

MARKET FAILURE AND COMMUNITY INVESTMENT:  
A MARKET-ORIENTED ALTERNATIVE TO THE  
COMMUNITY REINVESTMENT ACT

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The Community Reinvestment Act (CRA) is a model of ambiguity. In a roundabout way, it directs banks to meet “the credit needs of [their] entire communit[ies], including low- and moderate-income neighborhoods, consistent with . . . safe and sound operation.”<sup>1</sup> In enacting the CRA and making specific reference to low- and moderate-income communities, Congress presumably sought to have banks do something that market forces would not lead them to do, but exactly what is unclear. Did Congress intend to implement an ill defined “localist” or “communitarian” ideology by limiting the geographic scope of their lending? Did it intend to redress discrimination against ethnic and racial groups that reside disproportionately in low- and moderate-income neighborhoods? Did it intend to redistribute wealth from bank shareholders to residents of targeted communities? Or, did it intend, on efficiency

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<sup>1</sup> 12 U.S.C. § 2903(a)(1) (Supp. V 1993). The Act applies to “regulated financial institution[s],” 12 U.S.C. § 2902(2), which are defined to include insured national banks, state banks, and savings associations, *see* 12 U.S.C. § 1813(a)-(c). For simplicity, I will use the term “bank” to refer to all covered financial institutions. The CRA’s mandate is indirect in that it only directs the bank regulators to take a bank’s community service into account when they rule on applications for merger or expansion. *See* 12 U.S.C. §§ 2902(3), 2903(a)(2) (1988 & Supp. V 1993).

The CRA refers to “low- and moderate-income neighborhoods.” 12 U.S.C. § 2903(a)(1). For simplicity, I will use the term “low-income neighborhood” to refer to all neighborhoods covered by the CRA. Recently issued regulations, *see* Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156 (1995) (to be codified in scattered sections of 12 C.F.R.) (joint rules) [hereinafter Final Regulations], define “low-income” as less than 50% of the median family income in an area, and “moderate-income” as between 50% and 80% of the median family income in an area. *See id.* (to be codified at 12 C.F.R. § 228.12(n)(1)-(2)).

grounds, to remedy market imperfections? Congress's intent is wholly unclear.<sup>2</sup>

In debating the wisdom of the CRA, most commentators have paid little, if any, attention to the justification for regulatory intervention in low-income community credit markets. Community advocates call for more intervention and more loans.<sup>3</sup> Critics, emphasizing the cost of the CRA to banks as well as incidental social costs, argue against government intervention.<sup>4</sup> To the extent that

<sup>2</sup> In this issue of the *University of Pennsylvania Law Review*, Professor Overby describes the CRA as "the product of largely unreflective congressional debate as to the Act's purpose." A. Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431, 1439 (1995). In describing the Act's legislative history, she documents "deep-seated division over the Act as well as uncertainty over what the Act is intended to accomplish—and why." *Id.* at 1445. Two economists at the Federal Reserve Bank of San Francisco have stated that "[t]he language of the CRA statute was intentionally vague, balancing a social policy goal of encouraging banks to lend in lower income areas with regulators' concerns about bank safety and soundness." Jonathan A. Neuberger & Ronald H. Schmidt, *A Market-Based Approach to CRA*, FRBSF WKLY. LETTER (Federal Reserve Bank of S.F.), May 27, 1994, at 1, 1.

Overby identifies the term "community" as the CRA's principal source of ambiguity. *See* Overby, *supra*, at 1437. There are other substantial ambiguities as well. The concept of "credit need" is ambiguous. Is credit need limited to situations in which a borrower can afford to pay a risk-adjusted interest rate, or would a borrower have a cognizable credit need even if it could only afford a rate that did not reflect its risk of default? The constraint imposed by the clause "consistent with . . . safe and sound operation," 12 U.S.C. § 2903(a)(1), is also ambiguous. Does this mean that a bank should not make a loan above some threshold of riskiness? Does it mean that the bank should make such a loan but should also charge a compensating risk premium? Or does it mean that the bank should simply retain earnings and thereby maintain a level of capital that holds its risk of failure constant while it engages in risky or nonremunerative lending to borrowers in its community? Finally, what if a bank can find low-risk lending opportunities in its community but only at high search and monitoring costs? Would the safety and soundness constraint allow the bank to neglect such opportunities? Congress declined to address these issues when it enacted the CRA, and neither the regulators nor the courts have resolved them since then.

<sup>3</sup> This demand runs throughout the comments of community advocates at hearings held by the federal bank regulators during 1993. *See, e.g.*, Board of Governors of the Fed. Reserve Sys., Public Meeting Regarding Ideas on CRA Reform, Sept. 22, 1993 (transcript on file with author).

<sup>4</sup> Jonathan Macey and Geoffrey Miller have written the most comprehensive critique of the CRA in which they catalogue the program's social costs. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993). Lawrence White has also written a critique in which he emphasizes the inability of banks to provide CRA-induced services in the long run if they are making no more than a competitive return on their other businesses. *See* Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 FORDHAM URB. L. J. 281 (1993). White, however, does recognize the possibility that neighborhood externalities might justify government intervention. *See id.* at 284-85; *infra* part I.C.

commentators identify justifications more refined than more money for low-income neighborhoods or lower costs to banks, they refer to different justifications and largely fail to join issue.<sup>5</sup>

In this symposium issue of the *University of Pennsylvania Law Review*, Professor Overby attempts to place some structure on this unwieldy debate by focusing on the ends and means of the CRA. She argues that the CRA was intended to be, and can be justified as, an antidiscrimination law—an adjunct to the Equal Credit Opportunity Act, which prohibits discrimination in lending on the basis of “race, color, religion, national origin, sex or marital status, or age.”<sup>6</sup> In support of this reading of congressional intent, she relies on statements in the legislative history regarding “redlining,” and in support of her normative view, she invokes an equality argument.<sup>7</sup>

Overby concludes that an antidiscrimination objective requires an efforts-based enforcement regime rather than a results-based regime. She argues that banks should be required to search for lending opportunities in their local communities but that they should not be required to lend there if, after searching, they choose not to. Imposing an outreach and search obligation on banks, she contends, would create equality of access to credit at the least cost to banks. Requiring a bank to make loans, on the other hand, she argues, would compromise the bank’s financial safety and soundness.<sup>8</sup>

The CRA, however, is poorly suited to the task of combatting discrimination. It applies to residents of low- and moderate-income neighborhoods without regard to race or ethnicity, and even without regard to their individual incomes.<sup>9</sup> Moreover, the Equal Credit

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<sup>5</sup> For example, although Macey and Miller focus primarily on the social costs of the CRA, they describe the Act as grounded in an “ideology of localism” that fails to recognize the nationalization and globalization of financial markets. See Macey & Miller, *supra* note 4, at 303-12. Professor Anthony Taibi, on the other hand, imagines a world of community economic empowerment that somehow sidesteps these markets. See Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1465, 1536-40 (1994). Peter Swire describes the debate as comprising those who “wish to ensure greater devotion of resources to low-income and moderate-income communities” (implicitly attributing to them wealth redistribution arguments) and “those who oppose government regulation of market decisions” (implicitly attributing to them efficiency arguments). Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 351 (1993).

<sup>6</sup> 15 U.S.C. § 1691(a)(1) (1988).

<sup>7</sup> See Overby, *supra* note 2, at 1497-1505.

<sup>8</sup> See *id.* at 1508.

<sup>9</sup> The term “redlining” originally referred to the reported practice of banks

Opportunity Act specifically addresses lending discrimination. Finally, as discussed in Part I, there are at least theoretical reasons to believe that CRA-targeted neighborhoods may be systematically denied access to credit for reasons unrelated to racial or ethnic discrimination.

As for efforts-oriented versus results-oriented enforcement of the CRA, both modes of enforcement impose costs on banks. Whether one imposes higher costs than the other depends on how much effort is required, what amount of lending is required, and how much record keeping is necessary for a bank to prove compliance. A major criticism of current CRA regulations is that their efforts-based orientation leads to too much paperwork. This has engendered in many banks a willingness, in principle, to accept a results-based regime.<sup>10</sup>

In the discussion below, I analyze whether there may be an efficiency-based justification for intervening in low-income community credit markets, and whether, as some have suggested, the CRA can be justified on efficiency grounds.<sup>11</sup> I begin by describing market imperfections that may leave low-income neighborhoods with suboptimally low levels of credit. I then analyze whether the CRA promotes efficiency by responding effectively to those imperfections, and I conclude that it does not. Finally, I propose a

drawing lines around certain areas on a map and declining to make loans within those areas. The term, however, has different meanings to different people, and it is difficult to infer any particular meaning from its use in the congressional debates. See ROLAND E. BRANDEL & DAVID E. TEITELBAUM, *THE COMMUNITY REINVESTMENT ACT: POLICIES AND COMPLIANCE* § 1.01[c] (1991) ("The term 'redlining' meant different things to those who used it in 1977, referring in a variety of contexts to a variety of practices and results."); Macey & Miller, *supra* note 4, at 298-99; Overby, *supra* note 2, at 1446-53. Note, however, that the 1991 amendments to the CRA do allow bank regulators to award CRA credit for donations to banks owned by women and members of certain specified racial and ethnic minority groups. See 12 U.S.C. § 2907 (Supp. V 1993).

<sup>10</sup> See Macey & Miller, *supra* note 4, at 325-26; Overby, *supra* note 2, at 1468.

<sup>11</sup> These suggestions that the CRA may respond to market failures have been made casually, typically after analyzing the presence of market failures in depth. See, e.g., JACK M. GUTTENTAG & SUSAN M. WACHTER, *REDLINING AND PUBLIC POLICY* 39 (1980) (noting that the CRA may address neighborhood externalities); William C. Gruben et al., *Imperfect Information and the Community Reinvestment Act*, *ECON. REV.* (Federal Reserve Bank of S.F.), Summer 1990, at 27, 39-41 (noting that the CRA may respond to information asymmetries); Leonard I. Nakamura, *Information Externalities: Why Lending May Sometimes Need a Jump Start*, *BUS. REV.* (Federal Reserve Bank of Phila.), Jan.-Feb. 1993, at 3, 7 (noting that the CRA may respond to information externalities).

system of "tradable obligations" as a potentially more effective alternative to the current CRA regime.<sup>12</sup>

## I. MARKET IMPERFECTIONS AFFECTING LOW-INCOME NEIGHBORHOOD CREDIT MARKETS

Several economists have examined the possibility that market imperfections may result in a suboptimally low volume of credit reaching low-income neighborhoods. Some have referred to lending patterns created by such market imperfections as "rational redlining."<sup>13</sup> This Part examines these market imperfections.

### A. Information Costs

For a bank to make a loan to a borrower, the bank needs information regarding the likelihood that the borrower will default. Acquisition of that information, however, entails costs. Whether a bank will incur those costs and evaluate the creditworthiness of a particular borrower depends on the magnitude of the costs compared to the expected return from the loan. If the costs are higher than the expected return, the bank will forego consideration of the loan altogether.

The information costs of lending are compounded by an asymmetry of information between banks and borrowers. In general, a borrower knows more about his own risk of default than

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<sup>12</sup> Before moving on, a disclaimer is in order. The questions I address are narrow: First, if significant market imperfections are present in low-income neighborhoods, is the CRA an appropriate response? And second, is the tradable obligation system that I propose a better response? I make no empirical claim regarding the impact of these market imperfections, although I find it plausible that their impact is significant. Moreover, further study would be needed to assess the social cost of implementing my proposal compared to the social cost of the current CRA system or the social cost of nonintervention. At this point, I argue only that my proposal warrants consideration because it potentially offers a better response to these market imperfections than does the CRA as currently implemented. Furthermore, I take as a starting point the apparent political reality that banks are going to bear the cost of intervening in low-income neighborhood credit markets. I make no judgment regarding whether they, as opposed to society at large or any other constituency, should bear this cost.

<sup>13</sup> See, e.g., GUTTENTAG & WACHTER, *supra* note 11, at 7-8, 11-12; William W. Lang & Leonard I. Nakamura, *A Model of Redlining*, 33 J. URB. ECON. 223, 224 (1993). The term "irrational redlining" is sometimes used to refer to redlining based on racial or ethnic prejudice. See GUTTENTAG & WACHTER, *supra* note 11, at 13-14. Somewhere in between rational and irrational redlining is the situation in which banks with no racial or ethnic prejudice avoid lending to a neighborhood merely because of the absence of lending by other banks, whose policies have been motivated by racial or ethnic prejudice and which have caused the neighborhood to deteriorate.

does the bank to which he applies for a loan. As I will discuss in subsection 1, this asymmetry compounds the problem of information costs and can lead lenders to decline to serve entire low-income neighborhoods.

Information costs of lending are mitigated to some degree by positive information externalities that flow from one loan transaction to another. In the process of granting a loan, a bank produces information that can be used to facilitate future lending. For instance, in the case of a home loan, a bank's willingness to make a loan following an appraisal of the mortgaged property constitutes valuable information regarding the value of comparable houses. This information can reduce the cost of financing the sale of those comparable homes by increasing the accuracy with which lenders can appraise those properties. If sales slow down in a neighborhood, however, this information becomes less available, and the information cost of lending can rise. As I will discuss in subsection 2, this possibility is of particular concern in low-income neighborhoods.

### 1. Asymmetric Information and Credit Rationing

Asymmetric information is inherent in credit relationships. Not only do borrowers often know more about their own risk of default than do lenders, they can increase their riskiness after a loan has been made. This asymmetry can lead to "credit rationing," a situation in which a lender declines to lend to a group of borrowers that, on average, pose a high risk of default, even if some members of the group are not as risky as others.<sup>14</sup>

In this scenario, lenders decline to lend to some groups of borrowers at *any* interest rate. The underlying dynamic is that, as a bank raises the rate it charges a particular group of borrowers, the composition of the pool of potential borrowers within the group can be expected to shift toward riskier members.<sup>15</sup> At some point, the

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<sup>14</sup> Groups of borrowers are differentiated from one another by qualities that the lender can observe—for instance, age, occupation, or neighborhood. Asymmetry of information exists with respect to qualities that differentiate potential borrowers within "observationally distinguishable" groups. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 406 (1981).

<sup>15</sup> Adverse selection and moral hazard are the underlying phenomena explaining this shift. The borrowers who know they are relatively unlikely to repay a loan will be less deterred from borrowing by a high interest rate than others. *See id.* at 395-401. In addition, borrowers that accept loans at high rates will have a greater

increased expected return attributable to a higher rate is offset by the increase in expected defaults attributable to the riskier composition of the borrower pool. At that point, if the bank were to increase the interest rate it charges the group, it would actually reduce its expected return.<sup>16</sup> To the extent that borrowers in low-income neighborhoods are on average relatively risky, this dynamic may result in these neighborhoods being rationed out of the credit market.<sup>17</sup>

The credit-rationing scenario described above assumes, perhaps unrealistically, that a lender cannot distinguish between low- and high-risk borrowers in a low-income neighborhood. It assumes away the possibility that a lender can acquire information that allows it to identify the relatively low-risk borrowers, to restrain them from increasing their riskiness once a loan is made, and to offer them interest rates commensurate with their individual risks of default.

In a related model, this assumption is relaxed, and banks are assumed to be capable of acquiring information regarding the default risk of individual borrowers. Acquisition of this information, however, is assumed, realistically, to entail costs. In this model, not surprisingly, the extent to which a lender lends to groups that, on average, pose a high risk of default depends on the cost and value of information regarding such a group. The lower the cost and the greater the benefit of acquiring information about borrowers in the high-risk group, the more lending there will be to members of the group.<sup>18</sup>

This model also suggests that banks may rationally decline to lend in low-income neighborhoods, where the cost to a bank of acquiring credit-related information may well be high and the

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incentive than borrowers at lower rates to increase their risk of default. *See id.* at 401-02.

<sup>16</sup> Expected return refers to the amount of money the borrower is obligated to repay discounted to take into account the possibility of default. *See id.* at 393-94.

<sup>17</sup> For more detailed discussions of this dynamic, see David Jaffee & Joseph Stiglitz, *Credit Rationing*, in 2 HANDBOOK OF MONETARY ECONOMICS 839, 853-60 (Benjamin M. Friedman & Frank H. Hahn eds., 1990). *See generally* Stiglitz & Weiss, *supra* note 14.

There may be political and legal constraints as well that deter a bank from charging a higher rate to riskier borrowers. *See* John V. Duca & Stuart S. Rosenthal, *Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence on Rate Sorting and Credit Rationing*, 8 J. REAL EST. FIN. & ECON. 99, 100-02 (1994) (citing antidiscrimination laws, community pressure, and "bad press" as examples of constraints on the interest rates banks may charge).

<sup>18</sup> *See* Gruben et al., *supra* note 11, at 34-35.

benefit low. Credit analysis involves substantial fixed costs in initially assessing and then monitoring the economic conditions of a neighborhood and its surrounding area and in becoming familiar and maintaining familiarity with the neighborhood's businesses and residents. Moreover, there are significant fixed costs involved in evaluating an individual loan application and monitoring the riskiness of an individual borrower.<sup>19</sup> This is true for all lending. In a low-income neighborhood, however, the cost of lending is higher than that of lending in other neighborhoods. Potential borrowers are less likely to have had prior borrowing experience and are more likely to need special help both in applying for a loan and in repaying it. Outreach efforts are needed to get borrowers to make applications, and education is needed to facilitate compliance with the terms of a loan. Furthermore, information regarding the creditworthiness of low-income neighborhood residents may be relatively difficult to obtain, and the qualifications of even credit-worthy borrowers will often not conform with the standards that banks employ in other parts of their business.<sup>20</sup>

Moreover, the revenues over which the fixed costs of lending are spread are likely to be low in low-income neighborhoods relative to higher-income neighborhoods. First, there will be relatively few creditworthy borrowers; and second, loans in low-income neighborhoods tend to be relatively small.<sup>21</sup> Consequently, the relatively high cost of lending in a low-income neighborhood will be spread over a relatively small return.

In sum, these economic models suggest that the costs and benefits of acquiring information regarding lending opportunities in a low-income neighborhood may lead a bank rationally to conclude that it should do business elsewhere. This theoretical prediction is consistent with bankers' reports that they prefer to deny loans to borrowers they perceive as high-risk, rather than charging them a substantially higher interest rate.<sup>22</sup>

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<sup>19</sup> See BOARD OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON COMMUNITY DEVELOPMENT LENDING BY DEPOSITORY INSTITUTIONS 7-8 (1993) [hereinafter FED REPORT].

<sup>20</sup> Experts in community development commonly cite these differences from mainstream lending. See *id.* at 3, 8, 34, 36, 54; JULIA A. PARZEN & MICHAEL H. KIESCHNICK, CREDIT WHERE IT'S DUE 143-48, 173-78 (1992) (describing risk-management efforts and lending costs of community development banks).

<sup>21</sup> See FED REPORT, *supra* note 19, at 8-9, 21, 34.

<sup>22</sup> See *id.* at 34.



## 2. Information Externalities

To economize on information costs, banks rely on information generated by past lending—both their own lending and that of other lenders. In the case of home mortgage loans, banks rely heavily on appraisals, which in turn rely on past sales of comparable homes in a neighborhood. Those past sales occurred only because financing was available to earlier buyers, and their purchases were made possible by appraisals that relied on yet earlier sales. The home loan market thus depends on a continuous sequence of sales, which inform appraisals, which in turn facilitate additional sales. A loan thus creates a positive externality to future lenders and borrowers in the form of valuable information.

If, for any reason, the rate of home sales decreases in a neighborhood, this positive externality would decline as well. Fewer comparable properties will be available to appraisers, which would result in less accurate appraisals. In some cases, an appraisal will be lower than the amount the buyer has already agreed to pay the seller, and the bank will reduce the amount it is willing to lend. In other cases, the appraised value will equal the sale price, but the bank will nonetheless realize that the appraisal is based on weak comparisons and will reduce the amount it is willing to lend.<sup>23</sup> In either case, the sale will fall through unless the buyer agrees to make a larger down payment or the seller agrees to reduce the sale price. To the extent that neither occurs, houses remain on the market, or sellers rent their houses rather than sell them. As a consequence, less information is available to facilitate future sales, and the pace of sales in the neighborhood declines even more. Once begun, this dynamic can be self-perpetuating.<sup>24</sup>

This declining spiral can occur regardless of the fundamental value of homes in a neighborhood or the economic vitality of an area. It occurs because of the inability of lenders to discern the value of properties. The effect is to compound what would otherwise be a transient decline in turnover into a protracted period of illiquidity and a real decline in home values. As homes remain unsold, would-be sellers may defer upkeep, and physical deteriora-

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<sup>23</sup> An appraisal would be uncertain under these circumstances because it is based on sales that occurred too early or that were geographically distant from the property being appraised.

<sup>24</sup> This dynamic is modeled in Lang & Nakamura, *supra* note 13, at 225-29. It is also described in Nakamura, *supra* note 11, at 3.

tion may occur, which, in turn, would reduce their economic value further.

A similar dynamic can occur in commercial lending. Although appraisals are not necessarily involved, lenders rely on other information generated by past lending. Consultants to banks compile this information, and banks use it to analyze local economic conditions, industry trends, and the condition of individual firms.<sup>25</sup> In addition, by monitoring a business to which it has a loan outstanding, a bank acquires information regarding current business conditions. Such information can reduce that bank's cost of making a new loan to that borrower and possibly to other borrowers as well. If economic activity and hence lending in an area declines, however, this positive information externality declines as well. Consequently, the availability of credit can diminish, and the decline can be longer lasting and deeper than fundamental economic forces would dictate.<sup>26</sup>

Low-income areas are especially vulnerable to this dynamic. As explained above, home buyers can counteract its effects by increasing their down payments. Similarly, businesses may be able to rely on internal funds during periods of illiquidity. But in low-income areas, home buyers and businesses are less likely than their counterparts elsewhere to have such funds available. As a result, this phenomenon, which is present in all credit markets, can be especially severe in low-income neighborhoods.

### B. *Neighborhood Externalities*

A second market imperfection that may infect low-income neighborhood credit markets stems from the negative externality associated with the physical deterioration of a neighborhood. The deterioration of a home, store front, or other property can reduce the value of neighboring properties, and on a broad scale, physical deterioration can impair property values in an entire neighborhood. As a result, a lender may decline to lend in a neighborhood that it perceives to be in decline, even if the property offered as collateral provides sufficient security at the time a loan application is made,

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<sup>25</sup> For example, Robert Morris Associates, an association of bank loan officers, collects and publishes data that banks use in making credit decisions.

<sup>26</sup> See William W. Lang & Leonard I. Nakamura, *Information Losses in a Dynamic Model of Credit*, 44 J. FIN. 731, 744 (1989); Nakamura, *supra* note 11, at 10-13.

and even if the lender is confident that the borrower will maintain that property.

Furthermore, bank lending decisions can produce neighborhood externalities, especially in low-income neighborhoods, where property owners are relatively unlikely to have internal or personal funds. Under these circumstances, the withholding of a loan can create negative externalities. If credit is unavailable, properties for sale may remain unsold, and possibly unoccupied, because would-be buyers cannot get financing. Owners, in the meantime, may neglect maintenance. In addition, owners who want to rehabilitate their properties may be unable to do so because they cannot borrow the money needed. Thus, a lack of credit in a neighborhood can actually precipitate its decline, or prevent its rehabilitation. Conversely, the making of a loan can create positive neighborhood externalities. Because banks cannot ordinarily be expected to take these positive externalities into account, lending in low-income neighborhoods would be expected to be suboptimally low.<sup>27</sup>

### C. *Interaction Among Market Imperfections*

Each of these market imperfections can leave creditworthy borrowers in low-income neighborhoods without access to credit or with less access than they would have if markets worked perfectly. In combination, these imperfections can compound one another. Consider a neighborhood in which the volume of home sales declines precipitously for exogenous reasons. Perhaps a large employer has left the area, near-term employment prospects are dim, and sellers are initially not willing to drop the asking prices for their homes. If the area were otherwise healthy, one might expect new firms eventually to enter, employment prospects to brighten, and home values to return to their prior levels. During the interim, however, home sales slow down. As a result, information regarding the value of homes becomes difficult to obtain, appraisals are less accurate, and sales volume declines further. Residents may move before they sell their houses, and upkeep may lapse. Over time, the neighborhood may begin to deteriorate physically, and neighborhood externalities may further propel a downward spiral. At some point, banks that had previously made loans in the neighborhood

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<sup>27</sup> For a discussion of neighborhood externalities, see GUTTENTAG & WACHTER, *supra* note 11, at 7-9, 11-12; FED REPORT, *supra* note 19, at 9 (recommending collaboration among lenders to overcome information externalities).

based on the underlying health of the local economy may decide that it is no longer worthwhile to invest in distinguishing good from bad credit risks, and they may withdraw credit from the neighborhood entirely. Moreover, the new employer that would otherwise have materialized may not appear, either because it cannot get financing or because the neighborhood is already too dilapidated.

#### D. *Objectives of Government Intervention*

The discussion up to this point suggests that, to the extent that efficiency is a goal of government intervention in low-income-neighborhood credit markets, two intermediate objectives would be appropriate: first, a reduction in the cost of information, and second, the internalization of positive information externalities and neighborhood externalities created by lending.

A reduction in information costs would represent a clear increase in social wealth. If the cost of the lending in these neighborhoods were to decline, banks would be able to make more profitable loans. Both banks and borrowers in low-income neighborhoods would be better off.

The efficiency to be achieved by internalizing positive neighborhood and information externalities is less straightforward but nonetheless evident. If a bank is able to internalize the positive externalities created by its own lending, that bank will voluntarily make more loans to low-income neighborhoods. As a result, social wealth would be enhanced; the bank and its borrowers would be better off. This same increase in social wealth might be achieved, however, at least in theory, by forcing banks through regulation to make the same loans that they would make if externalities were internalized. The relative efficiency of forced lending, on the one hand, and voluntary lending spurred by internalizing externalities, on the other, would depend on the administrative cost and the effectiveness of each type of intervention. As discussed in Part II, the CRA largely takes the former approach, and it has been severely criticized by banks for imposing high costs on them and by community advocates for producing too little lending in low-income neighborhoods. Part III proposes a form of intervention that takes the latter approach and that is potentially more efficient than the current CRA.

## II. THE CRA AS A RESPONSE TO MARKET IMPERFECTIONS

The CRA directs every bank to “[meet] the credit needs of its community, including low- and moderate-income neighborhoods.”<sup>28</sup> To enforce this obligation, it requires the federal bank regulators to assign each bank a CRA rating of either “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance.”<sup>29</sup> These ratings are based substantially on a bank’s record of lending in low- and moderate-income neighborhoods within the area in which the bank operates. Although no direct sanction is applied to banks with low CRA ratings, the regulators are required to take these ratings into account when a bank or its holding company applies to charter a new bank, to open a new branch, to relocate, or to merge with or acquire another bank.<sup>30</sup>

The federal bank regulators have recently issued lengthy regulations designed to revamp CRA enforcement “to emphasize performance rather than process.”<sup>31</sup> The central feature of these regulations is a “lending test,” which evaluates the volume and dispersion of a bank’s lending in low-income neighborhoods within its area of operation.<sup>32</sup> These regulations replace regulations issued in 1977, which consisted of broad standards that emphasized a bank’s efforts to make loans in low-income neighborhoods, as

<sup>28</sup> 12 U.S.C. § 2903(a)(1) (Supp. V 1993).

<sup>29</sup> 12 U.S.C. § 2906(b)(2) (Supp. V 1993).

<sup>30</sup> See 12 U.S.C. §§ 2902(3), 2903(a)(2) (1988 & Supp. V 1993). Regulations provide for consideration in response to other applications as well. See Final Regulations, *supra* note 1 (to be codified at 12 C.F.R. § 228.29).

<sup>31</sup> See Final Regulations, *supra* note 1.

<sup>32</sup> The lending test, which is the most important of three tests in determining a bank’s CRA rating, “evaluates a bank’s record of helping to meet the credit needs of its assessment area(s) through its lending activities.” Final Regulations, *supra* note 1 (to be codified at 12 C.F.R. § 228.22(a)). To obtain a grade of “outstanding” on this test, a bank must have “[a]n excellent record of serving the credit needs of highly economically disadvantaged areas.” In addition, it must have “[a]n excellent distribution . . . of loans among individuals of different income levels,” and “[a]n excellent distribution of loans in its assessment area(s).” For a grade of “high satisfactory,” the regulations substitute the adjective “good” for “excellent,” and for a “low satisfactory” grade, the term “adequate” is used. *Id.* (to be codified at 12 C.F.R. pt. 228, app. A, § (b)(1)). A bank’s “assessment area” is roughly the one or more Metropolitan Statistical Areas that account for substantial portions of a bank’s deposit-taking or lending. See *id.* (to be codified at 12 C.F.R. § 228.41). In applying these lending performance criteria, examiners are directed to take into account a wide range of factors intended to reflect a bank’s opportunities to make profitable loans. See *id.* (to be codified at 12 C.F.R. § 228.21(b), (d)).

opposed to the loans it actually made.<sup>33</sup> Both the old regulations and the new regulations are similar, however, in that they direct banks to serve geographically dispersed low-income neighborhoods within their areas of operation.<sup>34</sup>

As discussed below, the CRA's requirement of dispersed service impedes banks from economizing on information costs and from internalizing information and neighborhood externalities. The heart of the problem is that this requirement hampers both specialization and coordination.

#### A. *The CRA and Information Costs*

By requiring banks to lend in low-income neighborhoods throughout the areas in which they do business, the CRA fails to promote information efficiencies. This is true for two reasons.

First, the CRA leads banks to incur redundant costs in seeking creditworthy borrowers in low-income neighborhoods. As discussed above, lending in low-income neighborhoods entails relatively high fixed costs and relatively low revenues.<sup>35</sup> Consequently, if too many banks attempt to lend in a single neighborhood, the aggregate cost of lending in that neighborhood will be suboptimally high—too many banks will chase too few loans. The CRA, in effect, directs all banks in an area to serve all low-income neighborhoods in the area. There is no reason, however, to expect lending opportunities in an area's low-income neighborhoods to support efficient lending by all of the surrounding area's banks. In fact, the economics of lending in these neighborhoods suggests that a much smaller number of banks would be optimal in any single neighborhood. In other markets, overcrowding leads the least efficient firms to exit until the most efficient firms remain. The CRA, however, does not allow this to occur in low-income neighborhood credit markets. Consequently, although it promotes lending, it does so at a higher-than-optimal aggregate cost.

Second, the CRA impedes individual banks from economizing on information costs because it deters specialization. A bank might find it efficient to concentrate its lending efforts in a particular

<sup>33</sup> See, e.g., 12 C.F.R. pt. 228 (1994) (Federal Reserve CRA regulations).

<sup>34</sup> Although the preamble to the recently issued regulations explains that a bank is not expected to lend evenly in every census tract within its assessment area, it also explains that the geographical dispersion of a bank's loans is a major factor in determining its CRA rating. See Final Regulations, *supra* note 1.

<sup>35</sup> See *supra* text accompanying notes 19-21.

neighborhood or community. To do so, its employees would get to know the people, businesses, culture, and economy of the neighborhood. If residents of the neighborhood speak a foreign language, the bank would hire employees that speak that language and provide forms, instructions, and other documentation in that language. If a community has developed credit practices, such as the *keh* in Korean communities,<sup>36</sup> the bank might develop financial products that make use of those practices. A mainstream bank could attempt to specialize in this way, or a bank might emerge from within a community and be owned and managed by community members. Either way, by being immersed in the life of a neighborhood, the bank could make individualized assessments of creditworthiness, rather than generic assessments that result in credit rationing.<sup>37</sup>

By requiring geographically dispersed lending, however, the CRA deters this type of specialization. A bank that concentrates on too few neighborhoods risks receiving a low CRA rating. Banks that have attempted to specialize in serving particular ethnic neighborhoods, for example, have run afoul of the CRA.<sup>38</sup> Moreover, the CRA further deters specialization by reducing the volume of lending a specialist bank can expect to do in a given neighborhood. A bank that specializes would have to compete with banks driven into its market by the CRA. Even if those banks are less efficient than the specialist, they will take some of the specialist's business in order to satisfy their CRA examiners.<sup>39</sup> Because the specialization entails

<sup>36</sup> See, e.g., Elyssa Getreu, *Taking a Lesson from Korea for Lending in the Inner City*, AM. BANKER, June 29, 1992, at 7 (describing *kehs*, a type of lending club in which members make monthly contributions to a pool that will eventually be awarded as a loan to the member possessing the best idea for a new business venture).

<sup>37</sup> Successful community-based lenders (which commonly are not banks and therefore not subject to the CRA or which, if they are banks, conduct operations highly focused on low-income neighborhoods) have taken this approach. See, e.g., PARZEN & KIESCHNICK, *supra* note 20, at 51 (stating that successful community lenders specialize); James B. Arndorfer, *'Hip-Hop Credit Union' Has High Hopes*, AM. BANKER, Feb. 6, 1995, at 10 (describing how Central Brooklyn Federal Credit Union developed expertise in Bedford-Stuyvesant); Ronald Grzywinski, *The New Old-Fashioned Banking*, HARV. BUS. REV., May-June 1991, at 87, 89-97 (describing ways in which South Shore Bank developed specialized knowledge of South Shore); Penny Lunt, *How Seven Banks Serve Low-Income Markets*, ABA BANKING J., Sept. 1992, at 57, 57-66 (describing ways in which several banks have developed neighborhood-specific expertise).

<sup>38</sup> See, e.g., KENNETH H. THOMAS, COMMUNITY REINVESTMENT PERFORMANCE 174-75, 203 (1993) (noting that targeting ethnic groups yields low CRA ratings); Terrence O'Hara, *Calif.'s Asian Banks Feel the Sting of CRA*, AM. BANKER, Dec. 21, 1993, at 6 (same).

<sup>39</sup> This effect of the CRA is reflected in the stories of some minority banks. See,

substantial fixed costs, this loss of potential volume reduces the returns to specialization.<sup>40</sup>

### B. *The CRA and the Internalization of Externalities*

The CRA also fails to promote the internalization of information and neighborhood externalities. In part, this failure is due to the impediments to specialization described above. If banks were allowed to specialize in lending to particular neighborhoods, a relatively small number of banks would serve each low-income neighborhood. This concentration would promote the internalization of these externalities. As an illustration, assume that only one bank served a given neighborhood and that it reaped benefits from the positive information and neighborhood externalities created by its own lending. Under these circumstances, the prospect of gaining these valuable externalities would serve as an inducement to lend. Even if the direct return that the bank expected from a loan would not justify making it, the value of these externalities would tip the balance at the margin in favor of making the loan. As a result, more loans would be made, and both the bank and the borrowers would be better off. Moreover, the neighborhood would be less vulnerable to spirals of illiquidity and deterioration.

The fewer the banks serving a neighborhood, the more each bank can expect to internalize information and neighborhood externalities and the less vulnerable the neighborhood will be.<sup>41</sup> By forcing many banks into each low-income neighborhood, the CRA fails to allow any single bank to expect to internalize these externalities.

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*e.g.*, Nanine Alexander, *Tough CRA Rules Hurting Minority Banks*, U.S. BANKER, Sept. 1991, at 70, 70 (describing the concern of many specialized lending institutions that they will lose customers to mainstream lending institutions entering their markets in response to a strengthened CRA). With high fixed cost, the profitability of a business depends heavily on its volume.

<sup>40</sup> Critics of this proposal may question my claim that the CRA drives banks into too many low-income neighborhoods. They would point out that the volume of lending in low-income neighborhoods is not very high. My point, however, is that if banks could specialize, they would lend more in these neighborhoods; but they cannot specialize, and that leads them to be more resistant to the CRA.

<sup>41</sup> Lang and Nakamura show that, under these circumstances, lending by a monopolist might be more efficient from a societal point of view than lending in a more competitive market. See Lang & Nakamura, *supra* note 26, at 739-40.



In addition to concentration, coordination among banks offers a means of internalizing externalities.<sup>42</sup> By coordinating their lending, a group of banks can internalize positive neighborhood externalities. As long as the group can distribute these benefits among members so that each is better off, there will be incentives to coordinate. Coordination, however, entails costs. There are costs in communicating and achieving consensus, and there is uncertainty regarding the commitment and reliability of other banks. Furthermore, in order to internalize neighborhood externalities within a group of banks, the group's share of loans made in a neighborhood must be large.

The CRA does little to promote coordination. Banks are given only limited credit for lending through consortia, a primary mechanism of coordination.<sup>43</sup> In addition, by requiring all banks to serve low-income neighborhoods, the CRA makes coordination difficult. In order to capture a large portion of neighborhood externalities, a coordinating group would have to be large. Large groups, however, have difficulty coordinating. Shirking is more difficult to detect, and the gains from coordination are more difficult to divide.<sup>44</sup>

<sup>42</sup> Concentration and coordination of course raise antitrust concerns as well. These concerns would be limited by the potential entry of lenders not currently in a neighborhood. Further analysis of this concern, however, lies beyond the scope of this discussion.

<sup>43</sup> In a typical consortium, banks contribute funds from which loans are made, and each bank holds a pro rata share of the pool of loans made. Participation in a consortium, however, offers only partial credit under the lending test. See Final Regulations, *supra* note 1 (to be codified at 12 C.F.R. § 228.22(a), (d)). The preamble states that direct lending is an "essential element" of the test. See *id.* For a description of consortia, see COMMUNITY AND CONSUMER AFFAIRS DEP'T, FEDERAL RESERVE BANK OF PHILA., COMMUNITY REINVESTMENT ADVOCATES 43-56 (Keith Rolland ed., 1993) [hereinafter COMMUNITY REINVESTMENT ADVOCATES].

<sup>44</sup> One unique example of coordination is telling, both because it illustrates the value of coordination and because it has not been replicated. The example is the Delaware Valley Mortgage Plan (DVMP). Under the DVMP, eight member banks make home loans directly to residents of low-income neighborhoods, but they cooperate by agreeing to apply flexible underwriting standards, by sharing information, and by sharing the cost of community outreach and education programs. To enforce their agreement and to enhance the likelihood that loans to creditworthy borrowers will be granted, a committee of representatives from member banks reviews rejected loan applications and can recommend that a bank reconsider a rejected application or that another member consider it. See Paul S. Calem, *The Delaware Valley Mortgage Plan: Extending the Reach of Mortgage Lenders*, 4 J. HOUSING RES. 337, 337-42 (1993) (describing the formation, goals, and operating procedures of the DVMP).

### C. *South Shore Bank: An Illustration*

The experience of South Shore Bank in Chicago illustrates how a bank that specializes in low-income neighborhood lending can successfully economize on information costs and internalize externalities. Since 1973, South Shore Bank has specialized in serving the low-income neighborhood of South Shore. In the words of Ronald Grzywinski, Chairman of Shorebank Corporation, the bank's holding company, South Shore had suffered a "spiral of decline" before the bank's current management took over: "The flow of capital [had] reversed direction; people stopped upgrading their homes; landlords stopped maintaining their apartment buildings; [and] store owners stopped improving their businesses . . ." <sup>45</sup> Essentially no bank would make loans in South Shore.<sup>46</sup> In the year before the current management took over, the bank had made only two home loans in South Shore, and other banks had redlined the area.

South Shore Bank's management began its redevelopment effort by getting to know the South Shore neighborhood. They went to neighborhood meetings, PTA meetings, block clubs, and churches, and they made loans that other banks would have denied. This investment in information paid off. The bank has had delinquency rates below the national average and a return on assets above the national average.<sup>47</sup>

Recognizing that negative neighborhood externalities had propelled South Shore's decline, the bank exploited the positive neighborhood externalities created by its lending to get the most value out of its loans. One of its primary lending strategies was to make development loans for projects that enhanced one another. As Mr. Grzywinski explains, "[t]here is synergy in neighborhoods. Each building that gets improved improves the general economic

It is unclear how much credit the CRA deserves for the DVMP. The DVMP was organized in 1977, before the CRA was enacted. The CRA has presumably heightened members' interest in the DVMP, and to that extent the Act may be given credit. For all of its virtues, however, the DVMP is expensive, which presumably explains why it has not been replicated elsewhere. The question raised is whether some other form of government intervention can promote more DVMPs or other arrangements that enhance the efficiency of low-income neighborhood lending. The fact that there is not a DVMP in every metropolitan area, however, suggests that the CRA might be improved upon.

<sup>45</sup> Grzywinski, *supra* note 37, at 89.

<sup>46</sup> *See id.*

<sup>47</sup> *See id.* at 96.

environment and the quality of all the loans in the area.”<sup>48</sup> In one project, South Shore coordinated financing for the renovation of eleven apartment buildings in a four-block area. The bank’s goal was “to lift the standards, appearance, and self-confidence of an entire disinvested neighborhood,” in contrast to the “scattergun approach” of lenders elsewhere.<sup>49</sup> Another South Shore practice was to condition loans to apartment building owners on a borrower’s commitment to renovate. The community as a whole and South Shore Bank in particular benefited from this practice. As Grzywinski points out, the bank’s position as essentially the sole lender in the neighborhood allowed it both to impose these conditions on borrowers and to reap the benefits of the conditions through the enhanced performance of its other loans.<sup>50</sup>

The bank also reaped continuing informational benefits from its relationships with borrowers. This information, consistent with theory, fueled later successful lending. Grzywinski tells of “housing entrepreneurs” whom the bank discovered by making certain individuals their first loans to rehabilitate small housing units. These initial loans allowed these individuals—and the bank—to discover their talents. Once discovered, the bank continued to finance their later renovation ventures. As Grzywinski states: “They make up a body of small-business people that no market survey could possibly have identified. They were invisible, and now they are an industry—the core of South Shore.”<sup>51</sup>

The success of South Shore Bank is obviously a longer story, but key ingredients included the management’s intimate knowledge of the neighborhood and its ability to capture positive neighborhood and information externalities created by its lending.<sup>52</sup>

<sup>48</sup> *Id.* at 94.

<sup>49</sup> *Id.* at 95.

<sup>50</sup> *See id.* at 94.

<sup>51</sup> *Id.* at 96.

<sup>52</sup> South Shore Bank’s entire business is presumably so concentrated in contiguous low-income neighborhoods that it need not worry about the CRA’s mandate of widely dispersed lending throughout its service area. A mainstream bank operating more broadly in Chicago would not be able to specialize in this way. For an in-depth description of South Shore Bank, see RICHARD P. TAUB, *COMMUNITY CAPITALISM* (1994).

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In sum, the CRA does not reduce the information cost of lending in low-income neighborhoods, nor does it internalize the positive externalities created by such lending. Instead, the CRA relies on command-and-control regulation to try to pry loans out of reluctant banks and into low-income communities. This may be unfortunate for both banks and residents of low-income communities. Whether it is or not depends on whether there is an alternative to the CRA that can achieve the same goals at a lower cost. That possibility is addressed in Part III.

### III. A MARKET-ORIENTED COMMUNITY INVESTMENT PROPOSAL: TRADABLE OBLIGATIONS

As an alternative to the CRA, I propose a system of "tradable CRA obligations"<sup>53</sup> analogous to the emissions trading programs currently being implemented in the area of environmental regulation. This Part sets out the basic outlines of such an approach and discusses its potential advantages over the current CRA regime.<sup>54</sup>

#### A. *The Proposal*

The proposal has two basic elements. First, all banks would be assigned an annual quota<sup>55</sup> of CRA-qualified loans. Second, banks would be given several options regarding how to meet this quota, including the option of transferring it, or a portion of it, to another lender.

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<sup>53</sup> I use the acronym "CRA" because of its familiarity. This proposal would probably not be authorized by the CRA; it would require new legislation.

<sup>54</sup> I originally proposed this system in a brief comment in the *American Banker*. See Michael Klausner, *Letting Banks Trade CRA Obligations Would Offer Market-Based Efficiencies*, AM. BANKER, Jan. 21, 1994, at 26. Following publication of that comment, the proposal was endorsed by two economists at the Federal Reserve Bank of San Francisco. See Neuberger & Schmidt, *supra* note 2, at 2-3.

<sup>55</sup> I recognize that, if I were trying to sell this idea in the political marketplace, the use of the term "quota" would be unwise. Nonetheless, the term expresses the concept well, and the trading described below would eliminate much of the credit allocation problem that would otherwise be associated with quotas.

## 1. Definition of the CRA Obligation

The CRA quota, or obligation, would be defined objectively and quantitatively. For instance, the annual volume of a bank's obligation could be a specified percentage of its assets or deposits. Qualifying loans would consist of loans to residents, businesses, and projects in low-income neighborhoods. These neighborhoods would be designated according to median incomes as is done under current CRA regulations.<sup>56</sup>

A bank could earn CRA credit by either originating or holding qualified loans. Each activity—originating and holding—would be assigned a weighting. For instance, if a 50% weighting were applied to originating a loan, the origination of \$500,000 of qualified loans would earn a bank \$250,000 of credit. Likewise, if a 50% weighting were applied to holding qualified loans, the holder of those loans would earn the same amount of credit.<sup>57</sup> If the originating bank held its loans, that bank would earn the full \$500,000 of credit. In addition, certain types of loans that are especially costly to make—perhaps multifamily housing construction loans and commercial loans, for example—might be given extra weightings in measuring credit toward a bank's CRA obligation.<sup>58</sup> This is a detail,

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<sup>56</sup> See *supra* note 1.

<sup>57</sup> Weightings for originating could differ from weightings for holding. For instance, originating might be given a 60% weighting and holding a 40% weighting. Because the CRA quota would be an annual obligation, credit for holding loans would have to be measured in terms of changes over the prior year. In addition, adjustments would have to be made to reflect loan durations in a bank's portfolio. For example, a bank that has \$1 million worth of one-year loans in its portfolio and that replaces those loans with another \$1 million of one-year loans in the next year should probably be treated no differently from a bank that has \$1 million worth of two-year loans in its portfolio during the same period.

<sup>58</sup> Weightings would be related to the cost of a particular type of lending and any external benefits that may exist. In 1993, the New York Banking Department proposed new regulations that would quantify obligations under New York's Community Reinvestment Act. That proposal included a complex weighting scheme. For example, construction loans for multifamily housing units in low-income census tracts were given a 50% higher weighting than mortgage loans to finance single family home purchases in low-income neighborhoods. (A 3.0 weighting versus a 2.0 weighting.) See DERRICK D. CEPHAS, NEW YORK STATE BANKING DEP'T, CRA PROPOSED REGULATIONS 14 (1993); see also Warren Traiger, *Proposed Changes to New York State CRA Compliance and Enforcement Program*, 61 Banking Rep. (BNA) 651 (Oct. 25, 1993) (summarizing the use of quantitative weightings in the proposed CRA regulations). The New York proposal did not involve any trading. Weightings would certainly be imperfect measures of the cost of lending, but they could be adjusted periodically.

A report by Federal Reserve staff members commented favorably on the New

however, that does not warrant elaboration for present purposes.<sup>59</sup>

## 2. Options for Discharging the CRA Obligation

Under this proposal, a bank would have several options by which it could discharge its CRA obligation. The most straightforward option for a bank would be to originate and hold the requisite volume of loans. A second option would be to transfer the CRA obligation, or a portion of it, to another lender for an agreed-upon price.<sup>60</sup> This is the key element of the proposal.

To illustrate, assume that BankTwo must make \$1,000,000 worth of CRA-qualified loans this year and that the rules of the system award a bank 50% credit for originating and 50% credit for holding a qualified loan. Furthermore, assume that BankTwo has identified \$500,000 worth of qualified lending opportunities and that it both originates those loans and holds them in its portfolio. BankTwo still has \$500,000 worth of CRA obligations to discharge. Countybank and DownShore Bank, two specialists in CRA-lending, each offer to accept BankTwo's remaining \$500,000 worth of CRA obligation. Countybank will take on the obligation in exchange for a payment of \$20,000, and DownShore will assume the obligation for \$16,000. Of the two, the DownShore offer is obviously more attractive. BankTwo would therefore compare the payment of \$16,000 with

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York proposal, but expressed concern that the weighting system would in effect transfer lending decision-making from banks to the government and thereby reduce innovation. See Griffith L. Garwood & Delores S. Smith, *The Community Reinvestment Act: Evolution and Current Issues*, 79 Fed. Res. Bull. 251, 264 (1993). These effects would be mitigated by the trading that I propose. In addition, an advance-ruling process, which I would allow and which the New York proposal allowed, could facilitate innovation. The Federal Reserve report also recognized the benefit of specifying CRA obligations in detail but explained that such specificity would reduce flexibility. See *id.* at 253. Again, the trading regime proposed here would achieve both specificity and flexibility.

<sup>59</sup> An alternative approach to giving credit for both originating and holding a loan would be to give credit only for originating. Under that approach, originators might still attempt to sell their loans, and a market-clearing price would presumably exist. It would be lower than it would be if the CRA credit were given for holding a qualified loan. That lower price would then be reflected in a higher price that originators would demand to take on another bank's CRA obligation. See *infra* part III.A.2.

<sup>60</sup> The transferee could be a bank or another type of lending institution, such as a savings and loan or a credit union. For a description of the many types of community-development lenders, see PARZEN & KIESCHNICK, *supra* note 20, at 101-06.

its expected cost of fulfilling the remaining quota itself. If its expected cost is greater than \$16,000, it will accept DownShore's offer and transfer its remaining obligation of \$500,000 worth of CRA-qualified lending to DownShore. DownShore will then have to meet its own CRA obligation plus \$500,000 worth of BankTwo's obligation.<sup>61</sup> Once DownShore has accepted BankTwo's obligation, BankTwo will have discharged its CRA obligation for the year.<sup>62</sup>

Under this proposal, a bank would have several options short of transferring its obligation. It could originate loans and sell them to third parties; it could originate no loans and instead buy loans from other lenders<sup>63</sup> (in the form of whole loans, participations, or securitized loans); or it could lend through a consortium.<sup>64</sup> The following examples illustrate some of the ways in which a bank could use these alternatives to discharge a \$1,000,000 CRA obligation, again assuming 50% weightings for originating and holding loans. If this system were actually implemented, other structures and vehicles would presumably be developed as well. First, a bank could originate \$2,000,000 worth of home loans in low-income neighborhoods and transfer those loans to a pool (perhaps assembled by another institution) from which securitized pass-through certificates would be sold to third parties. Second, it could buy \$2,000,000 worth of pass-through certificates representing interests in such a pool. Third, it could invest \$2,000,000 in a consortium that lends in low-income neighborhoods. Fourth, it could buy a \$2,000,000 million participation in a large loan originated by another bank for the construction of multifamily low-income housing. In each of these examples, the bank would either originate or hold \$2,000,000 worth of loans and would therefore earn \$1,000,000 worth of CRA credit—50% of the face amount of the loans.

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<sup>61</sup> DownShore has presumably determined that with the \$16,000 payment from BankTwo it can make money lending \$500,000 in CRA-qualified loans.

<sup>62</sup> The details of the trading process would develop over time. Brokers might emerge, auctions might be held, or parties might contact one another directly.

<sup>63</sup> The lender from which a loan is purchased might be a bank or another type of lender.

<sup>64</sup> If a consortium were structured as a jointly held pool, a bank would earn pro rata credit for loans that the consortium originates or holds. The weighting of this pro rata share is a detail that would have to be worked out.

### 3. Geographical Constraints on Originating, Holding, and Trading

Two related issues that would have to be resolved in implementing this proposal are, first, the extent to which a bank's CRA obligation would be tied to its area of operation and, second, how that area would be defined. If a bank's CRA obligation were tied to its service area as it is under current law, and if the obligation were defined as a percentage of the bank's assets, the distribution of loans would mirror the distribution of bank assets across service areas, which would raise certain problems. There may be no relationship between bank assets in an area and creditworthy lending opportunities in that area's low-income neighborhoods. Consequently, low-income neighborhoods with many large banks nearby might receive too much credit, and those with few banks might receive too little. This is a potential problem under the current regime as well. It is mitigated only by the regulators' discretion to take lending opportunities into account when assigning CRA ratings.<sup>65</sup> Additionally, if obligations were tied to a bank's service area, there might be too few lenders with which to trade CRA obligations or to which to sell CRA-qualified loans. As a result, there might be insufficient liquidity in the CRA trading market.

On the other hand, if CRA lending obligations could be freely transferred out of an area, the availability of credit to any particular low-income neighborhood could become volatile, which could mean temporary interruptions in the availability of credit.<sup>66</sup> As discussed above, the absence of positive information and neighborhood externalities could transform such temporary shortages of credit into a spiral of illiquidity and deterioration not warranted by underlying economic forces.<sup>67</sup> Therefore, there may be efficiency reasons to

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<sup>65</sup> See *supra* text accompanying notes 30-32 and accompanying text.

<sup>66</sup> Ordinarily, more trading in a market would be associated with more liquidity. In this case, however, banks would be forced to lend in their own service areas if they could not trade. Thus, if no trading could occur across service areas, each area would receive a volume of loans equal to the sum of its banks' quotas. In contrast, if trading were not constrained to a bank's service area, some areas would get more than that amount, some would get less, and the volume of lending in any given area would fluctuate.

<sup>67</sup> See *supra* part I.A.2. This is analogous to the "hot spot" problem in emissions trading, whereby trading can result in the geographic concentration of pollution. See Bruce A. Ackerman & Richard B. Stewart, *Reforming Environmental Law: The Democratic Case for Market Incentives*, 13 COLUM. J. ENVTL. L. 171, 187-88 (1988);



tie at least a portion of a bank's CRA obligation to a relatively localized geographical area and to allow a bank to satisfy the remainder of its obligation in any low-income neighborhood in the country.<sup>68</sup>

The issue of geographical constraints on trading is closely related to the issue of how to define a bank's service area for purposes of this trading regime. The current system, in which each bank defines its own "assessment areas" subject to review by its regulator,<sup>69</sup> would be unworkable. Every bank would want to maximize the number of its potential trading partners. Consequently, each bank would seek the largest trading area possible. A better approach would be to authorize the regulators to define trading areas. These trading areas could be states, local or regional banking markets, or any other geographical areas, so long as they are well defined and include enough lenders to ensure liquidity in trading CRA obligations and in the buying and selling of CRA-qualified loans. Trading areas might also be drawn to try to allocate low-income areas as evenly as possible.<sup>70</sup> In addition, to mitigate problems in defining borders, banks near borders could be allowed to choose which trading group to join.

### B. *The Economics of Information and Collective Action Under a Tradable Obligation System*

The CRA is essentially a regulatory tax on banks, the proceeds of which are used to subsidize lending in low-income neighborhoods.<sup>71</sup> The tradable obligation system proposed here constitutes

Richard L. Cohen, Note, *Environmental Lessons for the Development of a Market-Based Community Reinvestment Act System*, 4 N.Y.U. ENVTL. L.J. (forthcoming 1995). In this context, "cold spot" might appropriately describe areas that lack credit. The response in the pollution context is to constrain trading to avoid concentration. In the CRA context, tying at least a portion of a bank's CRA obligation to the bank's community might be similarly appropriate.

<sup>68</sup> There would still be a problem for banks with too few low-income neighborhoods in their service area.

<sup>69</sup> See, e.g., Final Regulations, *supra* note 1 (to be codified at 12 C.F.R. § 228.42).

<sup>70</sup> Unevenness could also be remedied by assigning lower quotas to banks in trading areas with fewer low-income neighborhoods. Alternatively, banks in areas with relatively few low-income neighborhoods could be permitted to trade a larger portion of their obligations to banks in other areas.

<sup>71</sup> The tax is not equal to the volume of lending to low-income neighborhoods. Most of those loans are repaid. The tax is the difference between the return on those loans and their cost, including search costs, monitoring costs, other administrative costs, and the cost of defaults.

a similar tax and subsidy. Although there are many details to be worked out and the practicality of the proposal would have to be considered further, this system can potentially produce more benefits for targeted communities per dollar of tax than does the CRA. Its advantages stem largely from the promotion of information efficiencies and the internalization of externalities. Other advantages may be present as well.

### 1. Specialization and Information Costs

In contrast to the current CRA regime, a system of tradable obligations would promote specialization.<sup>72</sup> Banks and other lenders would have incentives to develop expertise in lending in low-income neighborhoods. Those that succeed in developing that expertise could, in effect, sell their services to other banks. Through competition, the most efficient CRA lenders would emerge to serve CRA-targeted neighborhoods. Those lenders, which could range from small community-based lenders to community-oriented units within money center banks, would have incentives to gather information most economically and to use that information to make loans to creditworthy borrowers in low-income neighborhoods. This efficiency would be reflected in lower costs of screening and monitoring borrowers and lower loan losses. Less efficient lenders would pursue other lines of business while either paying a specialist to take over their CRA obligations or buying or participating in loans that specialists originate. As a result, information costs would be minimized.

The parallel to the pollution context is instructive. Under emissions trading systems, polluters are given rights to emit specified quantities of pollution. If a polluter can become sufficiently efficient to emit less than its quota, it can sell its unused rights to another polluter for cash. On the other hand, if a polluter wants to emit more than its quota, it must buy the unused rights of another polluter. Under this system, polluters have incentives to develop technologies and processes that produce high output for each unit of pollution emitted.<sup>73</sup> Under the proposal outlined above, lenders would have similar financial incentives. Some banks

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<sup>72</sup> For a discussion of the benefits of specialization, see *supra* part II.A.

<sup>73</sup> See Ackerman & Stewart, *supra* note 67, at 179; Robert W. Hahn & Gordon L. Hester, *Marketable Permits: Lessons for Theory and Practice*, 16 *ECOLOGY L.Q.* 361 (1989). See generally Bruce A. Ackerman & Richard B. Stewart, *Reforming Environmental Law*, 37 *STAN. L. REV.* 1333 (1985).

would attempt to become efficient lenders in low-income neighborhoods. By doing so, they would be able to take on other banks' CRA obligations at prices that are lower than the cost those banks would incur in making CRA-qualified loans themselves. Other banks—those that choose not to or that are unable to specialize in CRA-qualified lending—would impose a market discipline on these specialists by transferring their obligations to the lowest bidder and by making CRA-qualified loans themselves when opportunities arise that are less costly than paying another lender to take on their obligations.<sup>74</sup>

This proposal would also separate the function of originating loans from that of holding loans, further promoting the development of specialized expertise.<sup>75</sup> It is well recognized that originating and holding loans are distinct banking services.<sup>76</sup> Institutions that are successful at originating loans may not be successful at managing loan portfolios. Indeed, the separation of these functions has fueled a massive market in securitized loans.<sup>77</sup> A system of tradable obligations would allow low-income borrowers to reap the benefit of a similar separation. For example, small community-based lenders seem well suited to identify creditworthy borrowers and to monitor and educate those borrowers.<sup>78</sup> These institutions, however, may be poor portfolio managers and might do well to sell off large portions of their loans, just as banks, savings and loans, and mortgage bankers currently do with mainstream home loans, auto loans, and credit card receivables. By selling loans that they originate, low-income neighborhood lending specialists would be

<sup>74</sup> See Cohen, *supra* note 67 (applying experience with emissions trading to this proposals). Although I have described the market system in terms of specialists acquiring other banks' CRA obligations, the ability of specialists to sell loans that they originate—either in securitized form, as whole loans, or as participations—further contributes to the market process. Lenders that make good loans at low cost will make the greatest profit from selling those loans.

<sup>75</sup> The trading of obligations is not needed to obtain this benefit. If the current CRA allowed full credit for holding loans that a bank does not originate, this separation of function could occur.

<sup>76</sup> See, e.g., JAMES A. ROSENTHAL & JUAN M. OCAMPO, *SECURITIZATION OF CREDIT* 13-14 (1988).

<sup>77</sup> See 1 TAMAR FRANKEL, *SECURITIZATION* § 1.3 (1991); Joseph C. Shenker & Anthony Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1372 (1991).

<sup>78</sup> See *supra* notes 37-38 and accompanying text. This is not to say that large institutions will not be efficient CRA lenders as well. Under this system, market forces would sort out the efficient and inefficient lenders to low-income neighborhoods.

able to focus their attention on their strength, which is originating loans. Moreover, they would gain access to funds to support their origination business. Their loan volume would no longer be limited by their deposit base.<sup>79</sup> In addition, by selling loans and investing some of their funds in other financial assets, these specialists could diversify their portfolios, while still concentrating on geographically undiversified origination of loans. In short, this proposal would not only allow banks to specialize in originating loans in low-income neighborhoods, it would also provide those banks with a ready source of new funding.<sup>80</sup>

In sum, under a tradable obligation regime, competition would promote information efficiencies that are lacking under the current CRA regime. Consequently, more lending would occur in low-income neighborhoods for each dollar of regulatory tax imposed on banks.

## 2. Internalization of Externalities

This system of tradable obligations would also promote the internalization of positive information and neighborhood externalities. It would do so by promoting the formation of a relatively small number of lenders with a continuing interest in particular low-income neighborhoods and by channeling large volumes of loans through those lenders. This too would result in more lending per dollar of regulatory tax.

By accepting other banks' obligations and by originating loans that other banks will ultimately hold, a single bank operating under this system could originate a high volume of loans throughout a low-income neighborhood. Because of its large market share in a neighborhood, such a bank could expect to reap significant portions of the positive information and neighborhood externalities that its lending produces. The ability to reap information externalities would directly reduce its cost of lending. The ability to reap neighborhood externalities would lead a bank to target loans, as

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<sup>79</sup> See ROSENTHAL & OCAMPO, *supra* note 76, at 228 (stating that community banks are good originators and would benefit by being able to securitize the loans they originate). Banks would develop securitization structures that give loan originators incentives to lend to creditworthy borrowers and to price loans correctly. In addition, reputational interests would promote such lending practices.

<sup>80</sup> As discussed in note 59, it may not be necessary to provide credit for holding CRA-qualified loans. This separation of function might occur naturally by giving credit for origination alone. Originators would still have incentives to find markets for their loans.

South Shore Bank did,<sup>81</sup> in a manner that limits the impact of negative neighborhood externalities and that enhances synergies in positive neighborhood externalities. This would enhance the value of lending opportunities.

In addition, with a smaller number of banks involved in a neighborhood, banks could coordinate with one another to accomplish these results. By internalizing neighborhood externalities banks would produce more value per dollar lent than if they engaged in untargeted and uncoordinated lending. As a result, they would be able to make more loans per dollar of regulatory tax than they can under the CRA.

### 3. Allocation of Loans

Under the CRA, the allocation of lending in low-income neighborhoods is heavily influenced by the decisions of regulators. The judgment of bank examiners, and bankers' anticipation of those judgments, are primary mechanisms that link the quantity and location of a bank's lending to the availability of lending opportunities in low-income neighborhoods. Regulators' judgments, however, are unlikely to produce an efficient allocation of the CRA's benefits. Lending decisions entail too much detailed information regarding too many borrowers and potential borrowers for a bank examiner to assimilate. Indeed, dissatisfaction with reliance on regulatory discretion lies at the heart of today's widespread dissatisfaction with the CRA. Banks have incurred high costs in attempting to inform and influence regulators, and residents of low-income neighborhoods have reported that creditworthy borrowers remain unserved.<sup>82</sup> This dissatisfaction led to the recent promulgation of the new, more results-oriented CRA regulations.<sup>83</sup> But to the extent that these regulations increase pressure on banks to make loans, there is a danger that banks will be induced to make bad loans.<sup>84</sup> The only protection against this risk is the regulations' continued reliance on regulatory discretion to take into account the profitable

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<sup>81</sup> See *supra* text accompanying notes 45-52.

<sup>82</sup> See Macey & Miller, *supra* note 4, at 326-30. For another proposal that reduces discretion, see Swire, *supra* note 5, at 351-53 (proposing an administrative safe harbor provision that banks could qualify for by making appropriate investments in CRA activities).

<sup>83</sup> See *supra* text accompanying note 10.

<sup>84</sup> Quantified (untradable) obligations would create the same problem on an even greater scale.

lending opportunities available to a bank in assigning it a CRA rating.<sup>85</sup>

Rather than regulatory discretion, a tradable obligation system would rely on market forces to allocate loans in low-income neighborhoods. As in other markets, creditworthy borrowers and profit-seeking lenders would have incentives to find one another. The pursuit of profits would lead a community-based lender in a particular neighborhood to seek out the most creditworthy borrowers in its neighborhood and to help people and businesses become more creditworthy borrowers. Moreover, the pursuit of profits would lead community entrepreneurs to establish banks in neighborhoods that offer unmet lending opportunities.

A further problem with allocating loans under the current CRA is that banks can limit their obligations by selecting locations that have few low-income neighborhoods nearby. At the margin, the CRA drives banks away from low-income neighborhoods.<sup>86</sup> In contrast, the system proposed here would drive banks *into* those neighborhoods. The size of a bank's obligation would not be affected by its location. Moreover, banks with the appropriate expertise would enter low-income neighborhoods because they could make profits by doing so, and the absence of lenders serving a neighborhood would constitute a business opportunity.

#### 4. Enforcement and Compliance Costs

Enforcement and compliance costs would also be lower under this system than under the current system. There would be no uncertainty in the definition of CRA obligations. Consequently, there would be no need for the onerous paperwork associated with the CRA.<sup>87</sup> Nor would banks have to make loans in anticipation of an examiner's subjective review. Indeed, the CRA examination process could be bypassed. Bank examiners would not have to pore over bank records attempting to determine whether a bank has met the "credit needs" of its community. Once the quotas are defined, the primary role of the regulator would be to ensure that they are fulfilled and to enforce contracts to transfer those obligations.<sup>88</sup>

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<sup>85</sup> See *supra* note 32.

<sup>86</sup> See Macey & Miller, *supra* note 4, at 340-41.

<sup>87</sup> See *id.* at 324-33.

<sup>88</sup> A difficult enforcement problem would be the situation in which a bank takes on the obligation of another bank and then fails to fulfill the obligation. One answer is to impose a penalty on the transferee to deter such an abuse. To the extent that

Banks could simply file reports stating how they discharged their own CRA obligations and those that they accepted from other banks. Spot-checks, combined with penalties for misreporting, could be used to promote compliance.<sup>89</sup>

### 5. Measure of Social Cost

Finally, the system proposed here would provide valuable information regarding the social cost of forcing banks to lend in low-income neighborhoods. The prices at which CRA obligations trade would be a measure of that cost. Those prices could inform adjustments in the size of CRA quotas or the delineation of trading areas. If prices are deemed to be too high in a trading area, reflecting either a shortage of creditworthy borrowers or the high costs of finding them, quotas might be reduced, the trading area might be redefined, or other forms of intervention might be considered. Under the current regime, we have no measure of the extent to which profitable lending opportunities exist in low-income neighborhoods. The absence of this information inevitably confuses the debate over whether banks provide too little or too much credit in low-income neighborhoods.

### C. *Caveats and Qualifications*

The tradable obligation system proposed here would impose costs on banks, just as the current CRA does. I have argued that this system potentially offers more benefits to targeted beneficiaries per dollar of cost than does the current CRA.<sup>90</sup> This justification, however, would only be available up to a point. Above some level, a quota would not produce efficiency gains. It would merely redistribute wealth to residents of low-income neighborhoods. Moreover, if quotas were too high, inefficiency could result because

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enforcement is imperfect, however, there may also be a need to penalize the transferor in extreme cases—for example, those in which the transferor knows or has reason to know that the transferee is not acting in good faith. In general, however, transferors would need to be given assurance that their transfers are final.

<sup>89</sup> This system thus has the compliance benefits of a system based on objective, qualified obligations without the rigidity that can lead to bad loans.

<sup>90</sup> The tradable obligation system may also increase social wealth in comparison to a regime of nonintervention by imposing costs on banks that are lower than the benefits conferred on the residents of low-income neighborhoods. The net increase in aggregate wealth would be attributable to the reduction in information costs and the internalization of externalities.

banks might not be able to compete with financial institutions not subject to this regulatory tax.

The current CRA raises the possibility of such inefficiency as well. Under that system the regulatory tax is set by the low-visibility, decentralized decisions of presumably apolitical bank examiners. In contrast, under the tradable obligation system proposed here, the size of the quota would be highly visible and subject to political influence. This political problem may well be a fatal flaw of this proposal. It is the counterpart of the regulatory uncertainty and imprecision that make the current CRA problematic. Community advocates and banks specializing in serving low-income neighborhoods would fight for high quotas, mainstream banks would fight for low quotas, and there is no reason to expect the quota to be set just right. Nonetheless, the visibility of the prices at which the CRA obligations would trade under this system might blunt the impact of these political forces. As stated above, these prices reflect the social cost of intervening in these markets. Once revealed, perhaps the cost of intervention would at least inform the politics of intervention.

A second troubling aspect of this proposal is the fact that it, like the current CRA, forces bank shareholders to bear the cost of intervention. As stated at the outset, I have taken this political reality as my starting point, without attempting to justify it. Nonetheless, the imposition of these costs warrants justification. Consideration might be devoted to spreading the costs more widely, perhaps all the way to the taxpayer, by providing banks with compensating tax benefits or other transfers. Consideration might also be given to spreading the cost to banks' competitors, which would reduce the competitive disadvantage that banks currently suffer under the CRA. One incidental benefit of a tradable obligation system is the relative ease with which it could be applied to nonbank financial institutions.

#### CONCLUSION

The information costs and externalities discussed in Part I, may justify government intervention in low-income neighborhood credit markets. Further research is needed before we can accept this conclusion with confidence. The CRA, however, has attracted detractors on all sides, and appears to be poorly suited to responding to these market imperfections. Other alternatives are therefore worth considering. The system of tradable obligations proposed



here is one possibility. In comparison to the CRA, it offers a reasonable response to these market imperfections, and it offers other attractions as well. As emphasized throughout this discussion, however, there are details to be worked out and potential problems to consider further. At this point, my only claim is that in light of the stakes, for both banks and low-income communities, this proposal is worth considering.

