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# FRBSF WEEKLY LETTER

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## A Market-Based Approach to CRA

A recent proposal to change Community Reinvestment Act (CRA) compliance standards suggests that a major shift in emphasis may be underway. CRA was passed in 1977, and it requires regulators to encourage depository institutions (except credit unions) to help meet the credit needs of low and moderate income neighborhoods within their service areas. The 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.

In recent years, this vagueness has created uncertainty about how CRA will be enforced and led to some disputes among banks, regulators, and community groups. At the heart of the controversy is the evaluation of lenders' CRA compliance based on their efforts to make loans. The current approach has been criticized as placing too much emphasis on paper work and promotional efforts and not enough emphasis on actual lending. While bankers (and others) have serious objections to specific parts of the proposal, the general sense is that banks are willing to be judged on results rather than effort. Although such a change might result in some form of credit allocation, the certainty of meeting a measurable standard could be preferable to vague evaluations of effort.

This *Letter* discusses a refinement of a results-based compliance measure, one that seeks to achieve the goal with maximum efficiency: a market-based system in which CRA obligations can be traded among banks. An important precedent for this approach in the area of compliance involves anti-pollution laws. We describe how this market for pollution credits operates, and suggest that the experience in this market may have implications for a market-based approach to CRA compliance.

### Efforts vs. results

Under the regulations promulgated by the banking agencies, CRA evaluations have been tied explicitly to effort. The presumption underlying the Act was that banks needed to make a good

faith effort to serve the credit needs of all communities within their service areas. CRA ratings focused primarily on banks' procedures for advertising and soliciting mortgage applications from low-income and minority neighborhoods, not on the number of loan applications received or granted.

Increasingly, the principal parties involved in CRA have sought to move to more quantitative standards, although for different reasons. Community groups have been dissatisfied with the level of lending by banks to the target groups and seek standards that would result in a higher level of lending. Banks, on the other hand, have found the reporting requirements to document effort on CRA onerous and fraught with uncertainty and are interested in a system with more clearly delineated and measurable goals.

This distinction between evaluating compliance based on effort compared to actual lending is critical. An emphasis on effort assumes that CRA's goal is to make sure that banks investigate all lending opportunities in low-income neighborhoods. Having done their homework, the efforts orientation assumes that banks will employ sound business decisions to pursue profitable loans in those areas just as they would in any other area.

An emphasis on results, on the other hand, is essentially credit allocation (although it may not be binding). That emphasis presumes that banks have a responsibility to target some level of lending in low-income neighborhoods, regardless of the quality of available loans. If, as some CRA advocates suggest, there are many unexploited good loans to be made in the area, banks actually may exceed target loan levels. But if not enough "good" loans are found, a results orientation could lead to making loans that are less creditworthy.

A performance standard also runs the risk of becoming a "cookie-cutter" approach. Faced with a given standard, all CRA lenders could be forced to allocate similar proportions of funding

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to CRA lending regardless of individual banks' comparative advantages or the credit needs of their communities.

## A market approach

It is possible to achieve results-oriented compliance more efficiently by permitting market forces to operate. After determining a quantitative standard for loans to a target group and apportioning initial obligations among banks to meet those standards, market forces would permit banks to make decisions about strategic investments to achieve those targets that fit their particular comparative advantage.

In the January 21 issue of the *American Banker*, Professor Michael Klausner of New York University Law School proposed a specific market-based approach to CRA. In this proposal, all banks would receive an obligation to lend to borrowers from low- and moderate-income neighborhoods. The size of the obligation would be determined by some regulatory (or perhaps political) guidelines and would be intended to achieve the socially desirable level of low-income lending throughout the banking system. Banks could satisfy this lending obligation in one of several ways. They could make CRA loans directly, either on their own or through lending consortia and other intermediaries that have been formed around the country. Alternatively, banks could purchase CRA loans originated by other financial intermediaries.

The novelty of the proposal is that banks also could pay other banks to make CRA loans for them. For example, Bank A could pay Bank B to take on its CRA obligation. This transfer would not eliminate Bank B's obligation to make its own CRA loans. Instead, loans made on behalf of another institution are merely added to a bank's portfolio of CRA-qualifying loans. The terms of the deal are left to negotiation between the two banks.

The primary advantage of this system is that it would allow greater variation in business practices among banks while still achieving the overall objective. Certain banking institutions could focus their attention on particular areas of the banking business, such as commercial lending or retail banking, while others could choose to specialize more in making CRA-qualifying loans.

The advantage of specialization is consistent with recent research on differential lending patterns between neighborhoods (Gruben, Neuberger,

and Schmidt 1990; Board of Governors 1993). One possible reason for these patterns relates to bankers' access to information about the market value of properties and the creditworthiness of borrowers. If banks have been less active lenders in low- and moderate-income neighborhoods, they may have less information about these important variables. In addition, it may be costly for them to obtain this information, thus making them reluctant to lend in those areas. By encouraging investment in information by some lenders, the proposal could lead these banks to develop extensive databases of information about low-income neighborhoods and borrowers. In so doing, the problems associated with costly information could be attenuated or even eliminated.

A market for CRA obligations gives certain banks incentives to invest in the expertise needed to make CRA loans. These banks could develop a staff of lending officers who are familiar with the credit needs of specific targeted neighborhoods, who have extensive contacts with community activists and neighborhood associations, and who understand how to counsel low- and moderate-income borrowers in the ways of the banking system. Other banks, which might find such investments in their own staff prohibitively expensive, could choose to support efforts by other banks by purchasing credits from those banks.

Some may argue that this system would enable banks to get out of their obligation to meet the credit needs of the low- and moderate-income areas of the communities in which they operate. This need not occur, however, since all banks still would have a CRA obligation to satisfy. This proposal just provides an additional, market-based method to satisfy the obligation for the whole market, while allowing variation among institutions.

Another concern is that, since an individual bank could sell its CRA obligation to another institution, low- and moderate-income neighborhoods in the original bank's service area would be underserved. This concern could be met, however, by limiting the geographic scope of a traded CRA obligation. For example, if Bank A pays Bank B to meet its obligation, then Bank B must make the appropriate amount of CRA-qualifying loans in Bank A's service area. If there are no low- or moderate-income neighborhoods in Bank A's service area, then this limitation could be lifted, and Bank B could satisfy the transferred CRA obligation anywhere.

## Setting results-oriented standards

One of the key issues in a results-based orientation is determining the standard against which to measure results. A results orientation would require agreement on the appropriate level of CRA

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lending in a given community even in a market-based system. The required level of CRA lending could be set in the aggregate as well as for local markets, and could be determined in consultation with community groups, politicians, regulators, and bankers. All participants thus would know the basic parameters of the market.

In any results-oriented approach, setting the appropriate target level is problematic. However, while markets do not provide sufficient a priori information to determine the "correct" level, they do provide automatic feedback information to help adjust targets to systematically approach that desired level.

The way markets accomplish this feat is by revealing the "cost" of a given standard. For example, with very low standards, most banks will be able to find sufficient CRA loans on their own. As standards rise, it becomes harder for some banks to find qualified borrowers, so they would turn to banks better positioned to find additional borrowers. At some level, it may be necessary for even the more specialized banks to turn to less qualified borrowers, raising the risk to those banks for holding the loan.

Thus, activity and pricing in a market provides feedback as to the "cost" of any given standard. If the volume of trades is low and the premium paid by a bank acquiring a CRA credit is low, the standard is not imposing onerous costs. As the standard rises, trading would rise and the premium also would rise. If the premia observed are very high, the standard may be too high, and that would be a clear indicator that profitable lending opportunities are scarce. Conversely, if CRA advocates are right and sufficient quality lending opportunities exist at the established standard, then the premium would be small or nonexistent and the quantity of CRA loans traded would be minimal.

### **The market for pollution credits**

Developing a market for CRA obligations would not be without precedent. While details differ, similar institutions have been established to address other social goals more efficiently. For example, in the case of air pollution, regulators have increasingly abandoned costly plant-by-plant compliance standards in favor of area-wide compliance. Markets that allow trading of pollution credits have made it possible to achieve the desired results at lower cost.

The advantage of a market in meeting such goals can best be illustrated with a hypothetical example. Consider two plants producing different types of goods that both emit air pollution. Regulations require that emissions be reduced by a specified amount. One plant can install a simple pollution-control device or change its production process at low cost to eliminate all of its pollution, but the other factory can reduce pollution only by drastically changing its production facility at high cost. Under plant-by-plant compliance, both factories would be required to meet the same standards, causing the first plant to incur very low costs and the second plant to incur very high costs. Under a pollution credits market system, the second plant pays the first plant to make the relatively low-cost investment in pollution abatement to cover all of the mandated pollution reduction. The net effect on pollution is the same, but the cost is considerably lower.

Another major advantage of a market is that it facilitates changing the desired outcome over time. For example, Los Angeles is gradually reducing the stock of pollution credits, resulting in improved air quality. The market structure aids in rationally achieving this objective by raising the cost of a credit making firms search harder for ways to reduce their emissions. Thus, if the target level does not meet desired standards, the level can be modified over time with minimal cost.

### **Conclusions**

If CRA policy moves from an effort-based standard to a results-based standard, policymakers could take a cue from anti-pollution policy and consider allowing trading of CRA obligations among banks. As the market for pollution credits has demonstrated, trading in an open market allows variation among firms while achieving the desired social result at minimum cost.

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### **References**

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