Ethnic Community Small Business Finance and the Bank Response to the Spring 1992 Los Angeles Riots

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BUSINESSES LOCATED IN DISADVANTAGED communities in the United States often face difficulty borrowing money from banks. This has limited their economic development and is regarded as one cause of poverty in America. Banks are perceived to discriminate against ethnic small businesses located in disadvantaged areas by loaning too little and providing inadequate financial services. This is an aspect of redlining which is defined as banks explicitly delineating some areas of cities where they will not grant loans to otherwise creditworthy borrowers.

The Community Reinvestment Act was passed in response to redlining. The law encourages banks to make a greater effort to lend in disadvantaged areas. The 1992 spring riots in Los Angeles were centered in some of the poorest parts of the city. Many ethnically owned small businesses were looted and damaged by the riots. If the Community Reinvestment Act was effective, banks should have responded to the riot by lending more to businesses and individuals in the affected areas. This paper examines the lending response by banks to the riots.

The paper also considers some of the unique attributes of ethnically owned businesses, particularly Korean-American small businesses, which may explain why so many of these enterprises failed after the spring riots.

Banks are Different

All societies face the fundamental economic problem of how to link borrowers and lenders. In traditional communities, the solution to the

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problem is straightforward: borrowers and lenders know each other well. Lenders know who is likely to repay loaned money; borrowers know who has money to lend. Large complex communities, where borrowers and lenders do not know each other, require a more complicated solution: banks. The primary purpose of banks (and other financial intermediaries) is to channel funds from lender-savers to borrower-investors. They collect the deposits of the household sector, held in the form of transactions (checking) and savings deposits and recycle them into real investment capital. In the process, banks provide several socially valuable functions, such as payments services, maturity transformation (lending long-term and borrowing short-term), risk-reduction through diversification, accurate record keeping of amounts borrowed and lent, portfolio management, and the evaluation and monitoring of the creditworthiness of borrowers. Banks are a major source of investment funds to small and medium-sized businesses that are unable to directly raise money in the stock and bond markets.

Banks are obligated to return deposits to depositors on demand, yet banks typically lend long-term. This can lead to substantial problems when the market value of loan collateral is less than the nominal value of the loan. In such cases the public may lose confidence in the safety of their deposits and rush to withdraw their money, causing the bank to fail. Yet, because of the key role of banks in the payments system and credit creation, bank failure can have an enormous negative impact on the whole economy. Banks are different from other businesses in the sense that their systematic failure can cause depressions.[1] According to Gardner (1992), government regulation and supervision of banks is usually justified for two reasons:

1. banks in a free enterprise system depend absolutely on the confidence of the public in the soundness of their operations, and adequate supervision is perceived as an important factor in ensuring this confidence;

2. under crisis conditions the ultimate guarantee of the continued operation of banks can only come from government, and all governments seek to limit their need for this kind of intervention by ensuring the prudential operation of banks under normal conditions.

Bank supervision hopes to guarantee the integrity of the payments system and to prevent the failure of the financial intermediation process.

The creditworthiness evaluation function of banks provides another justification for regulatory intervention:

> banks either produce or are given access to information not available to other capital market participants. Banks then make lending decisions on the basis of this privately-held information and, when the banks' lending decisions become publicly available, they provide signals about the borrowers' creditworthiness to other capital market participants. Other capital market participants, in turn, are sensitive to the information embedded in banks' lending decisions and incorporate that information into their own evaluations of the borrowers' economic prospects.[2]

Banks influence the provision of credit both by directly making loans to borrowers and also by identifying which borrowers are creditworthy to other lenders. Problems arise when the market values of investment projects financed by bank loans are not equal to their social values. If the market value of projects such as lending to minority-owned businesses is less than the true social value, banks will rationally lend a less than optimal amount. Insufficient lending by banks would signal other providers of credit to lend too little as well.

Banks are uniquely advantaged in the gathering and processing of financial data regarding lending opportunities. Banks might alternatively lend an amount less than socially optimal if they were unable to collect or analyze financial information about borrowers. For example, if minority-owned businesses tended to keep informal or nonstandard business records, banks would find it very difficult to evaluate their creditworthiness.

These last two points, namely that banks might undervalue the loans and financial services they supply or that banks might not have sufficient information to correctly evaluate creditworthiness, suggest an additional role for government intercession in banking. In theory, suitable regulations could make banks consider more of the social value associated with their loans and financial services, and also motivate banks to collect more and better financial information about the creditworthiness of deserving minority businesses and individuals.

Redlining and Financial Parochialism

Redlining is usually defined in terms of the availability of mortgage finance. For the purposes of this research, however, redlining will be regarded as a part of a more general phenomenon that can be described as financial parochialism. Financial parochialism occurs when businesses and individuals who reside in certain regions such as the South-Central area of Los Angeles find it more difficult or expensive to obtain loans and other financial services such as check-cashing. Lenders are alleged to deny or limit loans and financial services to disadvantaged geographic areas regardless of the creditworthiness of the individual borrower or the inherent profitability of the financial service. Financial parochialism is often attributed to ethnic discrimination, racism, or hostility to the poor underclass. Although these explanations are plausible in view of the American history of race relations, the existence of financial parochialism neither requires nor proves prejudice based on race, ethnicity, or class. Geographic variations in the availability of loans and financial services can result from rational economic decisions without malice as well as the market failure described in the previous section.[3]

It is important to recognize that a basic function of banks is to discriminate among borrowers based on their ability to repay loans. This is not simply a matter of good, prudent banking practice; it is also required by government regulatory agencies. The challenge for government regulators is to motivate banks to respond to the credit and financial-service needs of disadvantaged communities, without diluting the credit-evaluation function of banks or risking the safety of the banking system. The policy goal is to provide a socially optimal amount of loans, not to force banks to make bad loans.

The Community Reinvestment Act

The Community Reinvestment Act (CRA) is part of the Housing and Community Development Act of 1977. Its main motivation was to respond to the view that socially undesirable redlining exists.[4] Before the CRA, redlining was not specifically proscribed. The Equal Credit Opportunity Act of 1974 outlawed discrimination in credit transactions based on race, color, religion, national origin, sex, marital status, and age. The Home Mortgage Disclosure Act of 1975 attempted to measure and implicitly repress redlining by requiring disclosure of the amount of mortgage financing based on geographic area.

Although widely perceived as an anti-redlining law, the legislative intent of the CRA was not entirely clear. Its text contains calculated ambiguities that permit regulatory agencies considerable latitude in its interpretation and enforcement. The main part of the law is stated as:

> (a) Congress finds that —
>
> (1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the communities in which they are chartered to do business;

(2) the convenience and needs of communities include the need for credit services as well as deposit services; and

(3) regulated financial institutions have continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.

(b) It is the purpose of this chapter to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with safe and sound operations of such institutions.[5]

Redlining is not formally defined. Specific measurable goals are not mentioned, nor are explicit penalties for failure to achieve goals spelled out.[6] Regulatory agencies apply penalties for failure to achieve goals through intentional administrative delays or denials in the processing of applications for new bank charters, relocations, expansions, mergers and acquisitions. In some respects, the CRA's application has been reminiscent of the Japanese Ministry of Finance's *gyōsei shidō* to banks.

This paper takes the approach that the primary purpose of the CRA was to empower community groups and government regulators to seek a more socially optimal allocation of credit and bank services to disadvantaged communities. The CRA is intended to encourage banks to make a greater effort to make loans and provide financial services to poor communities. It presumes that these services are not supplied at a socially optimal level.[7] It can apply penalties even in the absence of formal proof of redlining. Nevertheless, the CRA does not require that banks make unsafe loans or incur losses.

In practice, banks have responded to the CRA through a variety of programs intended to build friendly relations with community groups, market their financial services to disadvantaged communities and cultivate public images as concerned, responsible community members.

The Spring 1992 Los Angeles Riots as a Case Study

On April 29, 1992, four Los Angeles police officers accused of beating an African-American motorist named Rodney King were acquitted.[8] The reprieve for the officers was extremely unexpected in view of the fact that a video-recording of Mr. King's savage beating had been widely broadcast on television. The African-American community was outraged; it regarded the acquittal as incontrovertible proof that both the police and the American legal system were racially biased. The consequent indignation, combined with a slow and uncoordinated police response and what appeared to be opportunism by gangs and looters, caused catastrophic riots. The rampage caused the deaths of 53 people and injured thousands. Approximately 9,000 were arrested and the estimated damage was $1,000,000,000.[9] Much of the damage occurred to small and medium sized businesses in the South-Central/Koreatown area of Los Angeles. South-Central is an economically disadvantaged district mainly populated by recent immigrants and minorities. Many of the businesses in the area are owned by Asians, primarily Korean-Americans. Damage in the Latino areas of Los Angeles was comparatively light.

Tragic as the riots were, the aftermath has proven to be even more traumatic in economic terms. Riot-related damage devastated many small and medium-sized minority-owned businesses. These businesses tended to be undercapitalized and underinsured. They desperately needed credit to survive and rebuild. Even in relatively prosperous times, these businesses claim to face great difficulty getting loans. Banks reportedly regard small minority-owned businesses as uncreditworthy. The riots underscored the risky nature of loans to these small businesses and many banks have reportedly reduced loans to the affected areas.

Financial parochialism threatens to limit the amount of credit available for recovery from the riots. The problem was summarized eloquently by Joe Sanchez, a prominent Latino businessman:

> You combine the riots, the recession and the depression, it compounded the problem for us business people.... We have [minority] manufacturers, retailers and distributors that would make a commitment to hire the people that were displaced in the riot areas if we were only able to go to the federal government or the banks to get some loans to expand our businesses. El Rey Sausage Co. could hire 10 people: one driver, two in the plant and seven salespeople. All it would take is for these commercial banks or SBA or the federal government to help us expand those businesses. The truth is, it probably makes too much sense. And bureaucrats don't like things that make sense.... There is no way to increase Latino [business] ownership now, because the banks are holding onto the money. They're only lending it to [firms with] Double-A credit. Whatever Latinos are in business now [will] have to maintain. Most of them will survive, because we are survivors. We started with very little capital. We will survive more than non-Latinos, because we are used to less.[10]

The Small Business Administration (SBA) is a federal government agency intended to help small business enterprises.

If the CRA is effective, banks will recognize their legal, affirmative obligation to provide more credit and financial services. The spring riots provide a test of the effectiveness of the CRA in the sense that there is a clear need for increased credit and more generous credit terms by small and medium-sized businesses in the areas devastated by the riots. The question is whether banks are providing this extra credit.

DAMAGE TO BUSINESSES

The spring riots caused extensive damage to businesses in the South-Central/Koreatown area of Los Angeles. A detailed study published by Dun & Bradstreet (D&B), a respected credit information company, found that:

> More than 40 percent of the 522 businesses in the South-Central/Koreatown area of Los Angeles, previously identified by Dun & Bradstreet as sustaining damage in the May riots and recently reassessed by D&B, are no longer in operation. Many of those hardest hit were retail stores, small and long-established businesses.
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> D&B, which initially reported more than 1,700 damaged companies in the South-Central/Koreatown area, reassessed 522 of them last week for D&B customers.
>
> Of the 522 businesses, some of D&B's findings included:
>
> - 43.8 percent (229) are no longer operating at their last known addresses, 195 of the 229 were identified by D&B as retail establishments
> - 74.5 percent (389) of those affected are identified by D&B as retail establishments
> - 90.3 percent (472) are identified by D&B as small firms employing fewer than 50 people
> - 70 percent (366) are reported by D&B to have been in business more than 10 years.

Of the 140 businesses still operating and whose managers were able and willing to provide further information to Dun & Bradstreet:

> - 37 percent (52) reported being insured for 50 percent of the damage or less
> - 25 percent (36) reported being fully insured
> - Owner-estimated damage for the 140 businesses came to $35,580,790.[11]

Korean small retail businesses experienced the brunt of the damage. This might seem surprising because Korean-Americans were not involved in the Rodney King incident nor in the acquittal of the police officers responsible for the beating. Yet Korean-African-American relations had been deteriorating for some time before the spring riots. Much of the ethnic antagonism is based on the perception that recent Korean emigrants had displaced African-Americans from jobs and housing; the Olympic Boulevard area now called Koreatown had been "an underused, low-density residential quarter catering to working-class whites, blacks, and Hispanics" before the Korean influx, which led to increases in real estate values, traffic, and Korean tourism, and as a result, critical racial tensions.[12] There is also an apparently widespread belief that Korean-American retail merchants overcharge members of the African-American Community. The *Los Angeles Times* (1992a) reported that small neighborhood stores sometimes charge as much as 30 percent more than larger retailers. Further, a Korean grocer shot and killed a 15-year-old African-American girl for attempting to steal a bottle of soda in the year before the riot. The grocer was sentenced to five year's probation. The lenient sentence outraged much of the African-American community and led to boycotts and inter-ethnic violence.[13]

In terms of the looting and other damage associated with racial hostilities, the 1992 riots are comparable to the 1965 Watts riot, in which African-Americans looted and destroyed stores owned mainly by Jews and non-native whites. To the African-Americans living in Watts, these stores were foreign and symbolized the white power structure.[14] African-American anger was directed toward Korean merchants, whom they considered foreign. In both cases, African-Americans were not storeowners but rather looters angered and triggered by racially discriminatory events. However, one of the differences is that the 1992 spring riots were more ethnically complex, involving Hispanics and Asians as well as African-Americans. It is also more illuminating of government influence, because Affirmative Action has, since the 1970s, attempted to encourage minority entrepreneurship. African-American-owned businesses were damaged too.

KOREAN COMMUNITY FINANCE

To understand the riots' effects on minority business people and their potential for rebuilding their businesses, we should look into the sources of their funds. Studies show that different ethnic groups affected by the riots—African-Americans, Hispanics, and Koreans—raise business capital quite differently.

Los Angeles Korean businessmen, who are known for their entrepreneurship and also for the heavy damage they experienced in the spring riots, have two major systems for raising investment capital. One is from ethnic sources, which include rotating credit associations, and branches of Korean Banks.[15] The other is from United States government agencies. As a recent immigrant group, Korean-Americans demonstrated ethnic solidarity and mutual help to fight the financial disadvantages they faced. Despite the generally held image and their own self-perceptions, Korean businessmen are said to have actually had access to bank loans. Light and Bonacich (1988) say that in the 1980s the borrowing position of Korean-Americans had improved and was "even superior to that of non-Asians," partly because of the

> augmented supply of mainstream credit to non-white small businesses.... Stung by charges of racism and redlining, white-owned banks were more responsive to minority borrowing needs than in the past. Additionally, a number of minority-owned banks and savings and loan institutions existed in this period, and these institutions extended credit to coethnics.[16]

However, Korean immigrant entrepreneurs tended to rely less on bank loans than other ethnic groups. Because a large proportion of Korean immigrants arrived with higher education and income, they brought considerable savings. Many used their savings to start businesses. They also had their own rotating credit associations, or *kye*, as alternative sources for raising capital, rather than by borrowing from banks, which were actually trying to encourage minority businesses.

ETHNIC CAPITAL SOURCES

Most of the small business operators in the Korean community depended on *kye* for social and business purposes. Although the details of these organizations are not clearly revealed because of their informal nature and individual differences, many admit that *kye* are widely used for raising capital, both in the Korean-American community and in Korea. Light and Bonacich call them "an ethnic response to individual money problems."[17] One of the reasons that Light and Bonacich's interviewees gave for *kye* popularity in Korea was that "people needed kye because banks were useless, but in America people could obtain loans from banks."[18] The *kye* are popular among Korean-Americans, most of whom had higher education and income than average Koreans. "Since higher-status Koreans were overrepresented among immigrants to the United States, the heaviest users of kye in Korea were precisely the strata from which immigrants were recruited."[19]

The popularity of *kye* comes from the circumstances in Korea, where lower interest rates were offered by government or banks to large businesses and small business people were less likely to receive bank credit.

Kunae Kim, a UCLA anthropologist, categorized *kye* into three categories based on their purposes: social, mutual aid, and commercial profit.[20] The latter two are significant; even if *kye* were not good investments, Korean community members would participate for the betterment of their ethnic group as a whole. However, they were not paying money to *kye* for charity. The *key* pay interest, which may or may not be higher than the going rate for bank deposits or government bonds. Tax is rarely paid on *kye* interest income. As a form of investment, *kye* are risky because of their informal nature. There have been many *kye* defalcations.

Korea-Americans also raise capital from more traditional sources including banks. According to Light and Bonacich (1988), Korean entrepreneurs had received less favorable treatment of their loan applications in the 1970s. Besides *kye*, the Los Angeles Korean community opened a few ethnic financial institutions, such as Global Oriental Savings and Loan, the Bank of Finance, the Korean Community Bank, and the Wilshire State Bank.

> Like the kyes and private loans, the Korean-Americans' banks were self-help institutions of the Korean community. However, these formal institutions were built around self-conscious elites of business people whose subscribed capital was loaned to coethnics for profit. This pattern reflected bourgeois social stratification as well as ethnic solidarity. However, all these institutions did depend upon Korean ethnicity in the sense that a random group of equally wealthy business people would not have subscribed capital specifically to service the *Korean* community. Being Korean, the subscribers knew about the financial need of coethnics and how to service it. Additionally the banks all stated that their purpose was to provide capital for the Korean community, a benevolent objective. After all, subscribers might have invested in triple-A-rated corporate bonds had they only desired to maximize safety and yield. That they choose instead to establish banks in Koreatown is evidence that the profit motive was guided to this particular employment by ethnic feeling and ethnic information channels, as well as by the self-interested calculation of financial advantage.[21]

GOVERNMENT SOURCES

The American government also provided the Korean community with finance.

> A few Asians were beneficiaries of preferential treatment by state and federal agencies in the 1970s. This they received under programs intended to stimulate minority business enterprise. Initially launched by the Nixon administration in response to black pressure, these programs included all nonwhite minorities by the early 1970s.[22]

Minority Enterprise Small Business Investment Companies were started both by the federal government (in 1969) and California (in 1975), to help small businesses owned by nonwhites. The Small Business Administration and its Operation Business Mainstream and Economic Opportunity Loan programs "made direct loans or guaranteed bank loans for nonwhite owners of small businesses."[23] The U.S. Department of Commerce's Office of Minority Business Enterprise "funded local business development organizations in which coethnics managed the federal loan fund for the benefit of their people."[24]

Ethnic sources of capital were more common among Asian-Americans than among African-Americans. Light (1972) wrote that, unlike African-Americans, Chinese and Japanese businessmen could fall back on rotating credit associations in case ethnic banks failed, which were "better suited to the small business purposes of immigrants than were banks."[25] Although African-American entrepreneurship was far less prevalent than Asian-American, the affirmative action programs initiated by the government had resulted in more African-American-owned small businesses. But, being owned by African-Americans did not assure protection from riot damage during the spring riots. Many such enterprises were destroyed.

The Bank Response

The bank response to the spring riots was gauged by two approaches. The first was to note public responses in the media. The second approach was a confidential mail survey.

The size and extent of the damage discussed above (page 7) was consistent with the responses to our survey; 69 percent of valid responses reported that individual or business customers were adversely affected by the riots. A substantial portion of the impacted small businesses did not have enough insurance to rebuild. They desperately needed loans to restart.

Two large California banks responded aggressively to the riots with special programs that received considerable publicity. The *Los Angeles Times* reported that the Bank of America implemented a Small Business Investment Program, making loans of up to $100,000 available at low rates for locally owned small businesses; [and] provided a toll-free telephone number in three languages to assist applicants; [and] committed $100,000 in emergency grants to community organizations providing food, shelter and other services.[26]

Similarly, First Interstate Bank offered low-interest loans of up to $200,000 to small business owners as well as donating $200,000 to local charitable groups. Perhaps most impressive was the response by H. F. Ahmanson & Company, parent of Home Savings of America. Ahmanson & Company:

> Donated a modular building to temporarily replace a fire-damaged branch of Broadway Federal Savings and Loan; [and is] using minority workers to rebuild [the] Home Savings of America branch at Vermont and Slauson avenues; [and is] developing a program to train South Los Angeles residents as branch managers and loan appraisers. Home Savings has committed $100 million for home loans in South-Central Los Angeles next year. [It has] expanded [a] program that helps prepare students for college to five additional Los Angeles high schools [and made] other donations of furniture, clothing and cash.[27]

Broadway Federal Savings and Loan is an African-American-owned financial institution.

The positive public posture of banks was consistent with the results of our survey: 65 percent of the banks responding to our survey claimed to have made substantial donations in the form of money, goods, or services. Interestingly, some banks from outside the Los Angeles area made donations as well. Since the CRA requires banks to respond to the needs of their geographic community only, these donations must be regarded as expressions of genuine compassion.

Under federal and state government guidelines, certain regulations can be relaxed during emergencies. For banks, these rules chiefly concern the loosening of regulations concerning early withdrawal of money from time deposits and emergency loans. All of the responding banks in our survey group appear to have actively cooperated with these programs.

While the CRA is primarily discussed in terms of availability of credit, it is intimately concerned with the broader issue of financial parochialism. In this sense an important measure of a bank's commitment to its community's financial requirements is the number and quality of branches it operates. Based on our survey, 29% (4 of 14 valid responses) of the banks had branches that were damaged or destroyed by the riots. Most banks quickly repaired the damage, in some cases utilizing instant temporary facilities until permanent replacement buildings were completed. Our research also found that several banks continued to provide financial services during the riot. Most business in the affected areas closed down for the duration of the riots. One bank reportedly made arrangements for its small business customers to receive special deliveries of money. This is rather striking in view of the fact that law and order had completely broken down and police services were sparse.

The most important response by banks was the provision of credit to individuals and businesses in the areas devastated by the riots. This is an ultimate test of the CRA. Fifty percent (7 of 14 valid responses) of the banks in our survey changed their credit policies after the riots. All of the banks which changed their credit policies offered more generous terms to borrowers. Several banks offered unsecured riot recovery loans. Although the terms of these loans varied, they generally consisted of short-term business loans of up to $25,000 offered at low rates of interest. Importantly, these loans were available immediately after the riots, even before government emergency financial assistance programs started. Many banks restructured their loans to permit delayed payments without imposing deferral fees. Banks also provided a variety of bridge loans which allowed businesses to borrow money immediately in anticipation of proceeds from insurance, municipal, state, or federal disaster relief programs.[28]

A close reading of the comments that banks included in their survey responses revealed that some of those which claimed not to have loosened credit standards actually did offer more generous terms. These banks qualified their responses to the question, "Has your bank modified or changed its credit policy for individuals or businesses affected by the riots?" with such comments as, "Only for existing customers," and "For very good customers."

The evidence is persuasive. Banks did respond to the spring riots by providing more credit and more generous terms. Banks made special efforts to provide financial services during the riots as well. Yet, the evidence collected by Dun & Bradstreet and others shows that many businesses in the affected areas were no longer in operation six months after the riot. Korea-American-owned small businesses were among the hardest hit. These two facts apparently contradict each other. If these riot-damaged businesses had been able to secure bank credit, why are they no longer in business? There are two explanations.

The first is that Los Angeles, and indeed all of California, is in the midst of a major economic recession. By several measures, the recession is the worst in the last 60 years. Many small business-owners may have decided that such bad economic conditions do not justify the substantial investment necessary to rebuild after the riots. The issue is not primarily finding the necessary credit and capital to rebuild, but whether it makes sense to rebuild when the outlook for profits is so poor.

A second and more important explanation for the apparent contradiction of an increase in credit to riot-damaged communities but the subsequent failure of many businesses is that the new bank credit invariably was channeled to existing bank customers. Our research indicates that banks were concerned primarily with the credit requirements of their existing individual and business customers. Banks were reluctant to give loans to new customers. This is consistent with their function as evaluators of creditworthiness. Businesses which were regarded as poor credit risks before the spring riots would certainly not become better risks after the riots. Although the CRA states that banks have an affirmative obligation to meet the credit needs of their communities, it does not require banks to make unsafe loans.

The problem is that the businesses which depended on informal community sources of capital such as *kye* were unable to borrow from banks after the riots. The Korean-American community's wealth was (probably) devastated by the riots. The community could not fund new *kye* to help businesses rebuild. Community-based credit systems can support the borrowing requirements of a limited number of businesses, but when many businesses in a community are devastated by a common disaster such as the spring riots, local community organizations do not have sufficient financial depth to provide the necessary credit to rebuild. The result is that many businesses cannot recover. Further, government disaster relief programs tend to overlook some ethnic and immmigrant-owned small businesses because these businesses often keep informal or, in some cases, non-existent business records. Government disaster relief administrators, like banks, have difficulty evaluating the creditworthiness of these small businesses.[29] The financial affairs of *kye*-financed small businesses can be especially opaque because many Koreans believe that *kye* are illegal.[30]

The bank response to the spring riots was consistent with an effective CRA whose primary goal is to encourage banks to offer more credit to disadvantaged areas. Banks clearly responded by providing more credit. Indeed, banks might rationally have provided this extra credit in the absence of the CRA on the basis of sound banking principles. It makes sense to loan to essentially creditworthy customers who face temporary problems. The failure to provide enough credit for many creditworthy minority-owned small-businesses to recover from the riots does not prove that banks have failed to respond to the CRA. Rather, it suggests that the problem of credit availability may have other causes in addition to financial parochialism.

Conclusion

The Community Reinvestment Act (CRA) encourages banks to provide more credit to disadvantaged areas. Our research shows that banks in the Los Angeles area did provide more credit following the spring riots. Nevertheless, many of the minority-owned enterprises looted or damaged by the riots have gone out of business. There are two explanations for this: (1) California is currently in a major recession and business-owners may have decided that economic conditions do not justify the substantial investment necessary to rebuild; and, (2) minority-owned businesses were unable to secure sufficient credit to rebuild. The second explanation is apparently inconsistent with the observation that banks furnished more credit. The inconsistency is resolved when it is recognized that banks channeled additional loans to their existing business customers. Small businesses which depended on informal community finance were unable to secure traditional bank finance after the riots. These were the main businesses that failed.

The commercial bank response to the spring riots was consistent with an effective CRA that encourages financial institutions to make a greater effort to lend to disadvantaged communities. Nevertheless, the riots show that the CRA is not a complete solution to the problem of insufficient credit availability to disadvantaged communities. Ethnic communities often have their own traditional financial systems to link savers and borrowers. These traditional systems provide many of the services of banks. Yet, commercial banks and traditional systems do not share information about creditworthiness.

Ethnic small businesses capitalized by informal community financial intermediaries such as *kye* present a very unique challenge to traditional American banks. Banks will have to try harder to understand and evaluate the creditworthiness of these businesses. Ethnic small businesses must also change. Small business financial records must become more transparent.

Another solution might be to bolster the financial foundations of ethnic and community-based financial intermediaries. These organizations are, in theory, better able to evaluate the creditworthiness of businesses in their communities. With additional capital, these banks could originate loans to credit-starved minority-owned businesses.[31] The *kye* in their current form are unregulated and provide only some of the services provided by banks.[32] With such affirmative legislation as the CRA and more transparent business records, Korean-American business people should be able to qualify for bank loans. Using ethnic banks may be a good solution. From our research, American banks are responding to the government's policy to stimulate minority businesses.

APPENDIX

SURVEY DESCRIPTION

The following questions formed part of a larger survey that was mailed to 67 financial institutions listed in *Moody's Bank and Finance Manual* that were likely to have retail banking operations in Southern California. The survey was mailed seven months after the riots, which should have given banks sufficient time to formulate a detailed policy response. Respondents were assured that their individual answers would be kept confidential.

To date, 17 banks have returned complete or partial responses. The questions and responses used for this research are summarized below. In view of the CRA, banks are understandably sensitive to direct questions about redlining and financial parochialism. The response rate to surveys of this type is generally very low. The survey questions were intentionally phrased in non-inflammatory, non-racial terms. The authors believe that this less confrontational approach resulted in a greater response rate and more truthful answers, yet still provided sufficient data to investigate our hypotheses.

Banks were also asked a series of questions intended to measure their donations of money, services, and goods to relief organizations and individuals hurt by the riots; 65 percent (11) of the 17 responding banks contributed to the relief effort. One bank even arranged for its employees to take paid time off from work to assist with the repair, clean-up, and rebuilding after the riots.

Finally, many banks gave useful general comments on their response to the riots. These comments revealed that most banks with customers in the areas affected by the spring riots offered more generous terms to existing customers.

SURVEY QUESTIONS AND RESPONSES

1) Were any of your individual or business customers adversely affected by the riots?

Yes: 69% **No: 31%**

Valid Responses: 13

2) Were any branches of your bank damaged or destroyed in the riots?

Yes: 29% **No: 71%**

Valid Responses: 14

3) Does your bank plan to rebuild or repair its damaged branches?

Yes: 100% **No: 0%**

Valid Responses: 4

4) Has your bank modified or changed its credit policy for individuals or businesses affected by the riots?

Yes: 50% **No: 50%**

Valid Responses: 14

5) If your bank did change its credit policy, did the change:

Tighten credit standards: 0% **Loosen credit standards: 100%**

Valid Responses: 7

6) Please describe how your bank responded to the riots.

NOTES

[1] See Corrigan (1982) for a detailed explanation of why banks are unique.

[2] McConnell and Lummer (1992), p. 126. See also Campbell and Kracaw (1980).

[3] Geographic differences in financing might be caused by high costs of acquiring reliable credit information about borrowers and by neighborhoods differing greatly in their mean default risk. See Jones (1992) for a summary of the main explanations for redlining.

[4] In fact, evidence of redlining is mixed and controversial. Redlining research by the New York Public Interest Research Group (1977) and National Peoples Action (1976) provided much of the justification for the CRA. Yet, these studies have been the object of substantial criticism which points out that they do not consider other default-related factors as possible explanations for geographic variation in home finance. See Benston (1981).

[5] *Community Reinvestment Act. United States Code,* Title 12, sec. 2901 (1977).

[6] Subsequent revisions in published government regulations gave more specific guidelines for CRA compliance.

[7] This presumption is probably justified in the case of South-Central Los Angeles. Knight (1992) reported that the area, which had a population of more than half a million, had only 33 bank branches at the time of the riot. Yet South-Central had 177 check-cashing operations, which generally charge much higher fees than banks for their services.

[8] The jury found the officers not guilty of ten of the eleven crimes related to Mr. King's beating. These officers will be tried in the future for violating Mr. King's civil rights.

[9] *Los Angeles Times* (1992a), p. 130.

[10] Heredia (1992), p. 5.

[11] Dun & Bradstreet Information Services (1992).

[12] Light and Bonacich (1988), pp. 308–9.

[13] *The Japan Times* (1992).

[14] Light (1972), p. 2.

[15] Light and Bonacich (1988, p. 244) define a *kye* as "A rotating credit association con-

sist[ing] of a group who pool their funds on a regular basis then rotate the pool around the group until all members have received it. In this manner, all but the last receive an advance upon their saving. The organizer receives the first fund, which is also the maximum credit this form permits."

[16] Light and Bonacich (1988), pp. 261–2.

[17] Ibid., p. 244.

[18] Ibid., p. 248.

[19] Ibid., p. 245.

[20] Kim (1982) as cited by Light and Bonacich (1988), p. 253.

[21] Light and Bonacich (1988), pp. 270–1.

[22] Ibid., p. 262.

[23] Ibid., p. 262.

[24] Ibid., p. 263.

[25] Light (1972), p. 58.

[26] *Los Angeles Times* (1992b).

[27] Ibid.

[28] Our research also found that banks offered special terms to individuals affected by the riots. Several banks allowed individuals payment deferrals of up to two months without penalty fees. Some individuals qualified for increased limits on their credit cards.

[29] Government disaster-relief administrators and bank credit officers are often the same people. Several banks loaned their employees to government agencies to process and evaluate government-sponsored aid programs after the spring riots.

[30] Light and Bonacich (1988, p. 257) cite examples of Korean-American community newspapers reporting (incorrectly) that *kye* are illegal in the United States. Other researchers have found this belief widespread among members of the Korean-American community. The situation naturally encourages secrecy by small businesses who borrow through *kye*. Unfortunately, this secrecy makes it very hard for government disaster-relief administrators and banks to determine creditworthiness.

[31] Los Angeles currently has three African-American owned banks: Founders National Bank, Broadway Federal Savings and Loan, and Family Savings Bank. These small institutions claim to be able to make many creditworthy loans in disadvantaged areas if they had more capital.

[32] In particular, *kye* do a poor job of diversifying risk, and their informal nature makes them particularly vulnerable to embezzlement.

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