

The CRA as a Means to Provide Public Goods

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The Community Reinvestment Act (CRA) has proved to be a unique experiment in banking regulation. As the Federal Reserve Governor with responsibility for consumer regulation and community affairs oversight during much of the 1990s, I look back fondly on my experience, along with my good friend and then-Comptroller of the Currency Gene Ludwig, in working to design the current regulatory scheme of the act.

We and others designed those efforts to address the shortage of banking services in historically underserved communities in the 1990s. The problems then were real. Today, it is indisputable that access to banking services is far more widespread than it once was; that loans, particularly for real estate, have become far more abundant in underserved areas; and that awareness in the banking community of the need to serve the entire community has been enhanced. As such, the CRA reforms of the early 1990s should be viewed as a success.

However, conditions have changed since then, and the problems that preoccupied us a decade and a half ago have receded in importance. Therefore, a new look at the CRA is in order. To some extent, what has happened is reminiscent of the old curse, “beware of what you wish for, you might just get it.” In some instances, too much credit poured into communities that once had too little, creating a whole new set of problems. It also goes without saying that conditions in the financial world have also changed.

One thing that has not changed is my view that the proper role for the CRA, as with other government activities, is to provide a clearly defined public good. A public good is one that is not provided by the marketplace because the costs to provide it exceed the benefits accruing to the provider. Public goods therefore are undersupplied because no one individual or organization believes it is worth it to invest the money in something from which they cannot reap the benefits.

The CRA addresses certain clearly defined public goods. These include access to banking services, provision of credit for real estate development in depressed

areas, and (potentially) the provision of credit-related services such as consumer credit and home-buyer education. As is the case for all public goods, it is critical to identify why the private marketplace is unable to provide the good or service. Then, ideally, the rules and regulations should be crafted to address those particular problems.

Unfortunately, this “public goods” view of the CRA is not widely shared in the body politic, either among the CRA proponents and activists or among the act’s opponents. Too often, the CRA is viewed and used as a vehicle for providing “private goods” that benefit particular groups or individuals. At times, this devolves into what I think of as the Willie Sutton view of the CRA. Sutton, you will recall, was asked why he robbed banks, to which he replied: “because that is where the money is.”

The way the CRA is most commonly implemented only exacerbates this public goods problem. When a bank is seeking some regulatory favor, such as when it is applying for new branches or for a merger, the regulatory body approving the application focuses on its CRA ratings and overall CRA performance. Regulatory bodies by law must seek input from the affected communities. Well-organized community groups and elected officials know this and threaten to use this process to hamstring the bank’s application. This is one of those facts that everyone knows but declines to discuss in polite company. At times, the process devolves into payments by the bank to community groups to do “community service.” In return, the group either does not object or may even endorse the bank’s application. It is all perfectly legal, I suppose, but it certainly does have the air of Willie Sutton about it.

This behavior is then viewed by many in the banking community and among those not typically disposed to government meddling in the economy as creating a “CRA tax.” This group views the CRA as a cost of doing business, and the side payments and inefficient allocation of credit that may result as part of the price of doing something else the bank views as profitable. It is ironic that both those on the Left and the Right often view the

CRA the same way: as a means to extract resources from banks. Individuals may differ on whether the recipient is deserving, but it is hard to disagree that this kind of behavior is inefficient from a social or economic point of view. More important, the exchange does nothing to address the underlying issue of underprovided public goods. The resulting cynicism also can poison the well for truly constructive activities related to the CRA, of which there are many.

This emerging cynicism is evident in some of the calls for CRA expansion today. For example, it was suggested as recently as a year ago that the CRA be expanded to cover a whole new array of financial institutions, such as investment banks—back when we had investment banks. Similarly, in the name of leveling the playing field, people have called for including brokerage houses and other financial institutions. It is hard to make the intellectual leap from “serving an entire community,” as commercial banks are required to do, to including an investment bank, brokerage, or hedge fund under the CRA umbrella. Frankly, this lack of compelling logic feeds the view that Willie Sutton is back in town.

Stepping away from the view of the CRA as a tax and spending program administered through the regulatory process will help determine whether the CRA can become a stable part of the American banking scene or whether it will remain a political lightning rod, drawing fire with the vagaries of the political process. This may be impossible to pull off. At the moment, CRA proponents are ascendant and groups that benefit from them will see no reason to compromise. But the ideological bent of the body politic will change again, and when it does, programs that pour money into groups like ACORN, which many find lacking in legitimacy, will become targets. Finding a stable rationale for the program is unpopular, but it will be the key to its viability.

In holding this view, I am caught between the views of most of the CRA community, which believes that the CRA is unambiguously good, and the views of CRA critics, who argue that it is unambiguously bad. It reminds me of when I was a professor at Harvard and was introduced on Boston’s PBS station as an “educated conservative.” I quietly wondered if they ever introduced people as educated liberals. But, this being Boston and Public Broadcasting, the show’s host felt the need to explain to his listeners why they should waste their time on someone who didn’t share their perspective. On the other hand, during the rewriting of the CRA regulations in the

early 1990s, I was described in the *American Banker* as having been engaged in “politically correct theatrics.” But it is in this centrist view where the “public goods” rationale for CRA lies.

The CRA as a Payment for Other Benefits Is Not a Public Goods Argument

One of the more sophisticated arguments for expanding CRA coverage to more institutions borrows heavily from the public goods position, but is nevertheless internally flawed. It is that these banks are about to receive a variety of other public good benefits and therefore should pay the price of taking on a “CRA obligation.” Among the benefits supposedly being extended include access to the Federal Reserve’s Discount Window (or similar lending facilities) and the possible extension of insurance protection such as deposit insurance.

Two points to be clear on: First, access should not be provided to the Discount Window for the private good benefit of the financial institution. The Discount Window and similar lending facilities do not exist to make the bank richer. They exist to provide a very important public good: temporary liquidity that prevents a financial problem from becoming systemic and thereby leading to a possibly more widespread financial meltdown. In fact, the Federal Reserve’s Discount Window policy follows the 150-year-old advice of Walter Bagehot to “lend freely at a penalty rate.” The purpose of the discount window policy is to, first, discourage banks from accessing the window; second, to provide the money if needed; and third, to structure the incentives so that banks repay their discount window loans as quickly as possible. This is hardly a private benefit and certainly not a justification for imposing another “obligation” on a financial institution.

The same can be said of deposit insurance. Before the advent of deposit insurance, the presumption was that the depositor was obliged to determine whether a bank was creditworthy. But here is a classic public goods problem. The cost of accurately ascertaining and then continuously monitoring the creditworthiness of a financial institution is prohibitive relative to the interest the depositor receives. The private market once solved this problem by having banks hold much greater reserves than they now do, thereby driving up the cost of borrowing and driving down the return to saving for the bank’s customers. Even then, bank runs happened when inves-

tors and depositors suffered massive losses, followed by a loss of confidence (usually exacerbated by the public's inability to discern the bank's true condition and sometimes fanned by the bank's competitors). Again, if deposit insurance were a private-good benefit to the banks and not a public good, it is highly unlikely that Franklin Roosevelt would have proposed and Congress passed such insurance in the middle of the Depression. Deposit insurance is a public good.

The second major fallacy in using these public goods as justification for creating a CRA obligation is that public goods are provided in and of their own right and are never contingent on the provision of other public goods. Although some well-meaning people may reason that if an institution gets deposit insurance or access to the Discount Window it should also be covered by the CRA, the fact is there is no justification for such a position under the theory of public goods. What is therefore required is a description of what the CRA can do to address a public good problem in its own right, which justifies its existence, independent of other public policy issues.

CRA Public Good Number One: Access to the Payment System

There are three areas, I believe, where the CRA is entirely justified as a public good on its own merits. The first, and most important, is the need to provide payment services to the entire population. Today, these payment services take three forms: cash, checking, and electronic, more typically known as "plastic." The public good in question is the ability for the entire population to be linked in a fairly costless manner to these forms of payment.

The following illustrates why providing payment services is a public good. Consider the case of an employer or provider of public assistance, which supports the population on the income side. If an individual or a large class of individuals lacks access to the payment system, the position of the employer becomes awkward. Typically most employers pay employees by electronic transfer to their checking or other bank accounts. This is the cheapest and easiest means of payment for the employer. It also minimizes the chance of theft or embezzlement, and is by far the easiest way of complying with the various taxes that must be withheld from workers' paychecks and contributions for voluntary fringe benefits. Obviously, this requires that employees have

a bank account. The widespread provision of banking services is thus a public good from which nearly every employer in the country benefits.

An employee, of course, may request a paper paycheck. That form of payment, however, is more costly both in time and in direct expense to both the employer and employee. Ultimately, however, the paycheck must either be deposited into a bank account or converted into cash. The former requires a bank. The latter requires some entity willing to cash the check. It is true that check cashing services have sprung up in the private sector to serve these individuals, but transaction costs are extremely high. It is not that these services are "gouging" their customers, but that their own transaction costs are quite high, particularly identity verification and the risks involved in recovering bad checks. This is clearly a high-cost and very inefficient substitute for standard banking services.

A similarly huge cost advantage exists in the case of payment for goods and services. Customers make purchases either using checks or electronic methods such as credit and debit cards, both of which require access to the banking system for settlement, or through cash. The latter technically does not need access to the banking system, but the widespread development of an ATM network has certainly shown the significant cost advantages and economies in cash balances that a banking system can provide. Firms also need access to banks for payment services, particularly for cash. Easy access to deposit windows at the end of the day or even access during the day for the proverbial roll of quarters greatly facilitates the conduct of commerce.

Given the benefits of banking services, their availability across a wide variety of neighborhoods and communities is also a public good. This was clearly brought home to me as a Fed Governor when I went on community tours and saw areas with large congregations of people but no banks. One place that sticks in my memory is Houston's Fifth Ward, a primarily African American community. Small businesses were few, and residents had to travel long distances to access banks. A major national banking institution opened a branch there, and within a year demand was so high that its only major problem was acquiring the land next door to add more drive-up teller windows.

The CRA requirements that retail banking institutions expand their services to the entire area they intend to serve is therefore quite legitimate in my view. This does

not mean that the concentration of bank branches must be the same in every neighborhood or the same as it is in the center of town. The density of bank branches should still be subject to commercial considerations. Reasonable metrics for appropriate concentrations are easily calculated and the regulatory staffs at the Federal Reserve and the U.S. Comptroller's Office are capable of determining branch dispersion levels that meet minimum CRA criteria.

It is equally true that this requirement should not apply to financial institutions that do not provide retail access to the payment system. Nor does it follow under the theory of public goods that exemption from this CRA requirement means that we must find some other CRA requirement as a substitute. Remember, the provision of one public good does not depend on the provision of another. Just because Goldman Sachs provides no retail access to the payment system and is therefore not subject to a geographic test on the distribution of its nonexistent branches, it does not mean that CRA must invent some other "CRA tax" to impose on Goldman in the name of fairness. On the other hand, should Goldman decide to enter the retail banking business and provide branches to its clients in Scarsdale and Greenwich, then this aspect of the CRA should apply.

CRA Public Good Number Two: Real Estate Lending

Redlining is what garnered the CRA its greatest visibility—the demarcation of areas in which banks would not make loans. Interestingly, the practice of redlining did not start in the banking industry, but in government. During the 1950s and 1960s, New York was undergoing a dramatic transformation as people were moving to the suburbs in increasing numbers. City planners, notably Robert Moses, squared the city's budget commitments with the declining population and tax base by deciding to withdraw city services such as police protection from certain neighborhoods that were rapidly depopulating. Of course, the withdrawal of these services merely accelerated the decline of these neighborhoods.

In my five years as the Federal Reserve Governor responsible for the CRA, and in my capacity as chairman of the board of the Neighborhood Reinvestment Corporation (now known as NeighborWorks), I visited many inner-city neighborhoods and talked to a wide variety of their residents and community leaders. Clearly, the lack

of access to banking services and lending was a concern, but rarely was it the primary concern. Invariably, the lack of some vital city service such as police or fire protection or decent schools was at the top of the list.

This experience demonstrated the public good nature of residential real estate. An individual could invest large sums of money in building a wonderful home in an otherwise depressed neighborhood and find that the investment was not reflected in the home's property value. As real estate agents are fond of saying when they sell homes: "Location, location, location."

However, the public good aspect of residential real estate also explains why banks and other financial institutions might choose not to make mortgage loans in a given neighborhood. If an individual is about to invest money in a building and there is little reason to expect that the investment will produce a commensurate rise in the value of the property, it would be a violation of the bank's fiduciary responsibility to its depositors to offer a loan to that individual. The collateral behind the loan would simply not justify the transaction.

Of course, this is where the problem of public goods becomes sticky. If it is not prudent for any financial institution to make a loan to an individual who is willing to invest in a property in a neighborhood, then money will not flow into the neighborhood. If money does not flow into that neighborhood, then no improvements will be made. If no improvements are made, then the condition of the neighborhood will never improve. A vicious circle develops.

The CRA provides one avenue for breaking this vicious circle, and with that a second public good justification for the act. The logic begins with a theoretical proposition. If it were possible for all banks servicing a metropolitan area to collectively guarantee that they would each make a given amount of loans to a depressed community, then at least the public good problem of arranging finance would be removed. Borrowers, lenders, and investors would not have to fear that their properties would face valuation problems because surrounding properties could not get the credit needed to make similar improvements.

The set of CRA regulations we developed in the 1990s builds on this theoretical foundation. Banks were required to geocode their loans by census tract; that is they identified where exactly they were lending. This lending metric was then measured in the context of the income distribution of the metropolitan area's census

tracts, and banks' lending performance from a CRA context was based on that evaluation. In effect, the CRA established a set of geographically based soft quotas for banks to meet under the Lending Test.

No system is perfect, but this approach seemed optimal among the various constraints under which the CRA operates. First, it provided the framework to offer assurance of access to funds in underserved areas. Second, it allowed individual institutions to select which loans they wanted to make and even which underserved census tracts they wished to target, subject to an overall minimum threshold. Third, it emphasized measurable performance and not the subjective criteria of protests and public comment, which experience had taught were easily gamed.

As such programs go, the CRA regulations were indisputably successful. The question now being debated is whether the program was "too much of a good thing" and bears some responsibility for the so-called "subprime crisis" the country has been experiencing. There are undoubtedly some legitimate criticisms of CRA regulations in this regard, but responsibility for the credit cycle is much wider and includes the behavior of borrowers and lenders, regulatory breakdown, and political machinations of both parties.

The widespread finger pointing underway recalls the old lesson children are taught that when you point a finger at someone else you are simultaneously pointing three back at yourself. So, as someone who played a role in writing these regulations, let me take a look at those three fingers and consider some of the potential flaws in program design.

First, like all soft quotas, the CRA program was designed to meet the needs of the period in which the rules were written. But, by definition, the success of the program made those criteria somewhat outdated. In the early 1990s, the credit needs of these communities were horrifically unmet. Clearly, creditworthy (and profitable) individuals could be found, particularly given that the public good problem of lending in distressed areas was being addressed. These creditworthy borrowers got loans. As time went on, however, the requirements for the number of loans made did not change. In fact, it would be a real CRA black eye for a bank to reduce the number of loans it was making in a particular area. However, given that the most creditworthy borrowers had already received loans, a somewhat less creditworthy group had to take their place. As time went on, lending

standards had to be relaxed to avoid any "backsliding" on an institution's CRA obligations. In this way, the CRA did contribute to a downgrading of credit standards.

Second, the Investment Test under the CRA and the related deals the Justice Department struck with Fannie Mae and Freddie Mac during the 1990s created a natural market for securitizing these loans. Of course, securitization was occurring in its own right on a wide scale, but most securitization involved fixed lending criteria established by the government sponsored enterprises (GSEs). Given the problems discussed in point one above, an enormous market opened for securities of nonconforming loans, which involved some CRA credit that fell short of the Investment Test. This was a good thing in that it allowed credit to flow to underserved areas in far greater quantities than before, but the securitization of nonconforming loans involved a much greater risk, with far more pernicious consequences, than the securitization of conforming loans. By definition, nonconforming loans are more idiosyncratic, harder to monitor and model, and generally more geographically or socioeconomically concentrated than conforming loans. The CRA did not recognize this risk, and in fact gave a reason to ignore the risks inherent in the process. In this way, the CRA and the related Justice Department arrangements with the GSEs exacerbated the securitization problems in the subprime crisis.

Third, the very fact of "opening the flood gates" on credit exacerbated a normal problem in credit cycles which tends to mask risk, and thereby leads to greater excesses in the cycle. The CRA itself was part of this, but hardly the major element. Rather, it was the changing of the rules of the game that caused an abrupt shift. The story is as old as credit cycles. When credit suddenly becomes more available in any market, demand rises for the assets being financed. The very fact of rising prices leads to a lower rate of defaults and loan losses given that the rise in asset prices allows troubled borrowers to dispose of the asset and repay the loan easily. The lending community tends to view this as a reduction in risk and therefore lends more, pushing asset prices up further, defaults down, and thereby leading to even more easing of credit terms and more excesses. When the cycle ends and prices start to fall, the fundamental riskiness of lending in this market not only returns but is magnified.

This latter observation is also a comment in general on the development and crash of the latest housing bubble. That bubble began to develop in the mid-1990s and

took on steam, as all bubbles do, as the rising prices increased demand and still more credit. The CRA is not the cause of this phenomenon; the cycle has been well documented since at least the time of the South Sea Bubble in the 1600s. All bubbles are built on the fundamentals of human nature. Therefore, I am not saying the CRA caused the subprime crisis. But, it would be equally wrong to deny that the CRA played no part of that process.

Nor does it follow that the flaws in CRA design mean that the policy is a bad one. The world does not provide us with pristine policy options, only tradeoffs. Just as it was probably logical from a macroeconomic viewpoint to allow for the general expansion of credit in the 1990s and 2000s, so too was it logical to have a CRA program. Those who point fingers at particular entities and accuse them of being the “culprits” behind the crisis are wide of the mark.

On balance, there are two logical lessons from this experience. First, the Investment Test provides the wrong incentives for CRA lending; it is not truly meeting an obvious public goods market failure. Nonconforming loans require closer monitoring, and therefore securitizing them causes a greater breakdown than securitizing conforming loans. It follows that the wholesale expansion of the CRA to other financial institutions, creating an Investment Test obligation for them, will prove counterproductive.

Second, designers of the next set of CRA regulations must tackle a problem that has bedeviled the CRA from its inception. Does the CRA require banks to make loans that are less creditworthy than those the financial institution is making elsewhere? The experience of the last bubble indicates yes, although that was neither the intent nor the rhetoric of those who implemented the current CRA. Answering this question with a definitive NO in the next round of CRA reform would certainly dispel the idea that the CRA is a “tax” or worse. On the other hand, it strikes me as highly unlikely that the bulk of those pushing for CRA expansion would choose to definitively answer this question in the negative.

CRA Public Good Number Three: Consumer Education

The current financial meltdown includes individual stories of such debt and shockingly bad decisions that

one has to wonder, “What were they thinking?” In some cases, the fault clearly lies with financial services providers who were deceptive or possibly even fraudulent. More commonly, lenders complied with the letter of the law, but competition for customers created ever more lenient credit terms. There is a legitimate debate about the proper roles of caveat emptor and caveat vendor, but the legal distinction here is not a public good question, given that it is a matter of placing the private burden of caution between borrower and lender.

What is a matter of public good is that borrowers sufficiently understand the role of finance in their lives such that they can make reasonably informed decisions. Increasing such knowledge not only lowers the likelihood of a taxpayer-funded bailouts, but it also lowers the cost of providing credit generally given that overall losses should be lower.

Public schools have begun to take on this challenge, and they are a natural way to provide such a public good. The curriculum is well intended, but from personal experience, teachers need more training themselves. My son had to do a monthly budget, a good learning experience. The budget included buying transportation, and the students were allowed to finance a car for 36 months. My son used an online monthly payment calculator that different car dealers offer. The teacher marked his budget wrong because apparently her notion of finance was to take the cost of the car and divide by 36! When I wrote in and pointed out that we have such a thing as interest in this world, she relented, apparently having learned something for the first time.

The notion that banks should meet the credit needs of their entire community might certainly include teaching basic financial literacy, since apparently the entire community (or vast portions of it) appears to lack it. Here the nonprescriptive nature of CRA might well be an advantage given that what is clearly needed is some creativity in how to provide consumer education. Some institutions use classes, others, particularly in by-gone days, ran weekly savings programs in the schools. But if CRA regulators are looking for an alternative to the lending tests and branching tests described above, certainly funding of consumer education programs would warrant consideration.

Conclusion

The financial crisis the nation now finds itself in offers a natural opportunity to reconsider how the Community Reinvestment Act should be structured. But it is also a time when the central objectives of the financial regulatory community should be focused on other issues, notably capital adequacy and underlying safety and soundness. Although the political setting offers an opportunity for expanding the CRA, the economic setting will likely push the CRA to a back seat.

That is why it is critical that the CRA adopt a public goods stance and distance itself from a reputation of extracting commitments from banks. Once it is clear that the duty of the bank is to benefit the entire community, and not special pieces of it when community leverage is greatest, more people will support a sustainable CRA approach and compliance will be much easier. That should be the focus of the Congress in the next few years as it considers changes to the Community Reinvestment Act. ■

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