ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

Minority-Owned Banks: History and Trends

by Douglas A. Price

The Greater Cleveland community was informed on March 9, 1990, that the Office of the Comptroller of the Currency had moved to close First Bank National Association, the fourth minority-owned financial institution to fail in the Fourth Federal Reserve District in the last three years. Currently, only one minority-controlled bank remains operating in the Fourth District. The total number of minority-owned banks nationwide has remained steady during the past seven years, as the number of new entrants and banks gaining minority status has almost kept pace with the quantity of banks that have failed, merged, or lost minority status after a change in ownership.

Minority-owned banks have been operating in this country since 1866, and their performance characteristics have been the subject of numerous studies. In general, results indicate that minority-owned banks differ from other banks in many important respects, not the least of which is bank profitability. Compared with their peers, minority-owned banks have generated weaker profits, on average, for a considerable period. This continuing record of poor profitability suggests that many of these institutions are indeed still struggling for survival.

This *Economic Commentary* discusses the current health of minority banking in the United States by highlighting selected balance-sheet items for both minority- and nonminority-owned peer banks. These items are then interpreted against the background of previous research studies on minority banks. The most important implication is that minority-owned banks, because they are essentially "niche institutions," operate with different marketing plans, personnel, and customers than do nonminority banks of comparable size.

The minority banking industry, which experienced significant growth during the 1970s, remained strong through the 1980s, with a 71-percent increase in total assets between 1983 and 1989. But hidden in that figure is a dynamic process of growth and change resulting not only from minority banks' efforts to adjust to deregulation, adverse macroeconomic conditions, and increased competition—factors with which all U.S. banks must deal—but also from their efforts to deal with the specific environmental factors and risks that they alone face.

■ Identification and Classification of Minority Banks

Minority institutions experienced significant growth during the 1970s—growth that was assisted, in part, by social legislation. During 1969 and 1971, President Nixon signed Executive Orders #11458 and #11625, which were designed to develop a program to strengthen minority business. As a result of these directives, the Commerce and Treasury Departments established the Minority Bank Development Program (MBDP).[1] The MBDP publishes a roster of minority banks that is distributed to public and private organizations to encourage use of minority-bank services. Whether a bank participates in the MBDP is a common standard used to gauge its ownership status as a minority institution.

For purposes of eligibility, a minority-owned institution is classified as any

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institution owned or controlled by one of the following groups: black American, native American, Hispanic-American, Asian-American, Eskimo, Aleut, multiracial, or women.[2] The diversity of ownership is worth noting, because some researchers think that bank performance varies with the identity of the controlling group.

According to Treasury officials, approximately 150 U.S. financial institutions are minority owned or controlled and therefore eligible for the MBDP program. Government agencies such as the Department of Housing and Urban Development (HUD), the Internal Revenue Service (IRS), and the Department of Defense are encouraged to place federal and other Treasury-collected funds into minority institutions.[3] HUD and its grantees and recipients have provided $125 million to $140 million annually in deposits to qualifying institutions.

Minority-owned institutions are also currently receiving deposits of about $35 million annually through the Department of Energy (DOE), which has established escrow accounts to hold fines assessed against energy-related companies for alleged violations of federal laws and regulations. The DOE's program is in the process of being expanded.[4]

In addition to the adoption of social legislation designed to aid all minority banks, government assistance beyond the apparent norm has also been given at times. Irvine H. Sprague, in his book *Bailout: An Insider's Account of Bank Failures and Rescues*, describes how the Federal Deposit Insurance Corporation (FDIC) utilized the "essentiality doctrine" for the first time during 1971.[5] A provision of the Federal Deposit Insurance Act—informally called the essentiality doctrine—gives the FDIC's board of directors the authority to prevent a bank from failing if its services are regarded as essential to its community.

The FDIC first used this power to prevent Unity Bank of Boston from failing at any cost, because its services were determined to be essential to the community. In this case, "community" was defined as the black community that relied on the bank's services. The essentiality doctrine was also used in 1972 to assist the Bank of the Commonwealth in Detroit.[6] More recently, a combined effort by the National Bankers Association, state regulators, and the FDIC enabled the successful recapitalization of a failed minority bank in Seattle, while allowing it to retain its minority ownership.

Not surprisingly, minority-owned banks tend to be located where minority-group populations are large. Assets of most minority institutions are concentrated primarily in just three Federal Reserve Districts: San Francisco, Dallas, and Atlanta. These three areas account for 53 percent of all minority-owned banks and 63 percent of the assets held by such banks. Asian-American-owned institutions are located primarily in southern California, while the majority of Hispanic-American banks are located in southern Texas. The assets of black-owned institutions are found primarily in the Chicago, Richmond, and Atlanta Federal Reserve Districts, which collectively house 61 percent of black-owned banks and 68 percent of black-owned-bank assets.

Recent History of Bank Performance

During the 1980s, the financial industry began to face deregulation, adverse macroeconomic conditions, and increased competition. Many changes in legislation and regulation were passed with the intention of "leveling the playing field" for all financial institutions. However, the overall quantity of minority banks remained steady. In 1983, 105 minority banks existed; by the third quarter of 1989, that number had declined only to 103, a 2-percent decrease. Within each ownership group, however, the growth in number, as well as in assets, has varied. For example, during this seven-year period, the number of Asian-American and Hispanic-American banks increased 71 percent and 21 percent, respectively, while the number of black-owned banks declined 22 percent. By comparison, the total number of insured banks in the United States declined 12 percent (from 16,112 to 14,108) over the same period.

Despite a slight decline in the number of minority banks, their aggregate assets reflected strong growth from 1983 to 1989, increasing from $5.18 billion to $8.85 billion, or 71 percent. Hispanic-American institutions enjoyed the largest asset growth—$2.3 billion, or a 116-percent increase. During the same period, asset growth of black-owned banks increased only $231 million, or 14 percent. By comparison, the aggregate assets of all insured banks grew 38 percent, from $2.49 trillion to $3.43 trillion.

Measuring and Comparing Performance

Factors contributing to the success of minority-owned banks are the same as those for any banking institution: (1) banks must target specific community needs and service them, (2) the directors and management must work together toward achieving common goals and objectives, (3) prudent levels of risk should be taken, and (4) operations should be run efficiently. But because there appear to be fundamental distinctions between the balance-sheet profiles of minority and nonminority banks, strategies implemented by their respective directorate and management teams may need to vary with the type of institution.

Previous research on the operations and performance of minority-owned banks indicates that, compared with nonminority banks, these banks tend to rely more heavily on government deposits.[7] As a consequence, minority banks also hold fewer loans and more liquid assets.[8] The loan portfolio itself has traditionally shown a strong reliance on real estate, while commercial loans have been underrepresented.[9] Studies have also found that these banks have a more labor-intensive production process, possibly because

TABLE 1 BALANCE-SHEET COMPARISONS
(Averages for banks in operation for at least three years)

	Peer Group $10-$25 Million		Peer Group $25-$50 Million		Peer Group $50-$300 Million	
	Minority	Nonminority	Minority	Nonminority	Minority	Nonminority
SELECTED ASSETS (PERCENT OF TOTAL ASSETS)						
1. Net loans and leases	52.0	49.6	56.0	51.7	55.3	57.1
2. Real estate	27.3	21.4	30.9	24.8	29.6	29.2
3. Commercial	12.6	9.1	15.3	10.3	19.2	13.0
4. Consumer	12.8	10.2	9.5	10.5	6.4	11.9
5. Securities	22.8	32.1	20.8	31.2	24.7	26.8
6. Federal funds sold	9.3	5.0	5.9	5.0	7.9	5.0
SELECTED LIABILITIES (PERCENT OF TOTAL DEPOSITS)						
7. Domestic	81.7	90.7	86.3	91.2	88.5	91.7
8. Government	2.7	0.1	1.5	0.2	1.8	0.2
9. State/political subdivision	12.5	8.1	8.4	7.4	7.0	6.4
SELECTED RATIOS (PERCENT)						
10. Equity capital/total assets	7.6	9.3	6.9	8.9	7.0	8.1
11. Net income/total assets (ROA)	(0.1)	0.4	0.2	0.4	0.4	0.5
12. Net income/equity capital (ROE)	(1.0)	4.4	2.5	5.1	6.3	6.1
13. Loss provision/loans and leases	0.9	0.4	0.5	0.4	0.4	0.3
MEMO ITEMS						
14. Numbers of employees/ millions of dollars in assets	1.0	0.6	0.9	0.6	0.7	0.6
15. Number of banks	23	2,874	23	3,156	39	4,509

SOURCE: Consolidated Report of Condition, Board of Governors of the Federal Reserve System, June 30, 1989.

their depositors tend to keep accounts with small balances and high activity levels.[10] Current data suggest that most of these previous research findings remain valid.

The distinction regarding government deposits still exists: Last year, the average minority bank relied more heavily on deposits originating from the federal government than did nonminority banks. Such deposits as a percentage of total liabilities are several hundred basis points greater for the average minority bank than for its nonminority peer (table 1, line 8).[11] The average minority bank also holds between 9 and 54 percent more in deposits from the state government (line 9). Reliance on government-generated deposits is probably due to the MBDP.

Compared with its nonminority peer group, the typical minority bank with assets of less than $50 million has a slightly greater percentage of its assets tied up in loans, whereas the average minority bank with assets of more than $50 million holds a slightly lower percentage in loans. The distribution of these loans by type (for example, commercial, consumer, and real estate) is also quite different when comparing the loan portfolios of minority and nonminority institutions. One example is that the average minority bank generally holds 40 to 50 percent more commercial loans as a percentage of total assets (line 3).

Although data presented in table 1 are a snapshot of the industry as of June 1989, it does appear that minority-owned banks may have, over time, increased their holdings of commercial loans while decreasing their holdings of real estate loans. This may signal a shift in the primary mission of minority-owned banks from making loans to individual consumers to concentrating on business loans.

The liquidity profile of the average minority institution still differs from that of its nonminority peer group. The former owns fewer securities as a percentage of total assets (line 5) than does the latter. The average minority bank also continues to hold more of its assets in federal funds sold than does the average nonminority bank (line 6). Federal funds are highly liquid, but the rate of return is likely to be lower than that of longer-term securities. Bates and Bradford found that because the demand deposit accounts of black-owned banks are more variable than those of nonminority banks, such banks must hold a higher percentage of assets in liquid form (such as government securities and federal funds sold) to be able to meet withdrawals.[12]

Minority banks also exhibit varying degrees of performance success as measured by return on assets (ROA) and return on equity (ROE)—lines 11 and 12, respectively. The average minority bank with assets of less than $50 million generated lower ROAs and ROEs than did the average nonminority bank of comparable size. Note that ROEs may vary considerably by ownership type. One study suggests that profitability problems of minority banks can largely be attributed to black-owned institutions.[13] However, as a minority bank's assets increase, performance measures become more favorable and more similar to nonminority-bank averages. The average minority bank with assets of more than $50 million earns about the same ROE as does the average nonminority bank of similar size.

The ROE results can be explained, in part, by differences in capital levels. Capitalization (line 10) is important because it is the buffer that allows banks to remain viable in the face of unexpected loan losses. With the advent of risk-based capital guidelines, it is believed that banks with riskier asset mixes should possess higher levels of capital than should banks with higher-quality assets. Considering that the average minority bank has a higher ratio of loss provision to total loans (line 13), indicating a weaker or riskier loan portfolio, it should have a higher level of capital. Unfortunately, the average minority bank is more thinly capitalized than its nonminority peer.

Current data indicate that operating-cost differences among institutions remain notable. One proxy for measuring the efficiency of a bank's operations is its ratio of employees to assets (line 14). Although the average minority bank tends to have more employees per million dollars of assets than do nonminority banks, it becomes more efficient and more closely resembles its nonminority peer as its assets increase. Minority-owned banks may also benefit from reducing expenses related to bank premises, state and local obligations, and real estate and commercial loans.[14]

■ Black-Owned Banks

The earliest research studies of minority-owned banks implicitly focused on black-owned banks because they represented most of the assets controlled by minority-owned institutions at the time. As mentioned previously, the ownership mix of minority banks has become more diverse. Nevertheless, black-owned banks remain a subject of interest in their own right, especially in areas with large black populations. The recent closing of another black-owned bank in the Fourth Federal Reserve District has caused some to question the long-term prospects of these banks.

Although black-owned banks do have a slightly lower ROA than do all banks collectively, a study by Robert T. Clair submits that their long-run viability is unthreatened.[15] Clair's results show that loan losses and operating expenses are no higher at black-owned banks than at nonminority banks operating in the same specific neighborhoods. This suggests that the lower ROAs of black-owned banks are due to the location of the bank, not to ownership or management. Another study finds that minority bank presidents are well educated, possess a broad range of banking experience, and can be expected to contribute positively to bank performance.[16] This finding is significant, because several previous studies reported that experienced managers were in short supply at minority-owned banks.

■ Conclusion

Smaller minority banks, on average, are less profitable than nonminority banks of similar size, primarily due to a variety of market-area weaknesses. As a counterbalance, various government programs have been designed to increase the services demanded of minority institutions, but despite this assistance, some are still struggling. Deregulation, the increased competitive environment, and other market forces are pressuring all banks to focus on segments of their potential customer base and on specific products.

During this period of upheaval and consolidation in the banking business, it appears to be especially important that minority-owned banks target specific community needs, define an exact mission, retain strong management, risk capital prudently, and establish proper controls. With recognition of the peculiar risks and environmental factors they face, it seems likely that small minority banks can remain viable and can continue to contribute to the economic progress of their communities.

To the extent that bank location accounts for performance problems, especially for black-owned banks, one strategy may be to broaden the geographic market of the institution. Otherwise, managers may need to run their banks even more conservatively, given their thinner capitalization, greater loan-loss provisions, and higher cost structures. Relying on stringent underwriting guidelines may conflict with these banks' missions to provide greater banking resources to the communities that they serve. But management teams at the weaker minority banks may have to forgo short-term goals for profit and growth in order to ensure another implicit longer-term goal: continued viability of the bank.

Footnotes

1. Section 1204 of the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA) appears to reaffirm the federal government's role in the development of minority-owned financial institutions. One of the provisions states that "the Secretary of the Treasury shall consult with the appropriate federal banking agencies and the National Credit Union Administration Board on methods for increasing the use of underutilized minority banks, women's banks, and limited-income credit unions as depositories or financial agents of federal agencies."

2. Minority banks are classified based on ownership and control issues, not on the presumption of limiting the customer base to the same segment of the population.

3. The Treasury's list of minority-owned or -controlled financial institutions also includes savings and loans, mutual savings banks, and credit unions, while the Federal Reserve's list includes only commercial banks.

4. Another organization that services minority-owned or -controlled financial institutions is the National Bankers Association (NBA). The NBA was incorporated in 1972 as a national trade association for minority-owned institutions. It provides a forum for sharing information and resources and also actively solicits deposits from government agencies and major corporations for its members.

5. See Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues*, New York: Basic Books, Inc., 1986.

6. The legal basis for the FDIC's decision was the bank's service to the black community and the exposure to loss of the city government's own deposits.

7. See John T. Boorman, "The Prospects for Minority-Owned Commercial Banks: A Comparative Performance Analysis," *Journal of Bank Research*, vol. 4, no. 4 (Winter 1974), pp. 263-79.

8. See John T. Boorman and Myron L. Kwast, "The Start-Up Experience of Minority-Owned Commercial Banks: A Comparative Analysis," *Journal of Finance*, vol. 29, no. 4 (September 1974), pp. 1123-41.

9. See Donald L. Kohn, "Minority Owned Banks," *Monthly Review*, Federal Reserve Bank of Kansas City (February 1972), pp. 11-20, and Boorman (footnote 7).

10. See Edward D. Irons, "Black Banking–Problems and Prospects," *Journal of Finance*, vol. 26, no. 2 (May 1971), pp. 407-25, and Boorman and Kwast (footnote 8).

11. The table pertains to banks with assets of less than $300 million. Typically, banks of this size would be called "small" banks and banks with greater assets would be called "large" banks. However, because the data set contained just three banks with assets of $300 million or more, only the smaller banks were analyzed.

12. See Timothy Bates and William Bradford, "An Analysis of the Portfolio Behavior of Black-Owned Commercial Banks," *Journal of Finance*, vol. 35, no. 3 (June 1980), pp. 753-68.

13. See David R. Meinster and Elyas Elyasiani, "The Performance of Foreign Owned, Minority Owned, and Holding Company Owned Banks in the U.S.," *Journal of Banking and Finance*, vol. 12, no. 2 (June 1988), pp. 293-313, for findings that "...performance problems found in the aggregate minority banks are primarily due to the performance of black owned banks." (p. 307)

14. See Myron L. Kwast, "New Minority-Owned Commercial Banks: A Statistical Analysis," *Journal of Bank Research*, vol. 12, no. 1 (Spring 1981), pp. 37-45. Also see William L. Scott, Mona J. Gardner, and Dixie L. Mills, "Expense Preference and Minority Banking: A Note," *Financial Review*, vol. 23, no. 1 (February 1988), pp. 105-15, for another viewpoint about why minority-owned banks have higher operating costs. The authors contend that banks that fully utilized the MBDP do not have higher salaries or occupancy expenses, "...but did engage in nontraditional expense preference by offering relatively low loan rates to their customers over the period 1977 through 1983." (p. 114)

15. See Robert T. Clair, "The Performance of Black-Owned Banks in Their Primary Market Areas," *Economic Review*, Federal Reserve Bank of Dallas (November 1988), pp. 11-20.

16. See Mona J. Gardner, "Minority Owned Banks: A Managerial and Performance Analysis," *Journal of Bank Research*, vol. 15, no. 1 (Spring 1984), pp. 26-34, for the suggestion that bank profitability and a bank president's formal education are positively related.

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