors.

Pension funds are similar to mutual funds and often invest their pooled savings in mutual funds. For example, in 1994, pension funds held $248 billion dollars, or 11.5% of all mutual funds' assets. This is almost three times more than their share in 1984[10]. The primary difference between pension funds and other pooled savings arrangements, however, is that pension funds are specialized savings instruments targeted towards clients' retirement.

The major regulation governing pension plan activities is the Employee Retirement Income Security Act (ERISA) which was passed by Congress in 1974 and mandates, among other things, that all defined benefit plans (funds that have mixed benefit sources and promise a predetermined level of benefits upon retirement) must purchase federal Pension Benefit Guarantee Corporation (PBGC) coverage. PBGC insurance covers individual pension plan benefits up to an annual maximum in case one's pension plan is terminated. Plans may be terminated either by a single employer or by PBGC regulators if they seem to be approaching insolvency. The federal guarantee corporation, while created as a government agency, is funded by annual pension premiums that are levied upon participating plans and by any recovered assets that become available from terminated plans. In this way, the funding responsibility for PBGC is statutorily shared by both the government and the pension fund industry but generally devolves on participating plans in the form of higher premiums. In marked contrast, defined contribution plans such as the common 401(k) plan are not protected by PBGC insurance and have much less stringent diversification guidelines.

Insurance companies not only provide insurance but also serve as a vehicle for aggregating long-term savings. The role of insurance companies as savings vehicles became explicit with the creation of whole-life insurance, which packages standard-term life insurance into a redeemable savings plan that can be liquidated after a set length of time. These types of savings arrangements were particularly popular throughout the first half of this century and developed into a thriving industry of, in the words of financial writer Andrew Tobias, "invisible bankers" by the early 1950s. As other institutional savings arrangements also grew to offer competitive returns during this time, however, the role of insurance as savings vehicles inevitably diminished. While the use of life insurance companies as savings vehicles has thus been quite erratic and often controversial, many individuals still favor insurance-based savings arrangements because they offer large tax-deferred returns[11]. Insurance companies are also relatively safe investments because policy holders are protected against corporate defaults through the industry's reinsurance policies and through state insurance guarantee funds which operate in all 50 states. While these guarantee funds are formed as non-profit industry-governed organizations which recover funds in a post-assessment fashion from within the industry, the ultimate funding burden in many areas can be shifted onto taxpayers through institutional tax credits.

In contrast to the other parallel bank institutions, **finance companies** constitute the primary lending side of this unregulated intermediary market, emerging as a major source of consumer and business loans. Finance companies originally developed as captive subsidiaries of large manufacturing firms and focused on financing the sales of their parent company. For example, two of the largest finance companies today are General Motors Acceptance Corporation (GMAC) and Ford Motor Credit. These companies (like many others) have since expanded their lending and become independent lenders that provide financing for a full range of activities beyond the specialty of their parent company, including mortgage and home equity loans.

Finance companies first became attractive lending sources during the 1960s when banks' efforts to provide affordable loans were constricted by Regulation Q, a federal usury law that placed a limit on the amount of interest banks could pay on deposits. Regulation Q made it difficult for banks to borrow large sums of money and in turn inherently limited banks' ability to lend; this led many borrowers, who were beginning to become more credit-savvy, to patronize commercial paper and capital markets for their short-term borrowing needs as borrowing through finance companies became easier and less expensive than bank financing.

Finance companies borrow funds primarily by issuing commercial paper in the money market. Commercial paper comprises short-term securities or promissory notes that are typically issued in sums over $100,000 dollars and have an average maturity of less than 70 days. Finance companies' borrowing in the commercial paper market has grown dramatically over the past 20 years and has consistently accounted for more than 60% of the annual commercial paper issued since the early 1990s[12]. Most of this commercial paper is in turn purchased by institutional investors such as money market mutual funds. In fact, by 1991, commercial paper constituted an estimated 42% of money market mutual funds' total assets[13]. Nonbank companies typically choose to finance maturing commercial paper issues by rolling over outstanding commercial paper rather than paying out on the matured paper.

Bank lines of credit are central to this roll-over process. Finance companies specifically rely on bank lines of credit to cover liquidity problems they could incur when rolling over commercial paper. Back-up lines of credit in turn inevitably enhance the marketability of a commercial paper issue since the line of credit makes the security effectively risk free. A 1993 study by Jane D'Arista and Tom Schlesinger found that more than 90% of the outstanding commercial paper issued by the 15 largest finance companies in 1993 was backed by bank guarantees and lines of credit[14]. In addition, the rating of commercial paper depends on a finance company's perceived ability to cover and provide returns on its maturing paper. In this way, a finance company's commercial paper rating inevitably relies on liquidity from conventional financial institutions.

C. The Case for Extending Community Reinvestment Responsibilities to Parallel Banks

While the role of non-bank institutions strongly parallels that of conventional bank institutions, conventional banks have evolved under a very different and much more stringent regulatory environment. Conventional banks and thrifts are regulated by four federal agencies, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve System. This coverage is both a burden and a boon to regulated institutions—while compliance is expensive, the value gained from having deposit insurance and more importantly, the backing by the full faith and credit of the United States, has historically outweighed the regulatory costs. With the backing of the federal government, conventional banks gain substantially greater customer confidence. In exchange for these benefits, community reinvestment advocates have continually argued (with mixed success) that banks and other conventional financial institutions should give something back to the local communities which they serve.

The Community Reinvestment Act (CRA), the landmark legislation of community reinvestment efforts, is the primary mechanism used to ensure that banks recognize their social responsibilities. CRA was created in the late 1970s in response to widespread "redlining" by financial institutions. Redlining is an explicit practice on the part of banks in which they blatantly avoid lending in areas that are either low-income or have large minority populations. Even though institutional redlining is now illegal, CRA remains a primary tool to open doors and introduce credit and financial services to impoverished low-income neighborhoods. CRA has produced significant benefits and improved credit access for many American neighborhoods. More important, however, the legislation has required financial institutions to keep sight of their public obligations.

Community reinvestment policies such as CRA and fair lending laws have required banks to fulfill their role as social institutions and brought about significant improvements in the daily lives and opportunity structures available to millions of low-income individuals. In light of the Act's demonstrated success and the unabetting need for investment in low-income communities, current community reinvestment responsibilities need to be stronger and broader. To be truly effective, these obligations must be extended to all sectors of the financial system, including parallel banks.

The conventional banking system's market position has been compromised by growing competition from the parallel banking system. The interrelationships that make up the current financial landscape highlight that the parallel banking industry has grown at the expense of and largely because of the indirect support it has received from the conventional banking industry and taxpayer-backed guarantee programs. By providing expanded access to government and financial system protections, the conventional banking industry has in effect fueled its own competition and contributed to its own loss of market share. Extending community reinvestment responsibilities to these institutions would begin to equalize the benefits and costs borne by the dominant players in the financial industry and introduce a previously untapped source of capital to disadvantaged communities.

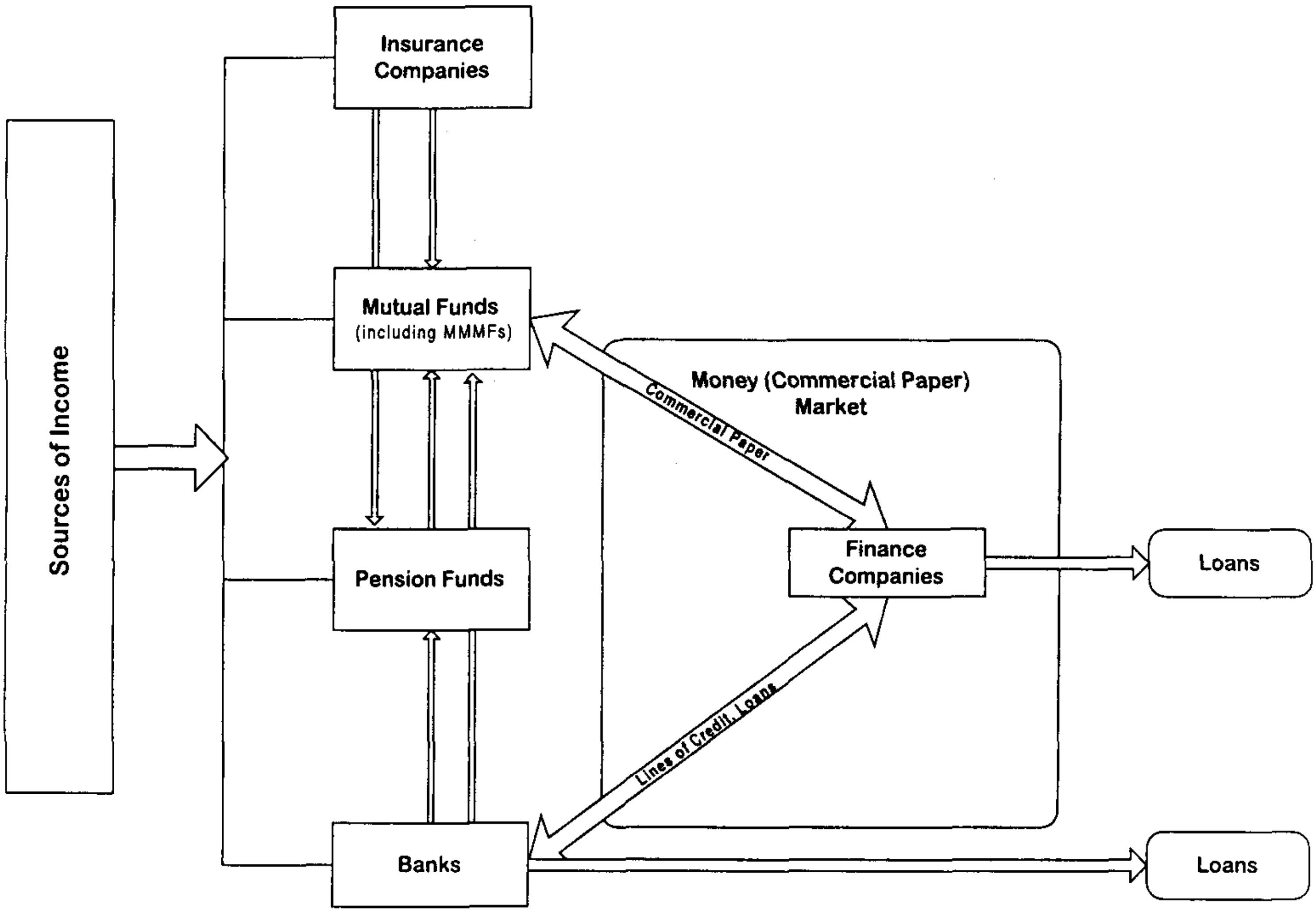
Parallel bank officials assert that they should not be subject to community reinvestment obligations because they are not structured like banks and do not receive the same benefits and protections as banks. Specifically, nonbanks cite the following as reasons for their exemption:

1) They can not buy federal deposit insurance for their liabilities,
2) They can not access Federal Reserve windows for funding,
3) They are not locally chartered institutions,
4) They are not depository institutions.

While technically accurate, these defenses are not grounded in a realistic assessment of the financial industry as it exists today. Non-bank institutions such as mutual funds, finance companies, insurance companies, and pension funds offer services to their customers that are virtually indistinguishable from those banks provide. A functional analysis of banks published in the *Harvard Business Review* characterizes banks by four core functions: as intermediaries, they pool resources, make payments, transfer resources across distances and time, and manage risk through diversification and insurance[15]. Extending these characteristics to nonbanks reveals that nonbanks perform almost all of the same functions. While parallel bank institutions may not take formal deposits as banks do, they are true financial intermediaries, using other people's money to carry out savings and payment services (See Chart C). To manage risks that may arise in lending, however, nonbank institutions generally socialize and spread risks or rely on third-party guarantees (such as bank lines of credit) rather than internalize risks[16]. In order to do this, parallel banks clearly rely on conventional banks and their government-funded safety-nets.

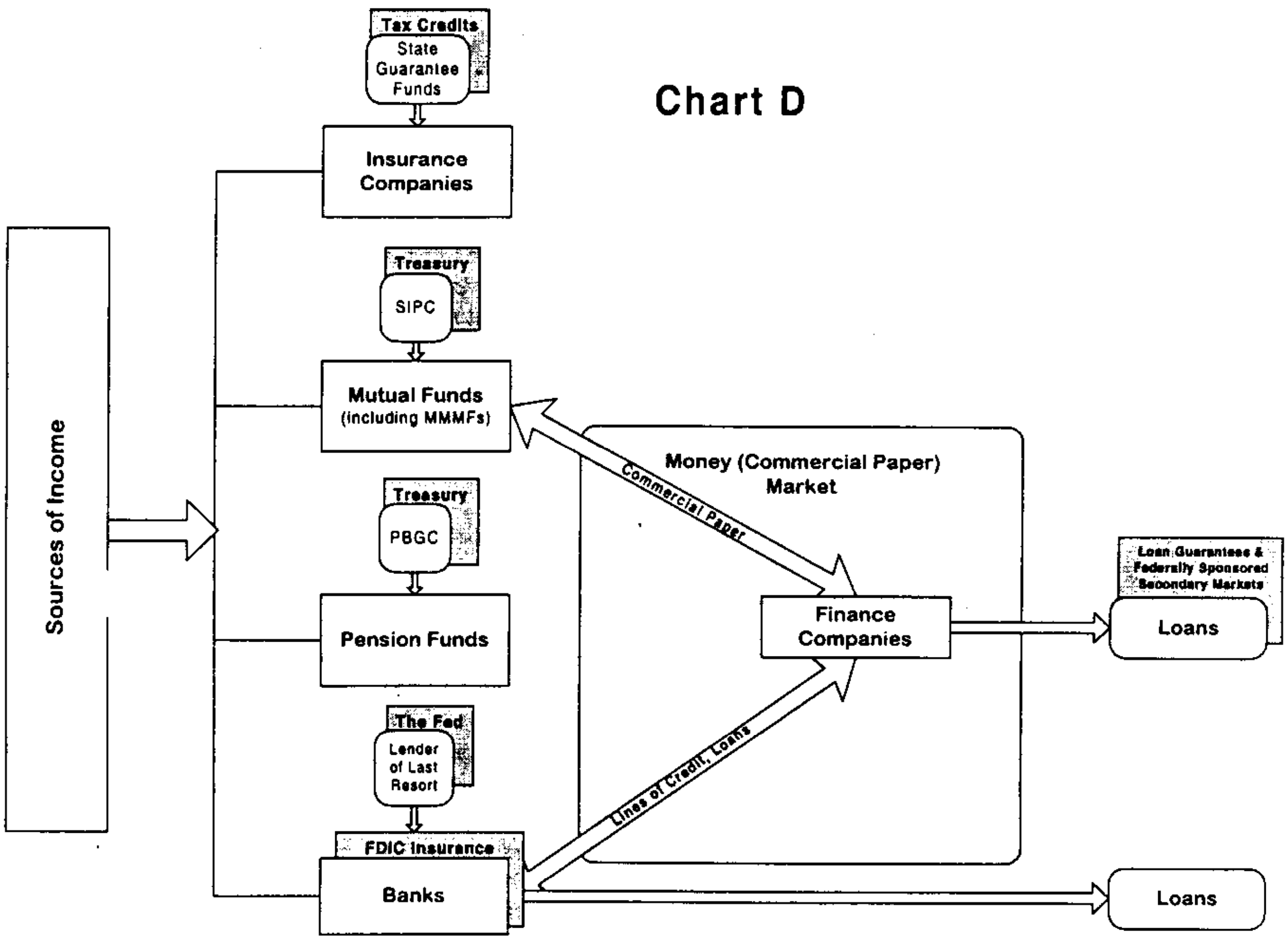
[Chart C on following page]

Chart C



Parallel banking institutions have gained access to numerous industry-driven (yet banking-dependent) insurance protections and federally guaranteed loan programs. While these industry insurance programs are generally financed by aggregated industry premiums, a majority of the programs can borrow from the U.S. Treasury for additional liquidity. In addition, finance companies and other issuers of commercial paper rely heavily on back-up lines of credit from conventional banks to cover periods of temporary illiquidity. Financial firms become especially dependent on conventional bank loans when their profitability wanes and their commercial paper is downgraded by raters and becomes difficult to sell in the money market. In this way, banks' support of parallel bank institutions seems to increase as the internal stability and competitiveness of financial firms decreases. (Chart D on page 11 illustrates how some of these federal protections extend both directly and indirectly to nonbank institutions).

By using federal guarantees and Treasury lines of credit as the ultimate safeguards against some nonbank insolvencies, the conventional system incurs substantial unanticipated risks that could overburden the safety-net system. Compounding these risks is the fact that financial protection can create a form of "moral hazard" on the part of beneficiaries. If beneficiaries are supported more by conventional banks as their own financial soundness decreases, their incentive to control losses and restore profitability will inevitably be weakened because they know that their losses will be covered by a third-party. In this way, financial risk becomes socialized and spread among many as the discipline in lending is removed. Supporting struggling institutions indirectly through bank guarantees and credit lines thus often exposes the banking system and its ultimate backers, taxpayers, to mounting levels of risk and significantly higher support costs over the long run.



The following sector-by-sector analysis of parallel bank dependence on government and/or government-aided financial supports explains that parallel banks could not operate without taxpayer assistance, thereby demonstrating the case for extending community reinvestment requirements to the parallel banking industry:

Mutual Funds

As private investment vehicles, mutual funds and other nonbank savings funds do not have access to FDIC insurance. Rather in economic downturns, individual investors must share market losses as the value of their investments simultaneously decreases to reflect changes in the market. Private protections do exist, however, to cover large institutional insolvencies. The Securities Investor Protection Corporation (SIPC), a non-profit guarantee association, was created in 1970 to insure the securities accounts of customers up to $500,000 if a securities broker or dealer fails and cannot meet outstanding obligations. While SIPC operates as a private-sector agency that is financed internally by member firms (all registered securities dealers must join), it has the ability to borrow up to $1 billion dollars from the U.S. Treasury during times of need. As some of the largest buyers of protected commercial paper, money market mutual funds also derive indirect benefits from the lines of credit that banks provide to issuers of commercial paper.

Pension funds

Pension funds benefit from similar government-sponsored safety net programs and tax advantages. As described earlier, all defined-benefit pension plans are required under ERISA to purchase federal Pension Benefit Guarantee Corporation (PBGC) insurance. Like SIPC, PBGC insurance is funded with industry premiums from pension fund sponsors as well as with recovered assets from terminated plans. In addition, the program operates with a $100 million dollar line of credit from the U.S. Treasury. Examination of PBGC's growth highlights that the pension fund safety net extends remarkably far and deep. As of December 1993, PBGC specifically protected the benefits of nearly 41 million Americans or about one-third of the United States labor force[17]. As the demands on the system continue to grow, PBGC's economic future remains relatively precarious. By 1993, PBGC had already accumulated a cumulative deficit of at least $2.6 billion[18]. Most of this deficit resulted from massive underfunding by pension program sponsors. Underfunding occurs when a company increases benefits but then makes risky investments or fails to take the necessary precautions to ensure that it will be able to cover outstanding liabilities when they arise. PBGC's deficit reduction efforts have been further thwarted by the fact that many sound pension plans have chosen to modify their benefit structure in order to move outside PBGC governance and effectively avoid subsidizing other plans' accumulated losses. The widespread prevalence of defined contribution plans such as 401(k)s is evidence of this fact.

Insurance companies

The supportive strings of the federally-backed safety net are even more apparent in the relationship between taxpayers and insurance companies. As described earlier, state insurance guarantee funds provide compensation to policyholders of insolvent insurance companies by gathering resources from within the insurance industry after a company fails. While these guarantee funds are generally governed and financed by industry representatives, the ultimate burden of funding the state guarantee pools is often reflected in forgone state tax revenues. In 41 states, insurance companies are permitted to offset their fund assessments (contributions) through amortized credits against their state premium taxes. While this arrangement does force companies to bear some up-front costs, the credits effectively reduce their net cost to zero over the long run. While facilitating household savings has been an important part of insurance company activities, many insurance companies also provide consumer loans such as student education loans to their policyholders. For example, in 1991, three insurance companies ranked among the top 100 originators of guaranteed student loans. As a result, these institutions benefited from the government insurance programs that protect these loans.

Finance companies

While many different types of institutions are becoming significant nonbank lenders, finance companies remain the primary private-sector non-bank lenders. Not surprisingly, they are also, therefore, some of the largest beneficiaries of federal loan guarantee programs. In 1993, finance companies reportedly originated more than 84% of all FHA and VA government-insured mortgage loans[19]. In addition, finance companies have become active in the student loan market and are some of the largest beneficiaries of the federal small business administration (SBA) loan guarantee program. Only 10 nonbank finance companies are allowed to participate in the SBA loan guarantee program for Small Business Lending Companies; in spite of this small pool, three finance companies ranked among the top five small business lenders in 1993. The fact that these loans have government guarantees boosts lenders' sales of these loans in the secondary market and generally expedites the lending process. Secondary market investors need not concern themselves with the collateral and repayment ability of original borrowers when they know they will be compensated regardless of the circumstances. Government guarantee programs thus ease the flow of funds and benefit all of the participants in a lending deal. Moreover, loan guarantees benefit any company that prefers to hold onto loans it has originated rather than sell them in the secondary market.

Finance companies have also benefited from the bank lines of credit that are now relatively standard in money market transactions. As some of the primary issuers of commercial paper, issuing more than 60% of all outstanding commercial paper in 1993, finance companies depend on bank lines of credit to sustain their money market activities. Virtually all commercial paper finance companies issue is backed to some degree by lines of credit since most institutional investors will not purchase the short-term notes without a formal liquidity guarantee. While banks receive a fee for performing these credit substitution activities, the fact that nonbank paper is backed by the credit of conventional banks makes commercial paper essentially interchangeable with bank loans and moreover, places banks in the position of supporting their competitors[20].

In a financial catastrophe, the parallel banking system may also have the ultimate protection of the Federal Reserve lender-of-last-resort provision. The lender-of-last-resort provision of the Federal Reserve System allows the Fed to save financial institutions from insolvency crises by issuing emergency, federally guaranteed loans to institutions that are facing short-term liquidity crises because of investor runs. This emergency liquidity provision is enacted only in the most drastic fiscal situations and is a contingent provision that exists to protect institutions from insolvency. A series of statutory and regulatory changes have recently expanded the scope of institutions that have access to the lender-of-last-resort, positioning the Federal Reserve as the ultimate protector of American financial market stability. For example, many analysts contend that government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac have retained their privileged status in the secondary mortgage market in part because investors believe that the government will not let the agencies fail. Fannie Mae has subsequently been able to generate more than $2.1 billion dollars in profit for its stockholders while paying nothing for the federal backing it receives[21].

In addition, when banks provide back-up lines of credit to issuers of commercial paper, the responsibility of covering impending illiquidity ultimately devolves to the Fed. In this way, many non-bank institutions continually receive indirect access to the Fed and the lender-of-last-resort provision. Conventional banks have had access to federal deposit insurance and emergency liquidity provisions since the early 1930s, but their access has been conditional upon their ability to remain within certain financial soundness guidelines. Access to the Fed's discount window is subsequently not a truly subsidized benefit because the protection is coupled with significant risk premiums. Federal protection for parallel banks, however, involves a substantial taxpayer subsidy because non-bank institutions are given federal protection without any of the same conditional provisions or soundness requirements. This suggests that nonbank institutions may take on significantly greater institutional risks yet benefit from having equal or near-equal access to federal protection and emergency loans. These inconsistencies highlight that by exempting non-banks from local reinvestment and soundness requirements, the government and the public are inadvertently supporting the development of a risky financial system that operates devoid of any regulation and social obligations.

D. Recommendation: A National Forum on the Community Reinvestment Responsibilities of Parallel Banks

NACDLF strongly supports the extension of community reinvestment requirements to the non-bank institutions that make up the parallel banking industry but recognizes that simply extending CRA in its current form would not work. While parallel banking reinvestment policies need to accommodate the institutional diversity that makes up the parallel banking industry, they must also be grounded in a clear substantive commitment to the needs of low-income communities. This can take either or both of the following approaches:

- Where appropriate, non-banks should be encouraged to develop viable vehicles for their own *direct involvement* in low-income communities. For example, direct investment by parallel banks could be promoted through income "distribution" requirements on nonbank investment and loan portfolios—e.g., finance companies might be required to target a percentage of their total lending at affordable rates to low-income households meeting certain income requirements. In turn, favorable ratings of finance companies' commercial paper issues could reflect a company's demonstrated ability to consistently target affordable loans to low-income populations[22]. This effort would be aided by industry-wide in-depth analyses of the distributional lending patterns and affordability of finance companies and other non-bank lenders' products.

  Savings instruments such as mutual funds and pension funds could similarly be tailored to meet the specialized savings and investment needs of low-income individuals. Individual development accounts (IDAs) are a possible model. These specialized savings accounts help low-income individuals accumulate wealth and direct savings towards high-yield public purpose investments such as education, business creation, and home ownership. The creation of similar "asset-building" mutual funds for low wage earners could help lower income households not only save for their future but also provide them with an entry point for participating in the parallel banking system. In addition, the development of more flexible "wealth" accounts which address low-income households' tendency to keep their savings in relatively illiquid assets would help individuals build viable bases for their future.

- In other cases, parallel banking institutions can participate in community reinvestment via *indirect partnerships* with CDFIs which specialize in financing revitalization efforts in low-income and other economically disadvantaged communities. By partnering with CDFIs, parallel bank institutions can substantially increase the leverage of their initial investment. Many CDFIs have already demonstrated significant creativity in collaborating with conventional financial institutions to distribute credit to unconventional markets. For example, some NACDLF Member CDFIs receive investments from, borrow debt from, co-invest with, and manage lending pools for conventional institutions. Several options for supporting even greater collaborations have been proposed:

  - The practices of some socially-responsible mutual funds which invest a percentage of their total mutual fund shareholder base as common stock in companies that operate with a demonstrated social awareness suggest one model. While investments in non-profits cannot be in the form of common stock, aggregated savings instruments such as pensions and mutual funds could make equity-like investments in non-profit CDFIs or true equity investments in for-profit CDFIs and earn consistent positive returns.

  - The Southern Finance Project has proposed creation of a National Reinvestment Fund, capitalized with levies on parallel banks, which would provide a capital base for CDFIs. The Fund would operate through the Federal Reserve System.

These approaches and proposals demand greater discussion, revision, and refinement. For that reason and to encourage greater attention to the community reinvestment effects of the structural shift in the financial services industry, NACDLF plans to convene a national forum in early 1997 that will seek a workable policy to extend community reinvestment obligations to the entire government-aided financial services industry. In addition to NACDLF and its Members, this forum will invite participation by community reinvestment advocates, conventional and parallel banking representatives and regulators, CDFI practitioners, academics, and others. In promoting a comprehensive discussion about the parallel banking system, NACDLF aims to raise local and national awareness about the subsidies that benefit nonbank institutions and develop an achievable agenda for bringing about greater social, political, and economic justice in America's low-income communities.

Finance companies—Nonbank corporate institutions that serve as important sources of credit for many households. Like a bank, finance companies offer a wide spectrum of loan types; however, finance companies do not accept deposits. Finance companies were originally started as captive subsidiaries of large manufacturing firms that financed customers' purchases of company durables. Since then, finance companies have dramatically expanded their market share and become some of the primary issuers of commercial paper and consumer durable loans. Examples of finance companies include The Money Store and Ford Motor Credit.

Glass-Steagall Act—A regulatory law passed in the early 1930s that established limitations on the securities activities conventional banks are allowed to pursue, restricting their focus to payment and intermediary services. Banks have continually pushed the boundaries of the Glass-Steagall Act as they are increasingly taking advantage of securitization trends overseas in the global financial market and becoming players in the global securities market.

Government-sponsored enterprises (GSEs)—Government chartered agencies such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) which were created to increase the volume of mortgage sold by facilitating the development of a secondary market. GSEs specifically participate in secondary markets by acting as the primary buyers of packaged conventional mortgages. Although created as government agencies, corporations like Fannie Mae have since become publicly traded stocks, providing benefits to a range of private investors.

Individual development accounts (IDAs)—Special savings accounts that are designed to promote savings by moderate income households. The assets in an IDA are sheltered from taxation (like conventional individual retirement accounts (IRAs)) and are not incorporated into the income calculations of public assistance agencies. Savings in IDAs can only be withdrawn for pre-specified investments such as education, homeownership, and business development. Many community development initiatives around the country are currently exploring the use of IDAs as asset development mechanisms.

Insurance companies—Companies that not only compensate individuals in the event of an accident or loss but also enter the financial market by serving as a vehicle for long-term savings. Using whole-life insurance as a means for savings was particularly commonplace before World War II. Whole-life insurance policies have fixed premiums that guarantee interest-earning benefits throughout the life of the insured; in this way, they combine long-term savings with regular term insurance. Since the rise of other high-yielding institutional savings arrangements in the 1950s and 1960s, insurance companies' roles as savings vehicles has declined. A primary benefit gained from using insurance companies as savings vehicles is that any income earned through the savings is tax-deferred; however, the returns available are somewhat limited because of regulations that govern insurance companies' investment choices.

Insurance guarantee funds—Funds established by the states and financed by insurance companies to pay outstanding claims of insolvent insurance companies. The funds cover individual policies up to an annual predetermined maximum. The size of a company's contribution to the state fund is proportional to the amount of activity a company does in that state.

Money Market Mutual Funds (MMMFs)—A specific type of mutual fund that invests in short-term securities such as commercial paper and other money market instruments. By the early 1990s, MMMFs had become some of the dominate buyers of commercial paper, holding over one-third of all outstanding paper. MMMFs have increasingly come to resemble conventional bank accounts because they allow one to redeem their investment shares by writing checks against one's money market account.

Mutual Funds—Long-term investment vehicles for households and businesses that are managed by investment companies and pool individuals' savings in share arrangements to pur-

Glossary of Key Terms

Commercial Paper Market (Money Market)—The financial market that concentrates in the buying, selling, and trading of short-term securities such as commercial paper. The appeal of money market instruments is that they are generally very safe and liquid because of their short maturity and the fact that they are almost always backed by bank lines of credit. Instruments traded in this market include negotiable certificates of deposit, Treasury bills, and commercial paper as well as inter-bank trades between Federal Reserve banks and conventional bank institutions. Commercial paper, an important part of this market, is short-term promissory notes issued by banks, corporations, and other borrowers and bought by those with surplus cash-flows. The average value of a commercial paper issue is about $120 million dollars. Finance companies are some of the largest direct and indirect issuers of commercial paper; their paper is then frequently purchased by money market mutual funds. Trading activity in the money market occurs either directly when finance companies independently place commercial paper into the market or indirectly through dealers.

Community Development Financial Institutions (CDFIs)—Community-based financial institutions that provide credit and related services to individuals and organizations who lack access to conventional financial institutions. CDFIs comprise community development banks, community development credit unions, community development loan funds, community development equity (or venture) funds, and microenterprise funds. The CDFI Coalition estimates that established CDFIs in the U.S. currently manage about $1.8 billion in capital and have loaned nearly $4 billion dollars in disadvantaged communities around the country.

Community Reinvestment Act (CRA)—Fair lending law passed in 1977 that requires banks to make an affirmative commitment to the credit needs of their local community, including the needs of low and moderate income residents. The CRA has been revised numerous times, most recently in 1995, culminating in much less stringent regulations. The CRA remains, however, the most encompassing and effective fair lending legislation passed this century.

Defined benefit pension plans—A type of pension plan which offers employees a pre-determined level of benefits when they retire. Benefit levels typically depend on the tenure of employment by the individual and his or her compensation in the final years of employment. Government and union-based plans historically tend to be defined benefit plans.

Defined contribution pension plans- Pension plans in which employers annually contribute a certain amount of money to be used towards the retirement savings of the plan participant. Employees also often make voluntary contributions or match the employers' share of their retirement savings under these plans. These plans have become increasingly popular because they are portable when people change jobs. Examples of defined contribution plans include 401(k) plans for for-profit corporations and 403(b)s for non-profits.

Employee Retirement Income Security Act (ERISA)—A regulatory pension law passed in 1974 that governs the activities of private defined benefit pension plans. Included in ERISA are plan diversification and disclosure guidelines as well as insurance regulations. Moreover, ERISA mandates that all defined benefit plans must purchase federal insurance from the Pension Benefit Guarantee Corporation.

FHA/VA mortgage loans—Mortgage loans that are targeted towards certain borrowers and are backed by government insurance either through the Federal Housing Administration (FHA) or the Veteran's Administration (VA). These mortgages are sold individually in the primary mortgage market but are then securitized and recirculated in the secondary mortgage market as mortgage-backed packaged investments. Because these mortgages are insured by the government, secondary market investors are eager to purchase FHA/VA backed investments for they carry extremely little repayment risk.

Notes

[1] Robert D. Hershey, Jr., "U.S. Discloses Pension Fund Rescue Plan," *New York Times*, 4 October 1996.

[2] James Grant, *Money of the Mind* (New York: The Noonday Press, 1992), 5.

[3] Edward Wyatt, "For Mutual Funds, New Political Muscle," *New York Times*, 8 September 1996, F1.

[4] In 1983, nonbank financial firms specifically held 26% of the outstanding domestic credit debt; by 1993, this share had risen to 37% while depository institutions' share (including foreign banking offices) had decreased 13% to 27%. The share of commercial paper contributed by all non-bank lenders has additionally increased fourteen percent to 62% of total outstanding commercial paper while banks' share has decreased to a low of 5% (Tom Schlesinger, "Reinvestment Reform in an Era of Financial Change," Southern Finance Project, 1995 Table 12).

[5] Ibid, Table 47.

[6] Saul Hansell, "Wave of Mergers Is Transforming American Banking," *New York Times*, 21 August 1995, A12.

[7] James L. Pierce, *The Future of Banking* (New Haven: Yale University Press, 1991), 67-70.

[8] *New York Times* reports from September 29, 1996 describe, however, that Fidelity, one of the largest mutual fund companies, is currently applying for SEC permission to develop a limited self-insurance mechanism which would insure $100 million of Fidelity's money market fund holdings. Other major mutual fund companies are exploring similar insurance schemes. While insurance seems to superficially benefit consumers, these self-insurance schemes may actually limit the liability that mutual fund companies ultimately face (*New York Times*, 29 September 1996, F6).

[9] James L. Pierce, *The Future of Banking* (New Haven: Yale University Press, 1991, 7.

[10] Tom Schlesinger and Regina Markey, "America's Restructured Financial System," Industrial Heartland Labor Investment Forum, June 14-15, 1996, Table 3.

[11] While pension funds also offer tax-deferred benefits, there is a limit to the amount of income that can be accumulated in a pension fund. Similar restrictions do not apply to insurance companies. In contrast, income raised through mutual fund investments generally is taxable, except for returns on municipal, state, and other tax-exempt bonds.

[12] Tom Schlesinger, "Reinvestment Reform in an Era of Financial Change," Southern Finance Project, 1995, Table 12.

[13] Meir Kohn, *Financial Institutions and Markets* (New York: McGraw-Hill, Inc., 1994), 329.

[14] Jane D'Arista and Tom Schlesinger, "The Parallel Banking System," Economic Policy Institute, 1993, 25.

[15] Dwight B. Crane and Zvi Bodie, "The Transformation of Banking: Form Follows Function," *Harvard Business Review*, March-April 1996, 110.

chase large volumes of both short and long-term securities. Most commonly, mutual funds invest in corporate stocks, bonds, options, and money market instruments. The distribution of investments is largely controlled by individual investors who may choose the level of risk they would like associated with their investment. For example, most mutual funds offer investments in either high-risk growth stocks for the more adventurous or low-risk short-term securities for more risk averse investors. Fidelity, Vanguard, and Merrill Lynch are three of the largest international mutual fund managers.

Pension Benefit Guarantee Corporation (PBGC)—An agency established by ERISA to insure and monitor defined benefit pension plans. If a plan seems to be in danger of insolvency, PBGC may terminate the plan but must compensate investors for lost benefits up to an annual maximum. The guarantee corporation is currently chaired by Department of Labor Secretary, Robert Reich.

Pension Funds—Long-term savings vehicles that provide retirement income to employees (and often, their spouses). Pension funds most commonly fall under two types, defined benefit and defined contribution plans and are frequently integrated with Social Security benefits.

Regulation Q—A federal usury law passed in the early 1930s that limited the amount of interest banks and other savings institutions could pay on time deposits. While this interest rate ceiling was phased out by 1986, its existence indirectly contributed to the dramatic growth of nonbank institutions in the financial system for the regulation gave nonbank institutions a clear competitive advantage in attracting funds.

Securities and Exchange Commission (SEC)—The primary regulatory body for capital and securities markets. The SEC was established as a federal agency in 1934 and is made up of five commissioners appointed by the President. The Commission governs all national securities exchanges and associations, sets diversification and disclosure guidelines for the industry, and generally works to protect investors in the capital market. In general, however, the regulation of securities markets is much less stringent than conventional bank regulation.

Securities Investor Protection Corporation (SIPC)—A guarantee fund that insures the accounts of securities firms' customers up to $500,000, providing $100,000 insurance on cash accounts. SIPC is financed internally by assessments on all registered securities dealers who are required to join SIPC. Many brokers also couple SIPC protection with additional private insurance coverage. SIPC has access to a $1 billion dollar line of credit from the U.S. Treasury.

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[16] James Grant introduces the idea of "socializing risk" in his book *Money of the Mind* to describe how more and more debt has become federally subsidized. With federal backing, lending costs are shifted as the public sector's credit effectively supplants that of the private sector (James Grant, *Money of the Mind*, New York: The Noonday Press, 1992, 5).

[17] Tom Schlesinger, "Reinvestment Reform in an Era of Financial Change," Southern Finance Project, 1995, 17.

[18] Ibid, Table 27.

[19] Ibid, 2.

[20] John H. Boyd and Mark Gertler, "Are Banks Dead? Or Are the Reports Greatly Exaggerated?" Federal Reserve Bank of Minneapolis, *Quarterly Review*, Summer 1994.

[21] Jackie Calmes, "Federal Mortgage Firm Is Facing New Assault to Privileged Status," *The Wall Street Journal*, 14 May 1996, A1.

[22] Finance companies are prevalent lenders in low-income neighborhoods but their loans are rarely affordable because of the extremely high interest rates they charge.

My name is Clara Miller and I am the President of the Nonprofit Facilities Fund. I also chair the board of the National Community Capital Association and am an Advisory Board Member of the U.S. Department of the Treasury's Community Development Financial Institutions Fund, which together give me a broad perspective on the CDFI industry.

The Nonprofit Facilities Fund is an experienced CDFI that operates nationally. NFF has $23 million in assets and five offices serving the San Francisco Bay Area, Massachusetts, Philadelphia, and Chicago, as well as New York. NFF supports its nonprofit clients' multi-faceted contributions to low- and moderate-income communities, advances community and economic development goals and works to fill the overall need for capitalization of organizations in this sector. It has financed approximately $90 million in projects with $25 million in loans, mostly in the New York area.

As most of us are aware, small- and medium-sized nonprofit organizations, especially those serving low- and moderate-income communities, have a difficult time accessing capital in general. They are frequently engaged in low- or no-margin businesses, thus lack retained earnings to fund their growth needs. They lack the ability to raise equity, since individual ownership is prohibited. NFF works in a variety of ways to improve their access to capital. One of its main strategies in doing so is to partner with banks—as direct lenders to nonprofits, as investors in NFF's loan program, and as partners in innovation, creating new products and services to address the needs of this market.

NFF has a long history of bank partnerships. Ten banks are direct investors in NFF's loan fund; some take part in other ways. With a few, we have relationships that include a complex mix: volunteer involvement, financial and business advice, product development, participation in deals and referrals—in addition to investment and grant support. Citibank has been such a partner, working with us to strengthen the nature and volume of financial and advisory services that we can provide to the nonprofit sector. As NFF has expanded nationally, our relationship with Citibank has expanded geographically as well.

Citibank has been a particularly valuable part of innovation in our sector because of the quality as well as the size of their investment. Citibank has made long-term commitments to us in the form of an innovative subordinated loan product (the equity equivalent investment, developed with National Community Capital); and Citibankers are working closely with us to develop a non-debt financial product. We have found that Citibank is willing to take the long view. It looks at the long-term growth needs of borrowers (including CDFIs such as NFF), is curious about and engaged in the community development market, and understands the broad needs of the market we together are trying to serve, including management development, non-debt financing and ongoing financial advice, as well as capital.

Based on our direct experience with Citibank over an 18 year period, I have no reason to believe that the proposed acquisition of Citicorp by Travelers Group, Inc. will impair Citibank's commitment to community investment.

YMCA of Greater New York
We build strong kids, strong families, strong communities.

Every Kid Deserves a Y

333 Seventh Avenue • New York, NY 10001
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June 24, 1998

The Honorable Alan Greenspan
Chairman
Federal Reserve Board
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Mr. William J. McDonough
President
Mr. James K. Hodgetts
Senior Vice President
Federal Reserve Bank ofNew York
33 Liberty Street
New York, New York 10045-0001

re: **Citibank-Travelers Group proposed merger**

Dear Chairman Greenspan, Mr. McDonough and Mr. Hodgetts:

The YMCA of Greater New York, founded in 1852, is a community service organization which promotes positive values through programs that build spirit, mind and body, welcoming all people, with a focus on youth. We serve 144,000 New York City youth today and expect to serve 200,000 by the millenium. We believe that the combined Citicorp-Travelers corporation will continue its strong support of our commitment to youth.

We have had long and supportive relationships with Citibank and Travelers Group. Since 1988 alone, Citibank has made more than $200,000 in philanthropic contributions to our work, and Travelers (including Salomon Smith Barney) has also contributed $200,000. As a result, we have been able to extend our programs—in youth sports, character and leadership development, community service, literacy—to as many as thousands of New York City children who would otherwise have gone without them.

Citibank and Travelers were early underwriters of the YMCA's *Virtual Y* after-school program in partnership with the New York City Board of Education. As the sponsors of sites at P.S. 50 in the Bronx, P.S. 169 in Brooklyn, and P.S. 142 in Chinatown, they are providing a constructive, literacy-based experience for on hundred elementary schoolers three hours a day, five days a week. Today there is much talk about the need for positive alternatives for kids during the critically important after-school hours. Citibank and Travelers are helping the YMCA to answer that challenge in New York.

The YMCA has been grateful for the solid support it has received from Citibank, Travelers and Salomon Smith Barney. I have worked closely with Paul Ostergard (Citicorp Foundation), Chip Raymond (Travelers Foundation), and Jane Heffner (Salomon Smith Barney Foundation), and I can attest to their personal and professional commitment to community development in New York City.

We have high confidence that the combined Citicorp-Travelers organization will maintain its strong position as a community supporter in New York City.

Sincerely,

Paula L. Gavin

Paula L. Gavin
President

TESTIMONY OF
PETER J. ELKOWITZ, JR. EXECUTIVE VICE PRESIDENT, CFO
LONG ISLAND HOUSING PARTNERSHIP, INC.
BEFORE THE FEDERAL RESERVE BANK OF NEW YORK
REGARDING TRAVELERS GROUP INC. ACQUIRING CITICORP
JUNE 25 1998

Good afternoon. My name is Peter Elkowitz, I am the Executive Vice President and CFO of the Long Island Housing Partnership, Inc. and its affiliates. The Housing Partnership is a not-for-profit organization whose mission is to create housing opportunities to those who, through the unaided operation of the marketplace, would be unable to secure decent, safe and affordable homes. LIHP has been accomplishing its mission through the development and sale of homes to persons of very low-, low- and moderate incomes as well as through the provision of various supportive services such as mortgage and financial counseling, technical assistance, downpayment assistance, etc.

I would like to take this opportunity to thank the Federal Reserve Bank of New York for allowing me to speak at this hearing. On behalf of the Long Island Housing Partnership and its affiliates, I would like to express sincere support of the proposed acquisition of Citicorp by Travelers Group Inc. on the assistance that the Housing Partnership has received from Citibank/Citicorp Foundation.

LIHP and its various affiliated corporations have been extremely productive with various accomplishments relating to housing production, community development and supportive programs. Since its founding ten years ago, the Partnership has constructed and sold over 400 units of affordable housing and has counseled thousands of prospective home buyers. In addition, the Partnership administers municipal community development programs and downpayment assistance programs.

The Housing Partnership has many members from the business, labor, religious, education and financial sectors. Much of our support, including administrative grants; construction loans for our affordable housing programs; and mortgage loans for our purchasers, comes from member financial institutions. I am pleased to say that Citibank/Citicorp Foundation have been active members of the Long Island Housing Partnership and have provided financial support and expertise over past ten years.

In fact, Citicorp has been one of LIHP's most responsive partners, consistently demonstrating a commitment to affordable housing and community development. Over the years, this institution has provided the Housing Partnership with over $179,250 in contributions for various programs and operating expenses.

Citibank serves as an active member of the Long Island Housing Partnership Board of Directors and its Regional Lending Consortium, as well as the Mastic/Shirley, Long Beach, Membership, Minority Outreach, Babylon, Nominating and Foreclosure Task Force committees. Specifically, Citibank's representative on the Partnership Board, Michelle DiBenedetto, is chairperson of the Mastic/Shirley, Long Beach, Nominating and Membership Committees.

In addition, Citibank co-sponsored mortgage counseling seminars for very low-, low- and moderate-income Long Islanders. Citibank has provided mortgage loans to low- and moderate-income persons who purchased homes through LIHP. Citibank is also a member of the New York Mortgage Coalition, an effort by financial institutions and community organizations, including the Long Island Housing Partnership, who are committed to increasing home ownership opportunities for persons of low- and moderate- income by helping them qualify for mortgage loans. As part of the New York Mortgage Coalition, Citibank offer mortgage products that make it easier for lower income persons to qualify for loans.

Citicorp Foundation funds were given to LIHP for training to the not-for-profit mortgage counselors in Brooklyn, Queens and Long Island and to assist with the development of 78 low and moderate income rental and home ownership units in downtown Bay Shore. Specifically the funds were used to offset administrative costs associated with securing public funds and to hire a social worker to assist with the relocation of current residents.

Citibank is also an active participant in the Long Island Regional Lending Consortium, a group of lending institutions that pool their funds and share the risk so that socially and credit worthy affordable housing can be financed and constructed.

It should also be pointed out that Michelle DiBenedetto from Citibank was instrumental in the success of the Federal Reserve Long Island Home Purchase Process Initiative (LIPPHI). In addition, as a LIHP Board Member, Ms. DiBenedetto kept the Board Members informed of the progress made by the Initiative.

It is noteworthy that, in anticipation of the merger, the new Citigroup has indicated that it would continue to provide substantial administrative support and special project grant funds for affordable housing initiatives to low- and moderate- income homebuyers. In addition, the Housing Partnership has been assured that the new Citigroup will continue to provide both construction and mortgage loans for its various affordable housing development programs.

Over the next five years, the Housing Partnership will be embarking on many affordable housing projects the largest of which are redevelopment efforts in the Town of Islip and Riverhead that are projected to yield over 150 affordable housing units for families of low income. The Housing Partnership also plans to develop other housing units in Nassau and Suffolk Counties which will require both construction and end-loan financing. While it is difficult to estimate the value of end loans projected for our affordable home buyers over the next five years, it is expected that such value will exceed $10 million. Based on past experiences, the Housing Partnership is certain that the new Citigroup will be an active participant in the financing of its affordable housing and community development programs.

The Housing Partnership is grateful to Citibank for its support through various community development programs. Furthermore, it commends the new Citigroup for its foresight of the importance of such programs. Again, the Housing Partnership would like to express its support of the acquisition of Citicorp by Travelers Group Inc. Based upon our past interaction with Citicorp, it is our belief that Citicorp's demonstrated commitment to the development of affordable housing and community development in this region will continue. Thank you for the opportunity to speak before you today.

The Housing Partnership looks forward to working with CITIGROUP to fulfill its pledge of $115 Billion for affordable housing and community development.

Testimony offered by William C. Dorsey At June 25, 1998 Public Meeting on Proposed Acquisition of Citicorp by Travelers Group Inc.

Good Afternoon Mr. President, Fellow Witnesses and Honored Guests.

My name is William Dorsey and I am the Executive Director of the Grow Bridgeport Fund. The Grow Bridgeport Fund is a capital access program designed to provide credit to small and medium sized businesses in the Greater Bridgeport region. GBF is a partnership made up of the City of Bridgeport, The State of Connecticut, Bridgeport Economic Development Corporation, Community Economic Development Fund, and three banks, including Citibank.

I came here today to talk about the crucial role that Citibank has played in the formation of the Grow Bridgeport Fund and how the bank's continued involvement is critical to the Fund's future development.

GBF grew out of the Bridgeport's Empowerment Zone application process, when the entire community recognized that a key impediment to the City's economic growth was that credit from traditional lenders was not available for small businesses. This sentiment was particularly acute in the wake of the New England banking crisis, which witnessed the demise of several local finan[illegible]nstitutions and the removal of credit decisions from local to regional banking centers. The community as a whole suffered from this lack of access to credit because it stymied Bridgeport's ability to expand its tax base and to create job opportunities for its low to moderate-income residents.

In early 1995, the City of Bridgeport sent out requests to 18 banks operating in Southwestern Connecticut, to participate in the Grow Bridgeport Fund. Citibank was one of only three banks that responded. From the earliest planning sessions, it has actively participated in the fund through its representative, Ellen Tower and its counsel Larry Brown. They have asked tough questions, but they were also willing to make the compromises necessary to make this unusual coalition of the private and public sectors work. Further, once our operating agreement was put into place in late 1997, Citibank was the first bank to provide an equity contribution in the amount of $250,000.

Since that time, the Grow Bridgeport Fund has gone on to make loan commitments totaling $612,000, with another $1.7MM in requests. Ellen Tower sits as a member of our Board of Managers and Michael LaBella serves on our Investment Committee, which reviews and approves all requests for credit. They continue to bring resources to the table, both human and financial, which contribute to the growth and stability of GBF. Citibank has made training available to develop and expand the capacity of our staff through classes taught by the National Development Council on the design and administration of revolving loan funds; it has helped to defray a portion of our marketing expenses; it has helped shape a risk rating system for our loan portfolio; and it has identified potential sources of capital, which will allow GBF to prudently expand its lending activities.

I think that Citibank's participation in the Grow Bridgeport Fund and other Bridgeport based organizations is all the more praiseworthy because there are no Citibank branches or loan offices in the city. What we are witnessing is not the implementation of some marketing strategy, but rather the type of corporate citizenship that has recognized the genuine needs of an underserved community and has taken concrete steps to meet those needs. Citibank's commitment to Bridgeport represents an act of leadership that is all to often absent in this era of consolidation within the financial services industry which has been marked by rampant disinvestment in smaller and less wealthy communities.

The collective expertise and wisdom of a Citibank is an invaluable resource and it is the most valuable asset to a fledgling organization such as the Grow Bridgeport Fund. As the financial services industry continues to contract, and creative alternative lenders continue to emerge to serve needs of those business borrowers at the lower end of the spectrum who don't met traditional credit criteria, energetic participation by traditional lenders is needed to support the efforts to manage and expand these portfolios. It is the transfer of the larger institution's expertise that is almost as critical as capital in making these alternative-lending institutions viable. Citibank's participation in the Grow Bridgeport Fund has been a model of how these knowledge transfers can take place and we hope that this example of responsible and enlightened corporate support will continue in the future.

Thank you for the opportunity to address you this afternoon. I would be pleased to answer any questions now or at a later date.

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GBF grew out of the Bridgeport's Empowerment Zone application process, when the entire community recognized that a key impediment to the City's economic growth was that small businesses could not get credit from traditional lenders. This sentiment was particularly acute in the wake of the New England banking crisis, which witnessed the demise of several local financial institutions and the removal of credit decisions from local to regional banking centers. Further, this lack of access to credit stymied Bridgeport's ability to expand its tax base and to create job opportunities for its low to moderate-income residents.

Planning for the Grow Bridgeport Fund began in early 1995 and Citibank participated in these sessions from the outset. Through its representative, Ellen Tower and its counsel Larry Brown, Citibank helped to shape the mission and policies of our organization. They asked tough questions, but they were also willing to make the compromises necessary to make this unusual coalition of the private and public sectors work. Further, once our operating agreement was put into place in late 1997, Citibank was the first bank to provide an equity contribution in the amount of $250,000.

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The collective expertise and wisdom of a Citibank is an invaluable resource and it is the most valuable asset to a fledgling organization such as the Grow Bridgeport Fund. As the financial services industry continues to contract, and creative alternative lenders continue to emerge to fill this vacuum at the lower end of the spectrum for business borrowers, energetic participation by traditional lenders is needed to support the efforts to manage and expand their portfolios. It is the transfer of the larger institution's expertise that is almost as critical as capital in making these alternative-lending institutions viable. Citibank's participation in the Grow Bridgeport Fund has model of how these knowledge transfers should take place.