Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Encouraging Investment, Spreading Opportunity

TO THE EDITOR:

Vern McKinley's interesting piece in the most recent issue of *Regulation* ("Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?" *Regulation*, Vol. 17, No. 4, 1994) presented one side of the policy dilemma which regulators face when implementing the Community Reinvestment Act (CRA). Congress passed the law in 1977 with very little detail regarding its intent. Regulators were simply required to encourage the lenders they regulate to lend in all parts of their community, to evaluate the extent to which banks helped meet the credit needs of their entire communities, and to take the record of lending into account when approving applications for expansions or mergers. No legal obligation of any sort was placed on banks. McKinley argues that in carrying out this mandate the regulators have moved into the business of enforcing credit allocation based on special-interest pleadings and political clout.

As a regulator with substantial responsibilities for CRA enforcement, I certainly recognize the possibilities for abuse which McKinley raised in his piece. These include the use of naive methods of data analysis, inappropriate practices by some self-styled community groups, and pressure on banks to pursue both individual loans and whole lines of business which might prove to be unprofitable. But while instances of such abuse may exist, I do not believe that they fairly characterize the record on the CRA.

In fact, the great majority of criticism of the performance of regulators is that we have not been tough enough on banks. Critics point to the statistic that more than 90 percent of all regulated institutions receive grades of "Satisfactory" or "Outstanding." In large measure, these grades reflect the fact that banks *must* help meet the legitimate credit needs of the communities they serve, or they would go out of business. Indeed, a consideration of the CRA needs to begin with an examination of why a bank might neglect profitable credit markets within its service area.

The theoretical case for the CRA, as with much government regulation, lies on evidence of market failures. In a regulated industry such as banking, many of the relevant failures aren't really *market* failures, but *regulatory* failures, with the CRA as a second-best solution. While I have argued elsewhere ("How to Lend a Hand," *Wall Street Journal*, November 2, 1994) that the best solution in many instances is to get rid of the initial regulatory failures, this in no way undermines the case for having the CRA in place in the absence of legislative relief on the primary problem.

Consider, for example, one very important area of serving one's community: the availability of banks within reasonable proximity to one's home or place of business. I ask you, the reader, to imagine living in a community of 50,000 people in which there were no banks. Imagine running a small business in a location where you may have to drive 20 to 30 minutes to make a deposit or even get change for your cash register. Easy access to banking is as important a part of the infrastructure needed to do business as are the roads and the postal system. Yet I have cut plenty of ribbons in communities of this size where the first bank in decades is opening its doors, so I know that many such communities do exist.

Why? Part of the problem is a regulatory "hangover." Many of these communities are in so-called unit banking states which prevent or limit branching. If you're a bank and can have one office, chances are it is going to be downtown.

Another part of the problem is risk, real or imagined. Government failure in the form of inadequate police protection can help induce market failure. But so can simple ignorance or prejudice. Many of the underserved neighborhoods I have visited may not be the first place someone would think of as having profitable business opportunities. That does not mean that such opportunities do not exist.

To use famed economist Joseph Schumpeter's phrase, markets move toward an ever-changing equilibrium as entrepreneurs engage in gap filling and input completing. We believers in free markets never maintain that all profitable market niches are always filled, merely that the profit motive is the best mechanism for signalling where such niches exist and for rewarding those who do meet those needs. This process always takes time and is never completed. In a highly regulated, historically nonentrepreneurial business such as banking, the process of filling niches can take, and in many cases has taken, a very long time.

As with underserved communities, there are also unmet product lines. For example, consider the case of adjustable rate mortgages (ARMs). ARMs were not generally available prior to 1981 because they were effectively prohibited by law. But today ARMs comprise 55 percent of the home mortgage market. The gap is being filled. Another product which has grown in market share is the credit card. Today we are so inundated with plastic that it is easy to forget that your typical revolving charge account is relatively new. It wasn't until 1968 that the Fed even bothered to collect statistics on credit card use. That year Americans managed to carry balances of a grand total of $2 billion. Today that amount has grown to over $350 billion. Certainly the potential market for credit cards predated Woodstock. But it takes time to fill the niche.

If you are a low- or moderate-income person, it was only very recently that banks discovered that you could be a safe and profitable credit card customer, or that you didn't need to put 20 percent down to qualify for a mortgage. Why? Again, markets move toward meeting needs, but never fulfill all of them all the time.

It is important to keep this in mind when considering why the CRA exists. Many areas of the country were geographically underserved by the banking industry. Many segments of the population were demographically underserved. The CRA was intended to help prod banks to serve these historically underserved areas and populations. The dilemma facing CRA regulators is to try to encourage banks to undertake new product lines and develop new geographic areas of service without engaging in credit allocation.

I believe that this function has a very important role in our society. There are certainly positive externalities to be obtained by making sure that all citizens have access to our financial system. Economic opportunity is a cornerstone of American capitalism. Spreading opportunity widely benefits not only the individuals directly affected, but all of us with a stake in our democratic capitalist system.

Unfortunately, a lot of the present criticism of CRA enforcement and charges of credit allocation actually have nothing to do with the CRA or the regulators who enforce it. Rather, it reflects policy judgments made by other agencies regarding the enforcement of non-CRA legislation. For example, the much-cited case of Chevy Chase Federal Savings Bank was an action brought by the Justice Department, an agency which has no CRA responsibilities. Issues such as disparate impact tests for lending discrimination also are not related to the CRA, but to the Fair Housing Act and Equal Credit Opportunity Act. The primary policers of these laws are the Department of Housing and Urban Development and the Department of Justice. Again, neither has CRA responsibilities.

In sum, most of the criticisms by Vern McKinley and others are misplaced. This is not to say that the CRA works perfectly. As regulators, we have a very difficult task: to encourage banks to meet the unmet needs of underserved communities and populations without allocating credit. But, by and large, I believe that we have balanced these obligations well.

Lawrence B. Lindsey
Member, Board of Governors of the Federal Reserve System
Washington, D.C.

Helping the Disadvantaged

TO THE EDITOR:

The article by Vern McKinley on the Community Reinvestment Act ("Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?" *Regulation*, Vol. 17, No. 4, 1994) reminds me of the old adage that an economist is someone who sees something working in practice and wonders whether it will work in theory. McKinley advocates repeal of the Community Reinvestment Act (CRA), but in drawing this conclusion, he overlooks the abundant evidence that shows that the law is successfully working to narrow credit gaps in underserved markets.

While McKinley's article covers a lot of ground, his criticism of the CRA basically stems from three faulty premises: (1) that the CRA interferes with credit markets in a way that harms both lenders and underserved communities; (2) that the concepts for the CRA and fair lending are interchangeable; and (3) that the CRA gives too much power to local community groups. Let me respond to each of these charges.

The core of McKinley's complaint about the CRA is that "[it] has become a system of credit allocation, rather than an ensurer of credit adequacy." This view assumes that market competition would otherwise ensure that credit needs are being served throughout a given market area.

Unfortunately, the article barely touches on the conditions that led to the passage of the CRA more than 17 years ago. It was growing concern that redlining was sapping the vitality of older urban neighborhoods that resulted in the CRA's enactment. Redlining is the discriminatory mortgage lending practice whereby lenders arbitrarily refused to make loans in certain geographic areas based on the racial or ethnic composition of those areas or the age of their housing stock. The CRA reflected the judgment that lenders—through the use of outworn stereotypes, prejudice, and sheer laziness—were overlooking important credit needs within their local communities. This translated into deteriorating neighborhood conditions and, eventually, the use of dwindling public sector resources to combat this decline.

Far from distorting the workings of the market, the CRA has improved its efficiency by breaking down unfair barriers to credit access. McKinley may label the CRA as "credit allocation," but experience indicates that the law has spurred a "win-win" situation for all concerned. The CRA has increased lending to credit-starved urban and rural communities across America, and it has done so in a way that generates profits for the banks by developing new markets. For example, a recent survey of 42 banks conducted by the independent Bank Insurance Market Research Group in New York found that 62 percent said that they were making money or expected to make money by lending to low-income communities. In contrast, only 5 percent said that lending to people in those geographic areas represented a financial burden to them.

In his article, McKinley questions my claim that the CRA has resulted in over $30 billion in new lending commitments to underserved areas. In fact, this is a very conservative estimate, limited only to negotiated CRA agreements and publicly announced commitments made by lenders. But even if the author doubts the accuracy of this figure, he need only look for himself at the scores of local reinvestment partnerships involving lenders, community groups, and local governments which are emerging in urban and rural areas throughout the nation to discover that the CRA is working to improve credit conditions. Such a listing of successful activity was recently published by the Philadelphia Federal Reserve Bank.

Instead of challenging actual experience, McKinley bases much of his criticism of the CRA on theoretical arguments. For example, he contends that the CRA causes lenders to avoid opening branches in lower-income and minority areas and that the law has undercut some lenders from specializing in low-income lending. Yet McKinley acknowledges that such criticisms are little more than speculation on his part, which cannot be supported with actual evidence.

The article jumps back and forth between CRA and lending discrimination as if these concepts are interchangeable, which they are not. McKinley refers to the Fair Housing (FHA), Equal Credit Opportunity (ECOA), and Home Mortgage Disclosure Acts (HMDA), as "sibling statutes" to the CRA. He seeks to link these laws together by asserting the "near-automatic determination that if ECOA and FHA are violated, the institution is not serving its community."

While there are some obvious linkages between these various laws, the CRA is conceptually very different from the antidiscrimination statutes. The CRA is not so much about curbing racial discrimination as it is about prodding lenders to make loans to anyone who is creditworthy. Thus, the CRA emphasizes low and moderate income geographies, rather than ensuring fair treatment for racial and other minorities.

Unfortunately, the article is not rigorous enough in sorting out the differences between community reinvestment and racial discrimination. In fact, the author uses race and class synonymously. For example, the article states that the "disparate impact" analysis that is employed in racial discrimination cases applies to "low-income borrowers." This is clearly not the case, since low-income people are not a protected class under the civil rights statutes. Racial discrimination can happen to people of all income levels. In fact, research using HMDA data consistently indicates that African Americans and Hispanics are more likely than their white counterparts to have their loan requests denied—regardless of income. Further, a 1991 Federal Reserve Board analysis found that affluent African Americans were less likely to obtain mortgage credit than low-income whites.

Space does not permit me to go on at additional length about the author's views on fair lending enforcement; and since the article is generally about the CRA, I will confine my comments to that subject. It should be noted, however, that the author is also wrong in asserting that the Boston Federal Reserve Bank lending study "found that overt discrimination, such as redlining, is not pervasive." Redlining was not included in the study's scope, which focused exclusively on the question of whether minority home-loan seekers were being treated differently than whites.

McKinley is especially critical in his article about the role of community groups in the CRA enforcement process. He labels efforts by local citizens' groups to negotiate improvements in service with lenders as "extortion" and "coercive." In fact, what he fails to account for is that the CRA implicitly sanctioned a strong role for local citizen monitors as checks and balances to the federal enforcement apparatus, which was viewed as too hostile or indifferent to achieving effective enforcement in this area.

While the author would have your readers believe that there is something unsavory about reinvestment plans that are freely entered into by lending institutions as an effective and efficient means of fulfilling their CRA responsibilities, our own research indicates otherwise. We surveyed both the lender and community group partners to a number of the most highly publicized agreements and found amazingly high levels of satisfaction among both types of partners with the way in which these accords have proceeded. Moreover, the Federal Reserve Board has testified that community group challenges to bank expansion requests have not resulted in appreciable delays in processing.

Again, it is unfortunate that the article misses the real story: that the law is working. This is not to suggest that CRA enforcement cannot be improved, because virtually everyone agrees that this needs to be done (revised CRA rules streamlining the relatively few compliance requirements for the act are due out next month). But the CRA is a law that anticipated the new federalism by almost 20 years. Far from establishing rigid, national, mandatory credit allocation schemes or relying on Washington bureaucrats to micromanage the efforts by lenders, the CRA merely encourages financial institutions to find creative ways to better meet the credit needs of underserved areas.

Allen J. Fishbein
General Counsel
Center for Community Change
Washington, D.C.

Robbing Banks

MCKINLEY replies:

I strongly take issue with Gov. Lindsey's statements that "charges of credit allocation actually have nothing to do with the CRA or the regulators who enforce it" and "[i]ssues such as disparate impact tests for lending discrimination also are not related to the CRA, but to the Fair Housing Act and Equal Credit Opportunity Act." Lindsey also implies that the case of Chevy

Chase is irrelevant to an analysis of the CRA. These statements are simply not true.

First of all, the market-share mentality and the other tests embodied in recent CRA regulations represent blatant credit allocation, as is supported by my examples in the article. As for the interrelationship between lending discrimination and the CRA, this is also clear. One need look no further than the Shawmut case, where the Fed decided on its own, without verification by the courts, that there was a strong case that lending discrimination under the Equal Credit Opportunity Act was present. Chairman Greenspan and governors Lindsey and Mullins cited the possibility of violations of the Equal Credit Opportunity Act as the sole reason for denying the proposed merger. Further, if lending discrimination is even mentioned in the same breath as a bank, you can be sure that community groups will come out of the woodwork to block mergers and extract credit commitments via the CRA.

Similarly, as to the Chevy Chase case, the Justice Department in its complaint cited the CRA as authority for its actions, and Deval Patrick, the assistant attorney general for civil rights, has publicly cited it in defense of his actions (most prominently in the *Wall Street Journal*). It is also likely that Chevy Chase feared that CRA-related applications would be denied if it did not settle discrimination charges. As I argued in my article, if you take the CRA out of the picture through repeal, the agencies are forced to prove discrimination in the courts—which they have been loathe to do up to this point.

Another key point is that nowhere in the course of Gov. Lindsey's response does he say why government is the proper agent for determining whether a bank is properly serving its community. I cannot be convinced that regulators in Washington somehow know the appropriate way for banks to serve their own individual communities.

I respect Gov. Lindsey's opinion on these issues. I especially enjoyed an interview with him that aired earlier this year on "Insights," Robert Novak's show on National Empowerment Television. Among Lindsey's comments were these revealing statements regarding the role of government in lending in depressed inner-city areas: "There is so much that this Congress can do to improve the situation in the inner city—to get government out of the way and to let people run their own lives and improve their neighborhoods"; "I think that if people are left in charge of their own life they know how to run it. It's when control of their lives is taken from them, when incentives are put up not to do what everyone knows is the right thing." And finally, in response to Novak's statement that government has been part of the problem in these distressed neighborhoods, Gov. Lindsey noted, "It has been a major part of the problem." Clearly, Gov. Lindsey has some good instincts with regard to inner-city lending issues, and if he applied the above-noted philosophical positions to the Community Reinvestment Act, then he should come to the logical conclusion that it should be repealed.

Two things are very obvious from Allen Fishbein's impassioned defense of the CRA: he cares about and believes in his work, and he is very knowledgeable about the issues in controversy. However, something else that is very obvious is that he has an appetite for increased intervention in our financial system that will not be satiated until we nationalize our banking system and appoint someone of his ilk as banking czar. Presumably, this is because the community groups somehow have knowledge that individuals in the marketplace do not have, i.e., the appropriate allocation of banking institutions and banking services throughout the economy. A more classic example of F.A. Hayek's "fatal conceit" would be difficult to conceive of. I will briefly address his major points.

Fishbein argues that the CRA increases lending to credit-starved areas and is good for our banking system and bankers. However, many of the conditions Fishbein cites from 17 years ago of blighted inner cities can be laid at the doorstep of governments; zoning and rent control laws as well as excessive local taxes come most prominently to mind.

The survey Fishbein mentions which notes that bankers are making money or expect to make money on low-income loans is hardly evidence of anything. Given that these loans are relatively unseasoned (heavy CRA enforcement is a very recent phenomenon), it would be very difficult for these bankers to know what will come of these loans. I examined banks in Texas (mostly small community institutions) during the mid- and late 1980s depression. If you would have asked those bankers in the early 1980s whether real estate and energy lending was profitable, you would have likely heard a resounding yes. Asking that question in the late 1980s would have brought a far different answer. Obviously, only time will tell on these loans that were extracted from institutions. My concern is that these loans are a result of political considerations more than market considerations.

Fishbein also argues that the CRA can be distinguished from fair lending laws. However, it is very difficult to perform this "carving out." I would have preferred to separate the two topics during my own work because it would have made my task of researching this area a whole lot easier. However, from my experience, the two topics are inseparable. In fact, many people when asked what the CRA is, respond that it is a lending discrimination law. Fishbein's discussion of the legislative history of the CRA is a testament to the overlap between discrimination/fair lending laws and the CRA. The link is also obvious in that Fishbein's organization would certainly use the CRA to cause difficulties for an institution the second it is criticized for lending discrimination.

I absolutely deny that I use race and class synonymously in my article. The sentence Fishbein cites regarding this conclusion is nowhere to be found, and I am fully aware that low-income people are not considered to be members of a protected class. In fact, I criticize the civil rights lawyers who developed disparate impact doctrines in the lending context, because "implicit in [these doctrines] is an assumption that minority status is equated with low-income status."

As for the CRA's implicit sanctioning of a strong role for local citizen monitors, the truth of the matter is that the relevant legislative history is a classic case study in public choice analysis. Community groups pushed through changes to the CRA as part of FIRREA, also known as the S&L bailout law, as a quid pro quo for passage of the bill. The bill expanded the capabilities of community groups to influence community lending, and, as I noted in the article, they are often paid handsome sums to administer the resulting lending programs.

I do think community groups have a role in a post-CRA world. They could raise capital to start up local community banks. Then they would witness firsthand the other focus of my article: governmental barriers to low-income lending. After dealing with these barriers for any length of time, I am certain the community groups would be convinced that many governmental barriers stand in the way of low-income lending.

Finally, there is the claim that the CRA is working. Fishbein's inability to respond to my criticisms of his $30 billion estimate is a clear admission that he cannot quantitatively back up his statements. I am tired of people arguing that more government intervention in the economy is going to magically increase the standard of living of the poor in our nation. The past 35 years of extensive government intervention in our economy have only exacerbated the plight of the poor.

*Vern McKinley**
Resolution Trust Corporation
Arlington, VA

**The opinions expressed above are those of the author, and not necessarily those of his employer.*