

Opening the Vault

BY CHARLES GERENA

Black-owned banks have a long history of providing financial services to underserved communities, but how important are they in today's market?

Robert Johnson, America's first black billionaire, decided to get into the financial services industry last year. He purchased a majority stake in a struggling minority-owned bank in Orlando, Fla., infusing millions of dollars into the institution to position it for a future national expansion.

Named Urban Trust Bank, the firm will target urban residents who don't already have accounts and have limited access to capital, particularly blacks. In addition to using capital from Johnson and his network of CEOs, bank officials want to join the Treasury Department's Minority Bank Deposit Program, which encourages corporations, federal agencies, and state and local governments to put their savings in banks owned by women and minorities.

Still, the bank's officers make it clear that Urban Trust isn't all about the black community. They want to make money by attracting customers of all races and backgrounds. Single mothers and people with questionable credit records will be served alongside minority students and small-business owners applying for loans.

More than a century ago, the economic realities imposed by segregation required blacks to pool their

resources and help each other. Black-owned banks are part of this long tradition. During their peak between the end of the Reconstruction era and the start of the Great Depression, more than 130 of these institutions opened for business, providing capital to black entrepreneurs and prospective homeowners at a time when it was expensive or impossible to get elsewhere.

Not surprisingly, most of these banks were in the South, where 90 percent of blacks lived. The Fifth District accounted for one-third of the total, with Virginia having the most of any state.

Today, there are only 44 "black-owned banks," where African-Americans own at least 51 percent of the voting stock. Three other banks have minority board of directors and focus on the black community. Again, most operate in the South. They commanded more than \$6 billion in assets in 2006, less than 1 percent of the total capital held at commercial banks.

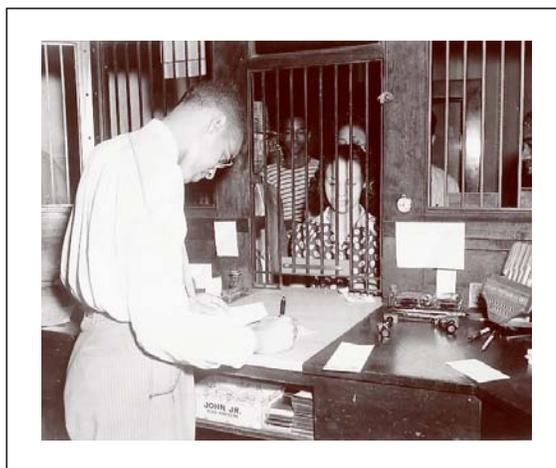
Whether there is still a need for financial institutions operated by blacks for blacks has been hotly debated. The United States is more racially integrated, but the challenges of serving African-Americans and other unbanked residents in poorer communities remain.

A Penny Saved, A Penny Loaned

In the 19th century, banking activity was fairly widespread. "Capital accumulation in the Southern financial sector in the antebellum period compared favorably with Northern accumulation on a per-capita basis," notes Howard Bodenhorn, an economist at Lafayette College who has written extensively about banking history.

As for blacks, some of those who were enslaved in the South managed to participate in the economy on a limited basis. They sold their services on

By the 1950s, Mechanics and Farmers Bank had become a fixture of "Black Wall Street" in Durham, N.C. The black-owned bank celebrates its 100th anniversary next year.



PHOTOGRAPHY COURTESY OF MECHANICS AND FARMERS BANK

occasion, and a few established small businesses on the side.

Their credit needs were filled by blacks who accumulated enough wealth to buy their freedom. These informal bankers collected other people's savings and used the funds to make small loans. Also, mutual-aid societies pooled people's resources to offer a variety of services, including financing for black entrepreneurs.

Meanwhile, free blacks in the North created similar institutions to provide banking and other services to each other. As the nation's industrialization and westward expansion increased the overall demand for capital during the mid-19th century, however, they realized other sources of credit were needed. Church and business leaders in the black community gathered in New York City in 1851 to discuss, among other things, the formation of a mutual savings bank. They believed the bank would help blacks buy their own homes and start businesses, as well as encourage thrift. Black leaders talked about this idea again in New York and in Philadelphia four years later. But the bank was never created. The tensions leading to the Civil War in 1861 probably reduced the viability of their plans.

Bodenhorn has his own theories. "Economic logic tells me that blacks just did not have the resources to keep a bank going," he explains. "Banks prosper when they can tap into two markets — wage earners who need a depository and entrepreneurs with potentially lucrative projects." Black communities often had neither. "Workers earning barely more than subsistence [did not] provide a reliable source of deposits, and black entrepreneurial projects were not the most promising of the available set of projects."

During the Civil War, the federal government established banks administered by Union generals as a safe place for black soldiers and refugee camp workers, as well as emancipated slaves, to park their money. Two of these banks opened in 1864, in Beaufort, S.C., and Norfolk, Va.,

where large numbers of black soldiers were stationed.

After the war, hundreds of thousands of dollars sat in these banks unclaimed — many depositors either had died or had returned home without closing out their accounts. Government and military officials decided to redirect this capital into a federally incorporated institution called the Freedmen's Savings and Trust Company in 1865. The bank eventually opened more than 30 branches — mostly in Southern states — and accumulated about \$3 million in deposits.

The Freedmen's Bank was supposed to help newly emancipated blacks. Instead, it didn't survive the banking Panic of 1873, when dozens of private, commercial banks failed following the bankruptcy of a prominent railroad financier. The Freedmen's Bank went belly up a year later.

Some historians blame the failure on a lack of accountability and mismanagement. Others argue that the bank was too cautious and focused on protecting its funds rather than earning a profit. Branches sent their deposits straight to the bank's headquarters to be invested in government securities, and weren't permitted to make loans until 1870.

Left Out

The failure of Freedmen's Bank left many blacks distrustful of the white banking community, especially since the bank was established and managed by whites and hired black advisers and employees later in its history. Combined with the Panic of 1873, it undermined the confidence of blacks in the nation's financial system.

Yet there was arguably pent-up demand for capital. The Reconstruction era, spanning from 1865 to 1877, gave blacks a taste of civil and economic freedom. In later years, however, banks imposed higher interest rates on black borrowers, or simply rejected them. In the 1880s, "Jim Crow" laws in Southern states formalized the segregation of whites and blacks.

Aside from blacks not being welcome in mainstream banks because

of the color of their skin, there may have been economic reasons why they generally were not attractive customers. "Deposits by African-Americans tended to be small and not always cost-effective," noted Nicholas Lash, a finance professor at Loyola University Chicago, in a 2005 journal article. "Also, loan profitability would be constrained by the small scale, illiquidity, and high risk of the loans." Still, there are accounts of blacks with good credit and a solid banking history being turned down for a loan.

To fill this gap, black churches, fraternal organizations, and benevolent societies began supporting the formation of banks in the late 1880s. Individuals also started industrial loan companies, building and loan firms, and credit unions. Thanks in part to these institutions, black business and homeownership rates continued to rise after the Civil War despite many social and legal barriers.

The two earliest examples of black-owned banks were in the Fifth District. The United Order of True Reformers obtained the first charter for a black-owned bank in March 1888 from the Virginia General Assembly. When the Richmond-based bank eventually opened for business in April 1889, it financed various enterprises, including a chain of grocery stores that operated in Virginia and Washington, D.C. But a series of bad loans and an embezzlement scandal eventually forced the state to close the bank in 1910.

Capital Savings Bank in Washington, D.C., opened for business in October 1888. The firm paid dividends to its shareholders and did well in its early years, but it also succumbed to mismanagement 14 years later.

Bad judgment, often attributed to a lack of experience in banking, contributed to the short life spans of a large number of black-owned banks during this period. Many firms either closed their doors or merged with other banks within five to eight years.

Economist Howard Bodenhorn says there are other explanations why

black-owned banks were smaller and less profitable. “[Blacks] had no legacy of banking,” he offers. “They had no substantial collateral [and] earned low wages. A far smaller percentage of blacks were literate.”

Along with these financial challenges came a period of continued volatility and distrust in banking. In addition to the Panic of 1873, two major crises struck the industry, the first in 1893 and the second in 1907. Banks of all stripes would close their doors for weeks at a time to head off runs on their deposits.

Black-owned banks suffered alongside their peers during the Great Depression, probably more so because they were located primarily in minority neighborhoods and served minority clients, says Harold Black, professor of financial institutions at the University of Tennessee. “In [black] communities, their patrons felt the effects of unemployment first and, probably, harder than the population at large,” he explains. “The Great Depression really set back black enterprise.”

At the same time, blacks started migrating from the South to Northern states where economic and social opportunities often were better. This created new customers for the latter region, but drained a significant supply of deposits from the former.

Some banks were strong enough to survive this challenging period. St. Luke Penny Savings Bank was founded in Richmond in 1903 by a black fraternal organization and managed by Maggie Walker. The bank offered low-cost mortgages to blacks and eventually expanded its services and influence beyond the black community, serving as a depository for Richmond’s utility and tax payments. It absorbed two of the city’s black-owned banks during the 1930s to become Consolidated Bank & Trust, which is still operating today as a subsidiary of Abigail Adams National Bancorp.

A Period of Transition

By the 1930s, only nine black-owned banks were still around. Just five new

banks organized between 1934 and 1951, according to one estimate, and many more shut down.

Harold Black says several factors contributed to a decline in the growth of economic well-being of blacks after the Depression and through the 1960s. The Federal Housing Administration supported racially restrictive zoning ordinances and covenants on homes, resulting in a drop in black homeownership. Labor unions worked to improve the wages of its members, but excluded blacks.

Aside from these issues affecting their customer base, black-owned banks faced a painful transition following the civil-rights movement of the 1960s. The racially segregated business districts that had created a captive market for banking services began to disappear. The banks that remained in these districts had to compete for customers with the mainstream banking industry for the first time. Additional competition came later when the Community Reinvestment Act (CRA) was enacted in 1977 to encourage lending to low- and moderate-income communities.

In the view of William Bradford, a professor of business and economic development at the University of Washington, these additional pressures pushed black bankers to improve their customer service, broaden their solicitation of deposits, and develop competitive advantages. Few were able to do so, however. “A number of them were bought out or failed,” Bradford says.

Black banking did experience a resurgence during the 1970s. There were still underserved markets to tackle. Some mainstream banks discriminated against blacks moving into white suburbs. Others allegedly didn’t fund development in poor and minority communities, a practice sometimes dubbed “redlining.” Also, the civil-rights movement encouraged blacks to empower themselves economically.

Government intervention also

played an important role. The federal Minority Bank Deposit Program helped increase the number of deposits at minority-owned financial institutions, while the Comptroller of the Currency pushed for more national bank charters to be awarded to blacks.

Nevertheless, Bradford argues that black-owned banks have become less necessary. In his opinion, the changes that have opened up banking markets to black customers in the last 40 years have reduced the demand for such institutions.

Where’s the Market?

Supporters of black-owned banks and others contend that redlining and similar forms of discrimination against black borrowers still occur, despite CRA requirements. Various studies of whether such discrimination exists have yielded only mixed results.

Finance professor Nicholas Lash of Loyola University Chicago says that there is no conclusive evidence of continuing discrimination against black borrowers. “People on each side of the divide would say, ‘Of course the evidence is conclusive.’ I’m still agnostic about it.”

In general, economic theory suggests that discrimination isn’t a rational choice because it leaves money on the table. Some bankers may have a “taste for discrimination,” as economist Gary Becker of the University of Chicago has argued, but in a competitive market that preference will cost them.

Further, Lash and others argue that the role of black-owned banks in community development is limited. “There may be possible market imperfections, but are [the banks] large enough and do they have enough of a presence to have a significant impact on urban poverty?” Lash questions. His view is that black-owned banks don’t appear to be efficient and profitable enough to have an effect, nor do they exist in sufficient numbers.

Academic studies of black-owned banks in recent decades have found that various aspects of their markets

make it difficult to be profitable. Deposits and loans tend to be small. Since a transaction can entail the same costs regardless of its size, this makes per-unit transaction costs at black-owned banks higher.

The amount of money kept on deposit in black-owned banks is also more variable and the volume of transactions is higher. Economist Harold Black at the University of Tennessee says that, on average, customers hold money in their accounts for relatively short periods. Rather, they deposit their paycheck and quickly start withdrawing funds to pay their bills.

In order to ensure that they have sufficient resources above their reserve requirements to cover transactions, black-owned banks tend to keep more of their money in liquid assets like U.S. government securities. The drawback to these investment vehicles is that they yield lower rates of return compared to corporate bonds or loans.

“Banks always have to balance between keeping some degree of liquidity and making higher profits on loans,” Lash adds. “Other things being equal, the more volatile your source of funding, the more liquid [you have to be] and the less lending you can do.”

Finally, black-owned banks make loans where the return tends to be lower and more uncertain. Combined with receiving lower yields on their investments and higher costs, this has made it very difficult to make money. A 1988 study by Robert Clair, formerly of the Dallas Fed, disputes this conclusion, finding that loan losses and operating expenses of black-owned banks are no different from their nonminority competitors in the same neighborhood. (Clair did find, however, that the return on assets of these banks was lower.)

Micro lenders that cater to the poor as an alternative to traditional banking have found ways to significantly reduce loan defaults, Lash says. Group lending uses peer pressure and monitoring to reduce the risk of default, while progressive lending involves giving small loans initially and increasing the size of loans as borrowers demonstrate their ability to repay. Still, micro lenders tend to struggle to turn a profit and are often heavily dependent on charitable donations.

An Uncertain Future

The continued viability of black-owned banks will depend on meeting the goals of any business — to provide a product that people want at a price they can profit from. But how?

Black bankers say they take the time to work with customers who may have less financial sophistication. “We see education as part of our mission and purpose,” says Kim Saunders, former president and CEO of Consolidated Bank & Trust in Richmond. Saunders recently took the helm of black-owned Mechanics and Farmers Bank, which opened in 1908 in Durham, N.C. “When we sit down with a customer, we are going to explain why we are looking for what we are looking, and why it is important,” she adds. “It is more hand-holding.”

Similarly, black-owned banks aim to have strong, long-term relationships with their customers. In turn, as various studies on banking in general have found, strong relationships provide additional market knowledge that helps banks manage their risks.

“As the industry changes and we add products and services to remain competitive, we are able to go to a specific customer and identify what might

enhance their business because we know them,” Saunders notes.

But can't any community-oriented bank do these things? Saunders says black-owned banks have chosen to stay in the heart of inner cities while other banks focus on the suburbs and the fringes of cities. “That positions black banks to serve a pivotal role in the development that is going on in a lot of the urban cities across the country.” Also, they may be able to develop and nurture relationships with their customers more easily than predominantly white-owned and -managed banks. Lash says it's in the gray areas where the riskiness of a loan isn't clear that black-owned banks may have an advantage. “You're not just looking at the financial statements. You talk to [borrowers] and get a sense of [their] character and reliability,” he says.

However, the banking industry in general is more racially diversified than it used to be. “A lot of banks in the past didn't hire black lending officers. Now they do,” William Bradford says. Relationship building had been something that set black-owned banks apart from their competition, but now major banks are also forging these relationships by hiring officers and representatives “who fit the ethnic profile of their customers.”

Competing against banks large and small, as well as other businesses targeting the poor and unbanked, black-owned banks will need to find a place in the larger marketplace in order to survive. So far, a few have positioned themselves successfully, but this is relatively rare. “You need to be socially valuable and economically valuable in order to prosper and grow over time,” Bradford notes. “It is a difficult position.” **RF**

READINGS

Ammons, Lila. “The Evolution of Black-Owned Banks in the United States Between the 1880s and 1990s.” *Journal of Black Studies*, March 1996, vol. 26, no. 4, pp. 467-489.

Clair, Robert T. “The Performance of Black-Owned Banks in their Primary Market Areas.” Federal Reserve Bank of Dallas *Economic Review*, November 1988, pp. 11-20.

Lash, Nicholas A. “Black-Owned Banks: A Survey of Issues.” *Journal of Developmental Entrepreneurship*, August 2005, vol. 10, no. 2, pp. 187-202.

Price, Douglas A. “Minority-Owned Banks: History and Trends.” Federal Reserve Bank of Cleveland *Economic Commentary*, July 1990.