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*Keith N. Hylton**

I. INTRODUCTION

Why are relatively poor inner cities underserved by financial institutions, and why is it so difficult to find a solution to this problem? Explanations of the lending shortfall problem range between theories based on discrimination to the view that the lending market is working flawlessly.¹ Drawing largely on the economic development literature, I elaborate an alternative explanation here. The asymmetric information theory I offer yields the prediction that urban minority communities will be underserved by financial institutions – indeed that minority loan applicants will often experience discrimination, in the sense that they will be rejected more often and have to meet greater burdens in the creditworthiness assessment process – , even in the absence of discriminatory intent. The market does indeed fail under this explanation, but reluctance to lend and seemingly discriminatory practices are observed largely as a byproduct of

* Professor of Law, Boston University School of Law; J.D. Harvard Law School, Ph.D. (Economics) Massachusetts Institute of Technology. This paper is an outgrowth of comments I made on the Community Reinvestment Act at the Federalist Society's "Banking in the New Millennium" conference, held June 4, 1999 at Washington University School of Law in St. Louis, Missouri. I have benefitted from many remarks by participants in that conference, especially George Kaufman, and Bert Ely.

¹ For a sophisticated treatment of discrimination theory and the lending shortfall problem, see Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 *Tex. L. Rev.* 787 (1995). See also, Anthony D. Taibi, *Banking, Finance and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 *Harv. L. Rev.* 1465, 1474 (1994) (arguing that widespread credit discrimination blocks home ownership and small business creation). For a critique of development lending regulation that takes the view that the market works flawlessly, see Jonathan R Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 *Va. L. Rev.* (1993). For an overview of market failure theories of the lending shortfall problem, see Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 *Geo. L. J.* 237, 253-262 (1996); see also Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 *U. Pa. L. Rev.* 1561, 1565-1572 (1995).

institutional and environmental constraints.² Moreover, the asymmetric information model has an advantage over the discrimination theory in the sense that it is not as vulnerable to the critique that profit-seeking and competition should cure any potential market failure.

I claim that the existing framework of banking regulation is in part responsible for the difficulty of finding a solution to the lending shortfall problem. The institutional and environmental constraints that make lending within relatively poor communities difficult can be surmounted, as demonstrated by alternatives to traditional banking institutions such as the South Shore Bank of Chicago and the Grameen Bank of Bangladesh.³ However, the existing regulatory framework makes it difficult for large scale development-oriented lending institutions to emerge. This is in part a result of the conflict between fair lending and safety regulation. Relatively small development-oriented banks are constrained by their own prudence or by safety regulators to diversify their loan portfolios, limiting the amount of lending geared toward community development. However, fair lending regulators, specifically Community Reinvestment Act examiners, give banks poor evaluations on the basis of a conservative lending policy.⁴ Banks that are forced to choose between satisfying the safety and the fair lending requirements will choose the former, since a failure to satisfy safety demands can lead to harsh disciplinary action by regulators. This tendency toward conservative lending, in turn, will limit their expansion possibilities, since CRA records are taken into account in expansion applications.

An ideal regime would encourage development-oriented banks to expand, and adopt a safety regulation scheme that gives banks greater freedom to lend in poor communities. For example, a private deposit insurance scheme could in theory give banks greater freedom to experiment with lending policies that may violate safety standards imposed by federal regulators.

² I hasten to add that I am merely elaborating a credit-shortage theory that is quite well developed, beginning with Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *Am. Econ. Rev.* 393 (1981). Under the asymmetric information theory, credit rationing occurs because the lender cannot distinguish good and bad credit risks, and therefore charges the same interest rate to both types of debtor while restricting the amount that can be borrowed. For applications in the economic development literature, see *infra* notes 39 - 46. What distinguishes the analysis in this paper from previous efforts to explain the lending problem in inner cities is the level of detail at which I apply the asymmetric information theory. Brief discussions of the credit rationing theory in the context of inner cities can be found in Klausner, *supra* note 1, at 1566-1568, and Hylton & Rougeau, *supra* note 1, at 258-259. I have gone into considerable detail here in applying the theory to inner city lending in order to provide a better understanding of lending market failure, and to understand the ways in which regulation may worsen or improve the market failure problem.

³ On the South Shore Bank and Grameen Bank development lending models, see *infra*, text accompanying notes 72 - 83.

⁴ See, e.g., Macey & Miller, *supra* note 1, at 317-318.

A private insurance scheme would allow banks to break out of a one-size-fits-all safety regulation regime, and encourage insurers to specialize in covering the risks of community development lending. Thus, counter to common intuition, a privatized or at least decentralized safety regime could encourage more development lending, with no reduction in safety. This implies that the CRA should be modified so that it no longer prevents small development-oriented banks that have followed a conservative lending policy from expanding, and at the same time deposit insurance should be privatized.

In spite of the potential benefits from these changes, they are unlikely to be observed in the near future. The current regulatory regime is likely to remain intact for many years to come. The reason for this is that the existing regime represents a political equilibrium supported by dominant interest group coalitions. Lending pressure groups, regulators, virtually all local politicians and some national politicians generally benefit from the existing enforcement regime for the CRA. More surprisingly, large banks enjoy some benefits and probably benefit overall from the existing CRA enforcement regime. The compliance costs are lower for them, for many reasons. In addition to scale economies, the large banks have access to the most creditworthy candidates among those satisfying CRA obligations, leaving the less creditworthy applicants to their smaller competitors. The large banks have an easier time cross-subsidizing unprofitable activities with profits from other lines of business.⁵ Given these advantages, the large banks probably are comfortable with the current regime, because CRA regulation provides them with a competitive advantage relative to their smaller rivals, foreign rivals, and potential rivals such as internet banks.⁶

In other words, the CRA remains durable today because it now operates in a way that fractures opposition among the most concentrated, well-organized interest group: the banks. Moreover, unlike many other regulations in the banking area, the CRA is unlikely to be made obsolete by technological change. My position on the political economy of CRA reform differs from that presented in the only other interest-group theoretic analysis of the CRA, that of Jonathan Macey and Geoffrey Miller. Macey and Miller suggest that banks are uniformly opposed to the CRA but unable to bring about reform because of political impotence.⁷ I think the inability among banks to effect reform has almost nothing to do with political impotence and very much to do with the invisible competition barriers provided by the CRA.

There are general lessons here for the theory of regulatory reform. The first is the

⁵ For the argument that such cross-subsidization is central to the CRA's effects on lending, see Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 *Fordham Urb. L. J.* 281 (1993).

⁶ On the competitive benefits provided to large banks, see *infra* notes 119-129 and accompanying text.

⁷ Macey & Miller, *supra* note 1, at 343-344.

importance of fracturing the dominant regulated interest group in order to keep a regulatory statute on the books. The CRA, as it is currently enforced, accomplishes this task by providing a competitive barrier that benefits large banks. Second, the CRA is a malleable statute that cannot be made obsolete by technological change. While many commentators have complained about the uncertainty of the statute,⁸ uncertainty is a major reason for its continuing vitality. More specific, definite, and clear regulations, such as branching restrictions in the banking area, were rendered obsolete by technological change well before they were repealed.⁹ Third, as a positive prediction, the CRA's malleability suggests that regulators will attempt to interpret the statute in the future in a way that both prevents it from being made obsolete by new technology and continues to fracture opposition among established banks.

II. REGULATORY EFFORTS TO PROMOTE INNER CITY DEVELOPMENT

The existence of an economic development problem in many of the nation's cities was acknowledged by Congress when it passed the Community Reinvestment Act in 1977.¹⁰ The CRA is intended to encourage commercial banks and savings institutions to help meet the credit needs of the communities in which they are chartered.¹¹ Although the statute is often described as a response to redlining,¹² the legislative history suggests that Congress was equally concerned with reversing or at least halting a general pattern of disinvestment from older, inner city

⁸ See, e.g., Macey & Miller, *supra* note 1, at 326 (“CRA ratings are inexact and subjective”); Klausner, *supra* note 1, at 1561 (the CRA is “a model of ambiguity”)

⁹ See *infra* notes 147-151 and accompanying text.

¹⁰ 12 U.S.C. §§ 2901-2907 (1994). For an overview of the CRA, see A. Brooke Overby, Symposium: Shaping American Communities: Segregation, Housing & the Urban Poor: The Community Reinvestment Act Reconsidered, 143 U. Pa. L. Rev. 1431, 1439-1482 (1995); Griffith L. Garwood & Delores S. Smith, The Community Reinvestment Act: Evolution and Current Issues, 79 Fed. Res. Bull. 251 (1993).

¹¹ 12 U.S.C. § 2901 (1994) states that: (a) The Congress finds that – (1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business; (2) the convenience and needs of communities include the need for credit services as well as deposit services; and (3) regulated financial institutions have [a] continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered. (B) It is the purpose of this chapter to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.

¹² See, e.g., Overby, *supra* note 9, at 1446.

communities.¹³

The CRA is directed at four regulatory agencies: the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.¹⁴ The statute provides that regulators should evaluate a financial institution's performance under the statute in the course of regulatory examinations and that regulators may take an institution's CRA performance into account "in an application for a deposit facility."¹⁵ In practice, this means that regulatory agencies take CRA performance into account when a financial institution seeks approval for a charter, a merger, an acquisition, a branch, an office relocation, or deposit insurance.¹⁶ There are four possible ratings given to financial institutions under the CRA: outstanding, satisfactory, needs to improve, and substantial noncompliance.¹⁷

The statute's impact on bank behavior is difficult to assess because it is only within the last nine years that agencies have begun to signal that CRA compliance may be a key issue in the expansion approval process.¹⁸ Moreover, this change of stance has occurred not because the agencies simultaneously decided to take CRA enforcement seriously, but in response to pressure from community organizations.¹⁹ The CRA does not create private rights of action on the part of individuals.²⁰ However, community groups have taken advantage of greater public access to information on the community lending performance of banks to put pressure on banks and regulators in the course of public hearings.²¹ Regulators have apparently felt a need to respond to the community groups by forcing banks to make changes in order to meet the CRA concerns

¹³ Hylton and Rougeau, *supra* note 1, at 241, Garwood and Smith, *supra* note 9, at 251.

¹⁴ See 12 U.S.C. § 2902(1)(A)-(D); Garwood and Smith, *supra* note ___, at 252.

¹⁵ 12 U.S.C. § 2903(a)(2).

¹⁶ Garwood and Smith, *supra* note 9, at 252.

¹⁷ *Id.* at 256.

¹⁸ See, e.g., Hylton & Rougeau, *supra* note 1, at 243-244.

¹⁹ *Id.*

²⁰ See, e.g., Hicks v. Resolution Trust Corporation, 970 F.2d 378, 382 (1992); Lee v. Board of Governors of the Federal Reserve System, 118 F. 3d 905, 910-914 (1997); Lara L. Spencer, Note, Enforcing the Community Reinvestment Act: The Courthouse Doors Are Closed, 2 N.C. Banking Inst. 169 (1998).

²¹ On the involvement of community pressure groups in the regulatory approval process, see, e.g., Macey & Miller, *supra* note 1, at 333-34.

raised by community pressure groups. This in turn, has emboldened the community groups to continue to protest bank expansions, particularly mergers and acquisitions.

An additional factor complicating the assessment of the statute's impact on banks is uncertainty over the compliance standards. Banks have complained over the years of uneven and unpredictable CRA enforcement,²² and compliance standards were recently revised in 1995.²³ In general, there are two models of compliance standards: a "soft" subjective evaluation process that permits a bank to essentially make its own case for a good CRA grade, and a "hard" quantitative process that examines numerical evidence on lending and deposits.²⁴ The soft model has dominated over most of the history of the CRA, but recent revisions have shifted the assessment process toward the hard model.²⁵ It is probably too early to tell whether the recent shift has led to a change in the behavior of banks. In spite of the uncertainty, it is possible to state some general activities that regulators look for in determining compliance. The Mortgage Bankers Association of America suggests the following: (1) staffing and training lender personnel for CRA compliance, (2) identifying and communicating with community input groups, (3) making self-examinations of compliance, (4) marketing progress in investment activity to the surrounding community, and (5) maintaining adequate documentation of community investment efforts.²⁶

The concerns over uncertainty in enforcement would seem unimportant if it could be shown that the CRA has had a substantial positive impact on development in depressed areas. Conflicting evidence has been presented by the statute's critics, proponents, and neutral parties.²⁷

²² Macey & Miller, *supra* note 1, at 328.

²³ For a discussion of the revised enforcement rules, see E. L. Baldinucci, *The Community Reinvestment Act: New Standards Provide New Hope*, 23 *Fordham Urb. L. J.* 831, 846- 856 (1996); Keith N. Hylton & Vincent D. Rougeau, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives*, 18 *Am. Rev. Banking Law* 163, 168 (1999) [hereinafter Hylton & Rougeau, *Perverse Incentives*].

²⁴ See Hylton & Rougeau, *Perverse Incentives*, *supra* note 22, at 167-170 and 186 (discussing general approaches to evaluating CRA compliance, and recent regulatory revisions).

²⁵ *Id.*

²⁶ Paul H. Schieber & Dennis Replansky, *CONSUMER COMPLIANCE AND ANTIDISCRIMINATION LAWS* (1991) (regulatory compliance guide for lenders, published by the Mortgage Bankers Association of America).

²⁷ Several news articles have reported statistics assembled by the National Community Reinvestment Coalition showing that the CRA has led to more than \$1 trillion in loans in underserved areas, see, e.g., Jacob M. Schlesinger and Michael Schroeder, *Law Requiring Banks to Aid Poor Communities Faces Uncertain Future as Gramm Mounts Attack*, *The Wall Street*

However, overall the empirical evidence is quite scant; there have been few rigorous empirical evaluations of the impact of the CRA.²⁸ Much evidence has been presented that cities are on the rebound,²⁹ and that mortgage and business lending by banks has increased in depressed areas.³⁰ But this evidence is insufficient to prove that the CRA has had a substantial positive impact on economic development in inner cities. There are many other factors that could explain the improving economic statistics in lending markets for the urban poor. Interest rates have declined considerably since 1980, with the prime rate falling from 15 to roughly 8 percent. Unemployment has declined over the same period from 7 to 4.2 percent. Wealthy individuals have shifted money out of bank accounts and into mutual funds, forcing banks to seek deposits from less wealthy customers.³¹ Lower income borrowers have emerged in recent years as the

Journal, Tuesday, July 27, 1999 (chart showing \$1 trillion in loans under the CRA since 1992).

For an article suggesting CRA has had little if any effect on lending, see Jeffery W. Gunther, Kelly Klemme, & Kenneth J. Robinson, Redlining or Red Herring?, Southwest Economy, Federal Reserve Bank of Dallas, Issue 3, May/June 1999 issue (finding that the share of home purchase loans by CRA-covered banks fell in 1996 and 1997, to 11.5 percent, while the share of such loans by non-CRA institutions increased over the same period to 14.3 percent in 1997). On the other hand, another recent study finds “no compelling evidence of lower profitability at commercial banks that specialize in home purchase lending in lower-income neighborhoods or to lower-income borrowers”, which could be interpreted as a demonstration that the CRA does not impose a heavy burden. See Glenn Canner & Wayne Passmore, The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington DC, January 1997, Discussion Paper No. 1997-7.

²⁸ Scott Barancik, Fed Governor: Study CRA to See If it Works,” American Banker, vol 164, No. 106, Friday, June 4, 1999, at 2; “Gramlich Urges More Research on Impact of Community Reinvestment Act, BNA News, Monday, June 7, 1999 (reporting on speech by Federal Reserve Governor Edward Gramlich in which he noted the dearth of empirical research on the effects of the CRA).

²⁹ For a survey of the state of American cities noting recent signs of improvement, see America’s Cities: They Can Yet be Resurrected, THE ECONOMIST, Jan. 10, 1998, at 17.

³⁰ See, e.g., Jacob Schlesinger & Michael Schroeder, Law Requiring Banks to Aid Poor Communities Faces Uncertain Future as Gramm Mounts Attack, The Wall Street Journal, Tuesday, July 27, 1999, at A24 (“During [President Clinton’s] first six years in office, about \$1 trillion in private loan and investment commitments were made to lower-income homeowners and small businesses under the [CRA]. That ranks CRA as perhaps the country’s biggest urban-development program ever.”)

³¹ On this process, known as “disintermediation”, see James L. Pierce, The Future of Banking 5-9 (1991).

fastest growing segment of the home mortgage market.³² Mortgage companies have competed with banks for the most attractive lending prospects, forcing banks to seek business in markets they had initially ignored. Big city mayors have typically been more interested in management today than in the 1970s and early 80s, and this has encouraged businesses to either stay or relocate in the cities, and this, in turn, improves the prospects for lending in depressed inner cities.³³ I cannot be sure that I have mentioned all of the factors that should be taken into account in any assessment of the CRA. However, any rigorous assessment should control for all of these factors in attempting to measure the impact of the statute on inner city development.

Since the passage of the CRA, Congress has enacted one other statute that can be described as having economic development lending as its major goal. The Community Development Financial Institutions Act of 1994³⁴ created the Community Development Financial Institutions (CDFI) fund, which is housed in the Treasury Department.³⁵ The CDFI fund was initially authorized to spend \$382 million over four years on CDFIs,³⁶ institutions whose goal is to provide credit to poor people who lack access to the services of conventional financial institutions. Most CDFIs concentrate on financing low-income housing, others provide consumer credit and small business loans.³⁷ The CDFI program is quite different from the CRA in the sense that it aims solely to subsidize development lending.³⁸

³² John R. Wilke, Giving Credit: Mortgage Lending to Minorities Shows a Sharp 1994 Increase, *The Wall Street Journal*, Tuesday, February 13, 1996, at A1.

³³ See America's Cities, *THE ECONOMIST*, *supra* note 28, at 19.

³⁴ Enacted at Title I of the Riegle Community Development and Regulatory Improvement Act, 12 U.S.C. §§ 4701 - 4718 (1994). For an overview of the Community Development Financial Institutions Act, see Robert W. Shields, Community Development Financial Institutions and the Community Development Financial Institutions Act of 1994: Good Ideas in Need of Some Attention, 17 *Ann. Rev. Banking L.* 637, 652-661 (1998); Calvin Cunningham, How Banks Can Benefit from Partnership with Community Development Financial Institutions: The Bank Enterprise Awards Program, 2 *N.C. Banking Inst.* 261 (1999).

³⁵ See, e.g., Cunningham, *supra* note 34, at 270.

³⁶ *Id.*, at 269.

³⁷ See "Banking on the Poor," *The Economist*, June 27, 1998, at 28.

³⁸ I have argued elsewhere that subsidization of development lending is desirable and probably the best approach to encouraging such lending, see Hylton & Rougeau, *supra* note 1, at 282-286. A more difficult question is the precise form subsidization should take. For an argument that a direct subsidy to existing banks would have been preferable to the CDFI machinery, see David E. Runck, An Analysis of the Community Development Banking and Financial Institutions Act and the Problem of "Rational Redlining" Facing Low-Income

Whether or not these regulatory efforts have or will improve matters, it remains important to understand the link between lending and economic development in cities. This is important to understand if we are to find a superior alternative to the existing set of development-oriented statutes. Economic conditions can change for the worse, reversing the new positive trends in development. Moreover, pressures for minimum wage legislation and living wage ordinances threaten to restrict access to the job market for many poor urban residents. In view of these risks, it is important to understand the imperfections in the market for development lending, and the ways in which regulatory statutes may worsen these imperfections.

III. THE ECONOMICS OF DEVELOPMENT LENDING IN INNER CITIES

The concepts of discrimination and asymmetric information have provided competing theories to explain inadequacy in development lending. The literature on inner-city development lending, specifically on the Community Reinvestment Act, makes heavy use of theoretical work on the economics of discrimination in order to justify statutes regulating bank lending.³⁹ Development economists, on the other hand, tend to focus on asymmetric information theories in explaining the lack of bank lending to the poor in developing countries.⁴⁰

Discrimination theory attributes low levels of bank lending to a process in which racial information plays an important role. Racial information enters the lending process in two ways: the lender relies on information regarding the loan applicant's race in assessing the creditworthiness of the prospective borrower, or the lender is concerned with the racial environment surrounding the final use of the loan.⁴¹ For example, the latter type of discrimination occurs when the lender is reluctant to lend to an applicant of any race who plans to use the loan to purchase a home or set up a business in a minority neighborhood.

Since the seminal work of Gary Becker,⁴² discrimination theorists have distinguished two types of discrimination. One, "taste-based" (or irrational), assumes that discrimination occurs

Communities, 15 Ann. Rev. Banking L. 517 (1996).

³⁹ Swire, *supra* note 1, 814-829; Hylton & Rougeau, *supra* note 1, 253-262.

⁴⁰ See, e.g., Debraj Ray, *Development Economics* 540 (1998). To be sure, the CRA literature includes some discussions of the asymmetric information theory, see, e.g., Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. Pa. L. Rev. 1561, 1566-1568 (1995); Hylton & Rougeau, *supra* note 1, at 258-259. However, most of these discussions mention the asymmetric information theory as one of several plausible explanations for sub-optimal lending patterns in inner cities.

⁴¹ E.g., Hylton & Rougeau, *supra* note 1, at 253.

⁴² Gary S. Becker, *The Economics of Discrimination* (2d. ed. 1971).

because the discriminating actor experiences some disutility from associating with the group he dislikes.⁴³ The other, statistical (or rational) discrimination, assumes that the actor treats the distinguishing characteristic of the disfavored group (e.g., race, ethnicity, language) as a signal of poor reliability, low ability, or some other unfavorable trait.⁴⁴

Asymmetric information theory focuses on the lender's inability to assess the creditworthiness of a particular applicant, or the riskiness of the applicant's intended use for the loan.⁴⁵ Race may play a role in this inability to assess risk, but it is not a necessary feature of the theory. Lending shortfalls due to asymmetric information may be observed in a market in which all parties are of the same race. The asymmetric information theory posits that the lender, in response to his inability to assess risk, sets a single interest rate that is below the level he would charge to the riskiest borrower in the applicant pool, and rations credit to applicants.⁴⁶ Credit rationing takes the form of a refusal to lend as much as some loan applicants would like or to lend at all to some applicants.

The two theories may both apply in the case where race serves as an important reason that a lender has difficulty assessing the risk associated with a loan. Moreover, the theories also overlap in the case of statistical discrimination. Under the statistical discrimination theory, the lender uses information on race as a proxy for information on risk that would be difficult to gather. Thus, statistical discrimination occurs as a response to informational asymmetry in this version of the discrimination theory. Although it is not difficult to think of scenarios in which discrimination and asymmetric information theories seem to both fit the facts -- indeed, I hope to show that the two theories provide a better account of the lending problems in inner cities when they are combined in a synthesis -- it is important to note that they have different policy implications. Discrimination theories assume that race plays a pivotal role in the lending process, whereas asymmetric information theory makes information itself the key variable of interest. While discrimination theories lead to policies that seek to reduce or eliminate racial information as a factor in the lending process, asymmetric information theory suggests policies that seek primarily to reduce informational disparities in lending.

⁴³ *Id.*, 16-17.

⁴⁴ Edmund S. Phelps, *The Statistical Theory of Racism and Sexism*, 62 *Am. Econ. Rev.* 287 (1973).

⁴⁵ *See, e.g., Ray, supra* note 40, at 532.

⁴⁶ *Id.*, at 553-555 (discussing the Stiglitz and Weiss model of credit rationing); Raj, K.N. "Keynesian Economics and Agrarian Economics," in C. H. H. Rao and P.C. Joshi (eds.), *Reflections on Economic Development and Social Change: Essays in Honour of V.K.R.V. Rao* (Bombay: Allied Publishers, 1979) (earlier discussion of asymmetric information and credit rationing cited in Ray text); Stiglitz & Weiss, *supra* note 2.

I will depart from the general approach of the community reinvestment literature by applying asymmetric information theory to the problems of development lending in cities. Following the development literature, I will use the term “formal sector” to refer to banks, savings institutions, and other traditional financial intermediaries.⁴⁷ I envisage a lending market that consists of formal sector lenders, such as banks, which operate in the clear sight of the authorities, creating records for tax purposes; and “informal sector lenders”, consisting of currency exchange outlets, pawn shops, loan-sharks, friends and relatives. Sup-prime lenders sit in a special place in this description because they serve as bridges between the informal and formal sectors. Sub-prime lenders serve customers who typically can obtain loans only from an informal sector lender,⁴⁸ but they also create credit records in some cases that can be used by the borrower to propel himself into the class of applicants deemed creditworthy by formal sector lenders.

Asymmetric Information, Segregation, and Lending

I will start with the problem of assessing borrower creditworthiness, and then move on to consider small business and residential lending.⁴⁹ I restrict my focus to the problems associated with bank lending for development purposes. Low income people have access to other sources of credit, such as sub-prime lenders and credit cards. However, these sources of credit are available for consumption purposes rather than small-business development.⁵⁰ I have adopted the implicit assumption that community development lending means lending primarily for businesses, and secondarily for homes.

⁴⁷ Ray, *supra* note 40, at 532; Jameel Jaffer, *Microfinance and the Mechanics of Solidarity Lending: Improving Access to Credit Through Innovations in Contract Structure*, Harvard Law and Economics Discussion Paper, 1999, at 6.

⁴⁸ Two of the biggest sub-prime lenders in the U.S. are Green Tree Financial, a Minnesota firm that specializes in mortgages for mobile homes, and The Money Store. Many large banks and insurers have purchased sub-prime lenders and use them to service customers with poor credit histories. Green Tree Financial was recently purchased by Conseco, a large insurer, and The Money Store was recently purchased by First Union, a large bank. See “Sub-prime lenders: Trailer Trashed”, *The Economist*, April 11, 1998, at 56-57.

⁴⁹ I should acknowledge my debt to Jameel Jaffer’s insightful analysis of micro-lending in developing countries, Jaffer, *supra* note 47. My discussions of borrower creditworthiness and business lending below have attempted to extend his analysis to the problem of lending in inner cities.

⁵⁰ This is obviously true in the case of credit cards. Sub-prime lenders, though a source of lending targeted to people with poor credit histories, focus on consumption loans, such as the purchase of a car. Sub-prime lenders typically do not extend loans to finance start-up businesses.

Borrower Creditworthiness and the Transparency Problem

As many have noted, the market for lending has changed from one of relationship-banking to an impersonal one dominated by credit-scoring models.⁵¹ As a result, it has become important for credit applicants to satisfy the demands of the modern mechanized process by being able to adequately answer standard form questions.⁵² Being able to provide verifiable answers to such questions makes a borrower transparent in the eyes of lenders. Transparency, therefore, has become an asset to applicants. Since the cost of processing his application will be low, a transparent applicant will be able to shop among competing lenders to find the best terms. Applicants who can achieve this transparency are better off today than in the days of relationship banking. Non-transparent applicants, however, have been unable to take advantage of the benefits of mechanized lending, and this has special implications for the disadvantaged in cities.⁵³

Low-income residents of inner city communities often cannot meet the transparency demands of the modern lending process, due to poverty and associated ills.⁵⁴ The most important handicap for many of these applicants is the existence of a poor credit history, or the absence of a credit history. For example, only forty five percent of black households maintain checking accounts, compared to eighty percent of white households.⁵⁵ Many of the minority residents in depressed inner-city areas carry out all of their transactions in cash. Rather than dealing with banks, they go to local currency exchange outlets, or sometimes local convenience and liquor

⁵¹ See, e.g., Peter Hurst, *The Guide to Credit Scoring*, Credit Management, Oct. 1998, at 33 (“One of the greatest changes in the consumer credit world in the last 20 years has been the replacement of manual judgmental credit assessment with credit scoring techniques.”) J.P. Morgan, for example, has recently decided to quit the business of relationship-lending to large corporations, see “Bankless banking” *The Economist*, April 11, 1998, at 56.

⁵² See, e.g., Jaffer, *supra* note 47, at 6-7.

⁵³ Several years ago, former Federal Reserve Board Governor Lawrence B. Lindsey called attention to the fact that increased use of credit scoring models had the unintended consequence of making it more difficult for low-income applicants to receive loans, see “Real Progress Without Unintended Consequences”, address by Lawrence B. Lindsey to the Federal Reserve Bank of Cleveland’s Community Reinvestment Forum, Columbus, Ohio, September 25, 1993 (on file with author).

⁵⁴ On poverty in inner cities, see John D. Kasarda, *Inner-City Concentrated Poverty and Neighborhood Distress: 1970 to 1990*, 4 *Housing Policy Debate* 253 (1993) (describing characteristics of distressed neighborhoods within the nation’s 100 largest central cities); Edwin Mills and Lubuele, *Inner Cities*, 35 *J. Econ. Lit.* 727, 748-750 (1997) (comparing income, education and poverty statistics between suburbs and inner cities for whites and blacks).

⁵⁵ Swire, *supra* note 1, at 1558.

stores, to convert checks into cash. In the course of doing so, they typically pay a large share, as much as 15 to 25 percent, to the check casher.⁵⁶ Without a financial record, a bank with no relationship with the loan applicant will find it hard to assess the applicant's history in repaying loans.

Employment instability is another factor explaining the poor credit histories of low income residents in cities. Unemployment rates are higher for minorities, particularly in cities.⁵⁷ Layoffs and job dismissals occur more frequently for these groups,⁵⁸ and this leads to poor credit histories, given the general lack of wealth – in the form of savings, inherited money, or home equity – to fall back on.⁵⁹

There are other problems associated with employment instability and lack of legitimate sector employment. Some loan applicants who cannot demonstrate a sound credit history can at least make up for it by demonstrating a stable employment history. However, for individuals

⁵⁶ “Consumer finance: Pay dirt” *The Economist*, June 5, 1999, at 28.

⁵⁷ See, e.g., John D. Kasarda, *Urban Change and Minority Opportunities*, in *The New Urban Reality* 57-58 (Paul E. Peterson, ed., Washington, DC: Brookings, 1985) (discussing unemployment rates of central-city males between 1969 and 1982, and noting that in 1982 the central-city unemployment rate was 9.5 percent for white males and 23.4 percent for black males); Gerald David Jaynes and Robin M. Williams Jr., *A Common Destiny: Blacks and American Society* 319-323 (Washington DC: National Academy Press, 1989) (discussing access to jobs in high-poverty urban areas). One commonly-offered reason for the higher unemployment rate for minorities in cities is the movement of businesses out of cities. On the “spacial mismatch” between the locations of jobs and city residents, see John Kain, *Housing Segregation, Negro Employment and Metropolitan Decentralization*, 82 *Q.J. Econ.* 175 (1968); Harry J. Holzer, *The Spatial Mismatch Hypothesis: What Has the Evidence Shown*, 28 *Urban Studies* 105 (1991); Steven Raphael, *Inter- and Intra-Ethnic Comparisons of the Central City-Suburban Youth Employment Differential: Evidence from the Oakland Metropolitan Area*, 51 *Indust. and Labor Relations Review* 505 (1998) (comparing downtown to suburban Oakland employment rates). For a survey of the empirical literature on racial differences in employment, see Harry J. Holzer, *Black Employment Problems: New Evidence, Old Questions*, 13 *J. Policy Analysis and Management* 699 (1994).

⁵⁸ For evidence that the unemployment rates of nonwhite males and Hispanics are more sensitive to fluctuations in aggregated demand than are those of white males, see Kim Clark & Lawrence Summers, *Demographic Differences in Cyclical Employment Variation*, 15 *J. Human Resources* 61 (1981).

⁵⁹ See Francine D. Blau & John W. Graham, *Black-White Differences in Wealth and Asset Composition*, 105 *Q. J. Econ.* 321, 327-330 (1990) (blacks have less wealth than whites, and blacks living in cities have less wealth on average)

with unstable employment histories, and for those who rely on a combination of welfare payments and informal sector work, there is little to show in this regard. The lack of legitimate sector employment also reduces the likelihood such an applicant will find a guarantor for a loan needed to set up a business.

These handicaps are all magnified by the problem of racial segregation, or “hypersegregation”, as Massey and Denton describe it.⁶⁰ African-American city residents are segregated to an extent far beyond that observed among other racial and ethnic groups in America,⁶¹ which amplifies differences in the incidence of poverty in white and black urban neighborhoods.⁶² In the Chicago area, for example, four out of five poor whites live in mixed-income areas compared with only one in five poor blacks.⁶³ This has several implications for access to credit.

⁶⁰ Douglas S. Massey and Nancy A. Denton, *American Apartheid* 74 (Harvard Univ. Press, 1993) (defining five types or “dimensions” segregation; and noting that African-Americans are more segregated than other groups on any single dimension of segregation, and also more segregated on all dimensions simultaneously; a pattern they describe as “hypersegregation”). Anticipating the work of Massey and Denton, William Julius Wilson has emphasized the multiplying effect of concentrated poverty among the urban poor, see William J. Wilson, *The Truly Disadvantaged: The Inner City, The Underclass, and Public Policy* 56-58 (1987)(discussing concentration effects that tend to multiply harmful consequences of poverty). For an excellent survey of the state of the cities and low-income urban residents, see Peter Dreier, *America’s Urban Crisis: Symptoms, Causes, Solutions*, 71 N.C. L. Rev. 1351 (1993).

⁶¹ *Id.*, 74-78. On the economic implications of hypersegregation, see David M. Cutler and Edward L. Glaeser, *Are Ghettos Good or Bad?* 112 Q. J. Econ. 827 (1997) (concluding that blacks in more segregated areas have significantly worse outcomes than blacks in less segregated areas).

⁶² Suppose, for example, that in a particular city the poverty rate among whites is 10 percent, and the poverty rate among blacks is 30 percent. If the city were perfectly integrated, with equal numbers of whites and blacks, the poverty rate in every sector would be 20 percent. However, if the city is perfectly segregated, the poverty rate is (obviously) 10 percent in the white area, and 30 percent in the black area. To get a sense of the how this differential in poverty incidences translates into experience, note that this implies that within the black sector, 100 percent of the residents live either next door or two doors down from a poor household, while in the white sector, only 20 percent live within two doors of a poor household. On segregation and concentration of poverty, see Massey and Denton, *supra* note __; at 118 - 125.

⁶³ “Urban Planning: A Windy City for the Next Century,” *The Economist*, April 10, 1999, at 26 (citing “Chicago Metropolis 2020” report issued by the Commercial Club of Chicago).

First, the most important informal sector credit source,⁶⁴ loans from friends and relatives, is effectively unavailable. Friends and family members are unlikely to have money to lend, and the whole notion of an informal network of borrowing would seem foreign in many poor, hypersegregated communities. Informal lending networks require some informational infrastructure.⁶⁵ Potential borrowers need to know whom to approach for a loan, as well as the reputation of the lender for sticking to the terms of his bargain. Informal lenders, on the other hand, need information on the reliability and trustworthiness of borrowers, as well as information on the likelihood that informal sanctions, such as ostracism or refusals of others to lend, will be applied to those who refuse to repay their loans.⁶⁶ However, in a community in which few lending sources are available and few individuals seek loans for business purposes, the flow of lending may be too small to support such an informational infrastructure.⁶⁷

⁶⁴ On the importance of informal financing for small business, see Philip Bond and Robert Townsend, Formal and Informal Financing in a Chicago Ethnic Neighborhood, 20 *Economic Perspectives* 3, 15-17, July/August 1996 (reporting findings that bank financing is seldom used, only a minority businesses in survey used any kind of loan).

⁶⁵ Ray, *supra* note 40, at 556-557 (discussing need for default information to be transmitted among lenders in an informal lending market).

⁶⁶ *Id.* See also, Janet Landa, A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law, 10 *J. Leg. Studies* 439-62 (1981)(in the absence of developed legal enforcement mechanisms, traders deal within ethnically homogeneous circles in order to access information on reliability of potential partners); Avner Greif, Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders, 49 *J. Economic History* 857 (1989); Kandori Michihiro, Social Norms and Community Enforcement, 59 *Review of Economic Studies* 63 (1992); Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 *Journal of Legal Studies*, 115 (1992) (as diamond traders become more ethnically heterogeneous, they rely increasingly on formal sanctions to enforce agreements).

⁶⁷ There is evidence consistent with the hypothesis that more segregated groups have greater difficulty forming informal lending networks. A recent study reports that black business owners start their businesses with significantly less capital than owners from other racial and ethnic groups. See Paul Huck, Sherrie L. W. Rhine, Philip Bond, and Robert Townsend, Small Business Finance in Two Chicago Minority Neighborhoods, 23 *Economic Perspectives* 46, 53 (Second Quarter 1999) (“Thus, a Black owner with baseline characteristics starts a business with an estimated 56 percent lower level of funding than a comparable Hispanic owner. By comparison, a White owner starts with 89 percent more funding than a comparable Hispanic; an Asian owner starts with 118 percent more...”). Although the difference in start up funding are in part attributable to personal wealth, they also result from informal loans. In particular, the gap between black and Hispanic start up funding seems to be largely due to differences in access to informal loans. See *id.*, at 53-54 (“The results show that the difference between personal

Second, because of hypersegregation, black and some Hispanic inner city residents are often denied access to the informal networks that reduce the cost of risk assessment for formal sector lenders. Hypersegregation increases the difficulty on the part of a bank loan officer in assessing risk, for the loan officer is unlikely to be from the same neighborhood as the applicant or to know anyone from the neighborhood.⁶⁸ If the loan officer were from the same neighborhood, or knew a neighborhood resident, he could contact people he trusted for information, but this option is practically unavailable because of hypersegregation. In order to gather personal information on the reliability of a minority applicant, the loan officer may have to find sources of information on the applicant from the applicant's neighborhood, and question them about their creditworthiness. This would be an expensive undertaking, with an uncertain payoff. Since the loan officer is unlikely to know anyone who knows the information sources, he cannot easily verify their reliability; and since the information sources are unlikely to have repeat dealings with the loan officer, they would have weak incentives at best to protect their own reputations for providing reliable information. The rational response of the loan officer is to heavily discount word-of-mouth reports from these information sources. Thus, loan applicants from hypersegregated urban communities will be discriminated against in the creditworthiness assessment process, in the sense that they will be burdened with the greatest informational demands and the highest rejection probabilities.⁶⁹

Small Business Lending, Segregation, and Risk Control

To this point I have considered the difficulty a formal-sector bank faces in assessing borrower creditworthiness when the applicant comes from a hypersegregated urban community.

funding provided by Black and Hispanic owners is small and statistically insignificant both for businesses started from scratch and businesses bought or acquired.”)

An alternative view on the effects of informal financing is suggested by Robert W. Fairlie, *The Absence of the African-American Owned Business: An analysis of the Dynamics of Self-Employment*, 17 *J. Lab. Econ.* 80 (1999). Fairlie finds that racial differences in assets levels and probabilities of having self-employed fathers explain a large part (roughly 30 percent) of the gap between black and white rates of entry into self-employment, though none of the gap in exit rates. See *id.*, at 80, 96 and 97.

⁶⁸ For observations on the importance of local information in the lending process, and the constraint imposed by segregation, see, Taibi, *supra* note 1, at 1482-1483.

⁶⁹ For empirical evidence that black-owned firms have greater difficulty in obtaining loans from commercial banks, see Timothy Bates, *Commercial Bank Financing of White- and Black-Owned Small Business Start-Ups*, 31 *Q. Rev. of Econ. and Business* 64 (1991) (finding that black-owned firms receive smaller loans than white-owned firms possessing identical measured characteristics). See also, Jeffery A. Tannenbaum, *Small Business Lenders Rebuff Blacks*, *The Wall Street Journal*, Wednesday, July 7, 1999, at A2 and A10 (reporting on studies finding discrimination in small business lending).

The difficulties are just as severe when the bank tries to assess the potential profits of a proposed business start-up.

One might think initially that business projects are easier to evaluate for risk assessment purposes than the creditworthiness of a particular borrower. But this is not at all clear. Even when the prospective borrower claims to have no special information about the project's prospects that the lender does not already have, the lender must still worry about the creditworthiness of the borrower. Put another way, even if the project itself is riskless, borrower risk is unavoidable, for the borrower could at any time abscond with the money. Given this, all of the information barriers generated by hypersegregation exist to make small business lending difficult within most poor urban communities.

Setting aside the issue of borrower risk, hypersegregation makes it difficult also to assess the risks associated with a start-up business.⁷⁰ If the business relies, as small businesses typically do, on the local consumption patterns, the labor-market skills of local residents, the reliability of local input providers, and other features of the community in which the borrower lives or intends to run the business, then it would be difficult for a loan officer who has neither information regarding nor informal contacts with residents of the community to independently assess the prospective borrower's claims. These problems suggest that business project risk *adds to* rather than reduces the level of difficulty for a bank assessing the risk of lending in a hypersegregated market.

Stiglitz and Weiss's seminal paper on credit rationing demonstrates that in the presence of informational asymmetry, a lender will ration credit.⁷¹ The lender cannot price-discriminate by charging higher interest rates to riskier applicants, because the borrowers are observationally indistinguishable. Moreover, the lender will not set the rate at the level he would charge the riskiest class of applicants, and let all applicants borrow as much as they want, because this would generate adverse selection, in which the worst risks seek loans. The rate that would have been appropriate *ex ante* for any particular class of loan recipient will turn out to be too low, *ex post*, given the higher selection rate among the riskiest members of that class. The lender's optimal policy in this setting may be one in which he charges a rate that effectively pools low and high risk borrowers, and limits his exposure by limiting the total amount loaned, and the amount each applicant can borrow. This policy creates a shortage in the credit market, since the demand for loans will exceed the supply.

⁷⁰ This is consistent with the evidence that debt capital is harder to obtain when the borrowing business is black-owned *and* located in an urban minority community, *see* Timothy Bates, *The Changing Nature of Minority Business: A Comparative Analysis of Asian, Nonminority, and Black-Owned Businesses*, 18 *Rev. of Black Pol. Econ.* 24, 40 (1989).

⁷¹ Stiglitz & Weiss, *supra* note 2 (adverse selection and bank lending). *See also*, David Jafee & Joseph E. Stiglitz, *Credit Rationing*, in 2 *HANDBOOK OF MONETARY ECONOMICS* 839 (Benjamin M. Friedman & Frank H. Hahn eds., 1990).

There are methods a lender can use to limit risk, and thereby meet the excess demand for loans. The lender can gather additional information on applicants, but I have assumed that this is extremely costly because of segregation. Specifically, I assume that the incremental cost of obtaining additional information on the loan applicant exceeds the incremental benefit to the lender. Another approach the lender can use to limit risk in the presence of asymmetric information is to require collateral.⁷² Collateral sometimes has the effect of controlling or mitigating the adverse selection problem and the further advantage of aligning the incentives of the borrower with those of the lender.

Collateral can limit the adverse selection problem by making the lender's terms less attractive to borrowers with the riskiest business plans.⁷³ Consider the case of a borrower who is not required to provide collateral, who does not intend to repay the loan if his project fails, and is judgment-proof with respect to the amount borrowed. In the absence of collateral, such a borrower with a risky project will compare the project's payoff in the best state to the amount that must be repaid on the loan. If the best-state payoff exceeds the amount due, he will consider the loan worthwhile, even if he would be unable to repay it in the worst state. The borrower is unconcerned with the worst-state scenario, because he intends to walk away from the loan in that event. Such a borrower would be willing to accept a loan with an interest rate so high that it would be unprofitable *ex ante* to a borrower who intended to repay the loan whatever the outcome. A collateral requirement would reduce this borrower's willingness to accept the lender's terms by introducing some downside risk to the borrower in the worst state. The borrower will demand a larger payoff in the best-state to compensate for the downside risk, and to secure this the borrower will demand a lower rate of interest on the loan. Hence, collateral can serve as a screen against borrowers with extremely risky plans.

Incentive alignment mitigates the problem of "moral hazard," the tendency of a borrower to fail to take steps to maximize the likelihood that he will repay the loan. A standard problem in the literature on bankruptcy is the incentive of the debtor-in-possession to adopt risky projects.⁷⁴ The debtor-in-possession has this incentive because he has nothing to lose, and can only gain by winning in a big way with the financial equivalent of the "Hail Mary" pass in football. The same incentive is observed after the borrower has taken the loan money, and faces a choice to take or

⁷² See, e.g., Stiglitz & Weiss, *supra* note 2; at 402-406; Ray, *supra* note 40, at 546; Jaffer, *supra* note 47, at 8.

⁷³ Stiglitz & Weiss, *supra* note 2, at 402; Stefania Cosci, Credit Rationing and Asymmetric Information 29, 39-42 (Dartmouth Publishing Comp., 1993).

⁷⁴ See, e.g., Douglas Baird and Thomas Jackson, *Bankruptcy* 756 (2d ed. 1990) ("The debtor then has an incentive to incur large debts or undertake riskier activities, because of the minimum level of protection the law provides.")

avoid a risky decision that could increase the project's profitability.⁷⁵ If the borrower effectively owes nothing if he fails to make enough from the project to repay the loan, he will have an incentive to take "Hail Mary" decisions after the loan has been extended. Under certain conditions, collateral has the effect of dampening this incentive and encouraging the borrower to take less risky decisions that are actuarially safer in the sense that they increase the likelihood he will repay the loan in full.⁷⁶

More generally, the effect of a collateral requirement on the borrower's incentives depends on the amount of collateral put at risk and the potential gains to the borrower from accepting additional risk.⁷⁷ A collateral requirement may have perverse incentive effects, from the lender's perspective. A collateral requirement may induce borrowers to choose smaller projects, and if smaller projects have higher failure probabilities, increasing the collateral requirement may increase the riskiness of the lender's portfolio.⁷⁸ Alternatively, if the project requires later stages of external finance, and the lender cannot credibly commit to refuse to lend in the future, the collateral requirement may induce the lender to choose a riskier project that requires more lending in the future.⁷⁹ More generally, given the borrower's limited liability, the borrower may contradict the wishes of the lender after meeting the collateral requirement by taking an extremely risky decision if the expected gain from the decision exceeds the expected loss.⁸⁰

Moreover, as a method of screening risky borrowers, the collateral requirement may fail. If wealthy individuals generally are willing to take on riskier projects, a collateral requirement may cause the less-wealthy borrowers to drop out of the market, increasing the risk of the lender's portfolio.⁸¹ Thus, in order to make the collateral requirement an effective method of sorting out risky borrowers and influencing borrower incentives, the lender needs sufficient information to determine whether the requirement will have the desired screening and incentive effects.

⁷⁵ For a neat numerical illustration of the incentive alignment effect, see Jaffer, *supra* note 47, at 8-9. More general discussions, see Stiglitz & Weiss, *supra* note 2, at 405-406; Cosci, *supra* note 69, at 42-44.

⁷⁶ Stiglitz & Weiss, *supra* note 2, at 403.

⁷⁷ See, e.g., Cosci, *supra* note 69, 42-44.

⁷⁸ Stiglitz & Weiss, *supra* note 2, at 402.

⁷⁹ *Id.*, at 405.

⁸⁰ Cosci, *supra* note 69, at 43-44 (citing Hildegard C. Wette, Collateral in Credit Rationing in Markets with Imperfect Information: Note, 73 *Am. Econ. Rev.* 442 (1983)).

⁸¹ Stiglitz & Weiss, *supra* note 2, 403-405.

This suggests one route through which hypersegregation may influence the lender's collateral policy. Given his lack local information, the lender will find it difficult to determine the selection and incentive effects of a collateral requirement. Unable to predict the incentives created by the collateral requirement, the lender presumably would use it as a precautionary measure rather than as a device for eliminating excess demand. Specifically, if the lender treats failure as an exogenous event beyond the influence of his contractual terms, he is likely to use the collateral requirement as a form of insurance, provided he is risk-averse.⁸² Such a lender would seek full insurance against the borrower's failure to repay, reducing the interest rate by an amount reflecting an implicit insurance premium paid to the borrower.⁸³ This suggests that the lender's collateral demands will be considerably steeper if based on the precautionary motive.

Whether used as an incentive device or precautionary measure, a collateral requirement is likely to be an extreme burden and often unaffordable for relatively poor members of minority groups. The problem is particularly severe for African-Americans. Although pay levels have been approaching parity among whites and blacks in the U.S.,⁸⁴ wealth levels remain far apart.⁸⁵ The level of collateral that might be considered reasonable to ask of a white loan applicant could easily be out of reach for a black applicant seeking a loan for the same project and of the same

⁸² A risk averse individual would be unwilling to pay 50 cents to enter a lottery promising \$1 with probability $\frac{1}{2}$ and \$0 with probability $\frac{1}{2}$. He would demand a lower lottery price in order to compensate him for his aversion to risk. For an introductory discussion, *see* Andreau Mass-Colell, Michael D. Whinston, & Jerry R. Green, *Microeconomic Theory* 185 (Oxford Univ. Press, 1995).

⁸³ This assumes that the implicit insurance premium is set at the competitive or actuarially fair price, *see id.* at 187-188 (discussing incentive of risk-averse decision maker to purchase insurance coverage).

⁸⁴ *See, e.g.,* Ronald G. Ehrenberg & Robert S. Smith, *Modern Labor Economics: Theory and Public Policy* 535-536 (Scott, Foresman and Company, 3d ed. 1988).

⁸⁵ *See* Francine D. Blau & John W. Graham, *Black-White Differences in Wealth and Asset Composition*, 105 *Q. J. Econ.* 321 (1990) (finding that on average, young black families hold 18 percent of the wealth of young white families); Paul L. Menchik & Nancy Ammon Jianakoplos, *Black-White Wealth Inequality: Is Inheritance the Reason?*, 35 *Econ. Inquiry* 428, 430 (reporting black-white household wealth ratio of roughly 20 percent). Menchik and Jianakoplos conclude that inheritance explains between 10 and 20 percent of the average difference in black-white household wealth, *id.* at 428. *See also*, Rukmalie Jaykody, *Race Differences in Intergenerational Financial Assistance: The Needs of Children and the Resources of Parents*, 19 *J. Fam. Issues* 508, 529-530 (1998) (reporting that the median net worth of an African-American household is \$3,397, compared to \$39,135 for white households. Among households with equal income levels between \$15,000 to \$22,499 the median wealth for a white household is \$35,739, and only \$11,300 for a black household).

amount. Hypersegregation and associated ills have implications for the value of collateral as well. A piece of machinery, or personal property, will be worth less in terms of expected value if located in an area where theft or injury to property is a relatively frequent occurrence.⁸⁶ If expenditures are required to protect the collateral, and the project goes bad, the lender loses whatever incentive he had initially to safeguard the value of the collateral. Aware of these problems, the rational lender would increase the level of collateral demanded, making it less likely that the applicant will be able to meet the terms of the lender. As a result, those applicants who come from the economically bleakest environments are required to meet the steepest collateral demands.

In sum, the asymmetric information model applied to small business lending implies that a formal sector lender that services a hypersegregated community will: (1) ration credit in order to screen out risky applicants, which should generate relatively high rejection probabilities; and (2) make relatively steep collateral demands. Put another way, loan applicants from hypersegregated communities will be discriminated against in the sense that they will face higher rejection probabilities and steeper collateral demands.

Residential Lending, Social Capital, and Segregation

When we turn to residential lending in poor urban areas, we find informational barriers to lending as steep as in the business context. First, we come up against the problem of assessing borrower creditworthiness again. This is unavoidable, and the aforementioned problems of hypersegregation make this assessment difficult for reasons already given.⁸⁷ Second, as we observed in the case of project lending with collateral, having an asset that can be repossessed does not always simplify the task of risk assessment. Instead, factors associated with poverty and hypersegregation combine to amplify the informational asymmetry and risk barriers in the residential lending process.

A house can be decomposed into two assets, one offering a consumption stream consisting of shelter and privacy, the other a security that can be transferred at market value to the lender at any moment. In this latter sense, a home mortgage gives the borrower a type of

⁸⁶ This is easy to see. Suppose A and B both own cars worth \$5000. The probability of theft in A's neighborhood is 1 percent, and the probability of theft is 15 percent in B's area. For someone who plans to take possession of the car in some future date, the expected value of A's car is $(.99)(\$5000) = \4950 , and the expected value of B's car is $(.85)(\$5000) = \4250 . Thus, being located in a high-theft area wipes off \$750 from the value of B's car.

⁸⁷ In applying the asymmetric information model to residential lending, I do not intend to minimize the historical importance of intentional discrimination in the residential market. For a survey of mortgage lending discrimination that includes a discussion of the historical evidence of intentional discrimination, see Michael LaCour-Little, *Discrimination in Mortgage Lending: A Critical Review of the Literature*, 7 J. Real Estate Lit. 15 (1999).

derivative known as a “put option”: if the value of the security falls below a given price, the owner of the put option can sell it to the other party to the contract at the fixed strike price.⁸⁸ In the home mortgage contract, the outstanding amount of the loan is the relevant strike price to the borrower. The borrower has an incentive to exercise his put option by defaulting on the loan whenever the market price of the house falls below the outstanding amount of the loan.

Viewing the house as a consumption stream, the lender is largely concerned with the creditworthiness of the borrower. However, this assessment is complicated by the effects attributable to the put option portion of the contract. If the borrower decides to default he will no longer have an incentive to take actions that protect the market value of the house. Hence, a borrower who is less than creditworthy may take actions that reduce or fail to protect the value of the house after he has decided to default.

Viewing the house as a security, the lender is concerned that it will be able to repossess an asset with a market value close to that of the outstanding loan should the borrower default. Even if the borrower is creditworthy, the market value of the house may fall, and if it falls sufficiently far, the borrower will have an incentive to exercise his put option by defaulting.

As in the case of business lending discussed earlier, poverty and hypersegregation lead to a result in which the bank rations credit to residential borrowers. Given that the borrower’s liability is limited, high interest rates will attract applicants with riskier income streams and higher propensities to default. If the borrowers are observationally indistinguishable to the lender, a likely result of segregation, and if the adverse selection effect is sufficiently strong, the lender will prefer to ration credit rather than raise the interest rate in order to eliminate the shortage of credit.

Perhaps unlike the business lending scenario, we have a case in which the underlying collateral, the house, has a market value that may fall precipitously. A decline in local property values will induce borrowers to exercise their put options, which in turn may trigger further reductions in a downward cycle. In this sense the put-option feature of mortgage contracts introduces an additional degree of variation or sensitivity in local property values. This is amplified by the greater likelihood that property values will fall below the relevant put-option strike prices in poor hypersegregated areas. The lender, therefore, will be concerned about the future stability of property values in the area in which the home is located. The problem of

⁸⁸ A put option on a stock permits the holder of the option a right to sell the stock at a fixed price. Thus, if the share price falls below the fixed price, the holder of the option will exercise his right to sell. See, e.g., Richard Brealey and Stewart Myers, *Principles of Corporate Finance* 432-433 (2d ed. 1984). On put options and mortgage contracts, see Brent W. Ambrose & Richard J. Buttimer, Jr., *Embedded Options in the Mortgage Contract*, Working Paper, University of Wisconsin-Milwaukee, December 3, 1998; Jimmy Hilliard, James B. Kau, and Carlos Slawson, “Valuing Prepayment and Default in a Fixed Rate Mortgage: A Bivariate Binomial Pricing Technique,” 26 *Real Estate Economics* 431-468 (1998).

assessing local incentives to invest in property makes this predictive assessment of risk difficult.

I have mentioned the importance, for both informal and formal lending processes, of local information on borrower trustworthiness, norms of consumer and labor-market behavior, and informal sanctioning mechanisms. Such information is a form of “social capital” that a person usually acquires by being located within a community.

Robert Putnam has defined social capital as the ability of a community linked by social relations to discipline individual behavior.⁸⁹ For the purposes of this essay, I will treat social capital as information -- information embedded within a system of norms. Moreover, I will assume that there is a certain material threshold that must be met before this capital can be said to exist or to have any value. I noted earlier that information on borrower creditworthiness and the reliability of lenders is likely to be available only in communities in which the volume of informal lending is above a certain threshold, so that failure to follow customary rules can be transmitted among other potential contracting partners. The same can be said about information on work opportunities and the reliability of potential employees. Probably the most harmful effect of hypersegregation is that it puts relatively poor city residents in communities in which these forms of social capital are either weak or nonexistent.

Social capital of a particular type plays an important role in the residential lending market. Lenders obviously are concerned about the incentives of mortgagees to maintain the value of a parcel. But those incentives depend on the behavior of others. If a home is located in an area where a large percentage of families have dissolved, where few residents have an ownership interest in their residences, and there is a relatively low state of public order, the borrower (or “homeowner”) will have relatively weak incentives to make investments in maintaining and improving his property. For example, one would have weak incentives at best to

⁸⁹ See Robert Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* __ (Princeton Univ. Press, 1993). The general notion of social capital has started to take center-stage in analyses of many policy issues. Edward Banfield’s study of culture in a poor Italian town is considered one of the early contributions, see Edward G. Banfield, *The Moral Basis of a Backward Society* (1958). Among economists, Glenn Loury is probably the first economic theorist to rely on the notion of social capital in explaining the inter-generational transfer of wealth and social status, see Glenn C. Loury, *A Dynamic Theory of Racial Income Differences*, in *Women, Minorities, and Employment Discrimination*, (Phyllis A. Wallace and Annette M. LaMond eds.) (Lexington, MA: Heath 1977); id. “Intergenerational Transfers and the Distribution of Earnings,” 49 *Econometrica* 843 (1981). For recent contributions in the social capital literature, see, e.g., Shelly Lundberg and Richard Startz, *On the Persistence of Racial Inequality*, 16 *J. Labor Econ.* 292-323 (1998) (community human capital and individual human capital); Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990) (emphasizing importance of trust and low-cost enforcement mechanisms for economic growth); Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995).

repaint a home if the probability that it would be defaced by graffiti were significant. In addition, one's incentives to maintain property are dampened to the extent that other homeowners have weak incentives. If other homeowners are not maintaining their property, it makes little sense financially for you to maintain yours, given that prices will be depressed by the general state of disrepair. This disincentive should be stronger, everything else the same, in poor communities where relatively few residents own their residences.

I am using the term social capital now to refer generally to neighborhood public goods, actions undertaken by residents that provide benefits to others living in the area. Investing in property is one such good, because it enhances the attractiveness of surrounding parcels. Efforts to maintain safe streets and to monitor the quality of local publicly-provided goods, such as education and law enforcement, also fall in this category. Each of these services has the peculiar quality that it is provided in adequate quantity only when there is an equilibrium in which few residents "defect" by failing to provide their share, and once defection becomes the norm, no resident has an incentive to provide the service. I have already given the example of property maintenance. Consider safety in the streets. Once residents regard the streets as unsafe, no law-abiding resident will have an incentive to wander outside; and once this state is reached, the only people wandering outside will be those intending to commit a crime. Or, consider the quality of local schools. If no one believes the schools are good, residents who are concerned about the education of their children will take their children out of the local schools, reducing their quality. What these examples are intended to suggest is that social capital is often fragile. Changes in conditions affecting the supply of neighborhood public goods can lead to herding behavior,⁹⁰ and self-fulfilling prophecies.

Coordination problems, herding, and self-fulfilling prophecies have been offered as reasons banks may be stuck in a bad equilibrium in which no bank has an incentive to lend within a certain community, though it would be profitable for them if all banks were to lend.⁹¹ I have emphasized social capital at the level of individual production of neighborhood public goods because there are many low-level, continual investments that can be made without calling

⁹⁰ By herding, I mean the tendency of individuals to base their conduct in part on what they see others doing. Herding is rational in an environment in which each individual assumes (correctly) that he has only limited information, and observing the behavior of others can provide more information. Rational herding is clearly relevant in explaining the decisions of people to move into or out of certain neighborhoods. On rational herding generally, see Banerjee, A., *A Simple Model of Herding Behavior*, 107 *Q. J. Econ.* 797 (1992); David Scharfstein and Jeremy Stein, *Herd Behavior and Investment*, 80 *Am. Econ. Review* 465 (1990).

⁹¹ See, e.g., Hylton & Rougeau, *supra* note 1, at 257-258, Swire, *supra* note 1, at 822; Klausner, *supra* note 1, at 1571 (tendency of banks to follow lending decisions of their rivals contributes to investment declines in depressed communities).

on the help of a bank. Coordination problems can arise with respect to these investments.⁹² Given the probable necessity of these cheaper, continuous investments in order to maintain some types of social capital within a community, it would be rational for a bank to make some assessment of the state of these investments before committing itself to lend within it. For this reason, I am inclined to treat coordination issues with respect to social capital, specifically the private production of public goods, as a more important factor explaining under-investment than coordination issues among banks.

The incentive of a mortgagee to default – i.e., to exercise his put option – depends to some extent on the social capital of the community in which he is located, which is a function of poverty and hypersegregation. The social capital factor presents both an informational obstacle and an opportunity to prospective formal lenders. The formal lender will have difficulty assessing risk; a loan officer who has no connection to a particular community will rely on general and stereotypical descriptions of the environment. However, the lender can make investments to enhance social capital. The lender can coordinate with other lenders to extend credit to areas in order to support development efforts undertaken by residents, or counsel and provide services to borrowers in order to encourage local development. But these efforts are costly and have uncertain payoffs.⁹³

These statements do not imply a moral or value judgment about communities with social capital that is weaker in the sense considered here. Such a judgment is unnecessary and irrelevant; but more importantly, there is no clear reason to say on moral grounds that the existence of weak social capital in a community implies that there is something morally at fault with its residents. Moreover, nothing in what I have said so far implies that residents who live in areas where the relevant social capital is stronger should be considered models of virtue. The incentives that motivate residents to provide some neighborhood public goods are sometimes exclusionary, as in the case of large-lot zoning. Competition for social status motivates residents to make certain investments in their property. The moral implications of these incentives are

⁹² Take the simple case of enhancing safety within a community through a “neighborhood watch” program. To the extent such a plan requires participating members to supply a public good, safety, it is vulnerable to individually-rational shirking by participants in the plan. Or take the case of a street with a grassy island dividing the two lanes. Who maintains the island (cuts the grass, picks up trash) if the city is unable to do so?

⁹³ Indeed, one important cost to the lender is the additional risk he incurs by investing in social capital. Although the lender’s strategy may reduce the risk premium on a typical loan, it also leads to an increase in the amount capital put at risk. For further discussion of social capital investment and risk, see *infra* text accompanying notes 97-98. some aspects of risk by making investment to enhance social capital, such investments

ambiguous at best; and some thoughtful critics have said they lead to wasteful expenditures.⁹⁴ However, whatever the moral implications, competition for social status is not entirely wasteful if it enhances the provision of public goods.

Summing Up

The asymmetric information theory developed so far is arguably superior to the alternative theories of market failure based on discrimination models. The theory yields predictions that are consistent with observations in the lending market, and also avoids some of the difficulties attending the discrimination theories. For example, consider the theory of irrational or taste-based discrimination. This theory is vulnerable to the critique that competition should provide a cure to the problem.⁹⁵ Given the scale of the underinvestment problem in poor urban communities, the taste-based discrimination theory would imply the existence of enormous profit opportunities that lending institutions were consistently overlooking, which seems implausible.⁹⁶ The asymmetric information theory, however, is not vulnerable to the competition critique. There is nothing to guarantee that competition will reduce the credit rationing problem; indeed, competition may exacerbate the problem as lender try more strenuously to screen out bad risks.⁹⁷

Consider also the statistical or rational discrimination theory. As I noted earlier, the statistical discrimination theory can be synthesized with the asymmetric information theory, which I have attempted to do in much of the preceding discussion. However, if we consider the two theories separately, it seems that the asymmetric information theory has the advantage. First, the statistical discrimination theory may lead to the prediction that the lending market is one hundred percent economically efficient, which is a troubling implication given the obvious waste of resources observed in poor urban communities. To avoid the efficiency result, one must allow for the possibility that statistical discrimination adversely affects the incentives of potential

⁹⁴ Robert Frank, *Choosing the Right Pond: Human Behavior and the Quest for Status* (1985); Richard McAdams, *Relative Preferences*, Yale L. J. ; Richard H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 Harv. L. Rev. 1005, 1007-08 (1995) (discrimination results from competition for social status).

⁹⁵ Hylton & Rougeau, *supra* note 1, at 254; see also, Macey & Miller, *supra* note 1, at 308- 309.

⁹⁶ Hylton & Rougeau, *supra* note 1, at 254.

⁹⁷ J. Miguel Villas-Boas, *Oligopoly with Asymmetric Information: Differentiation in Credit Markets*, 30 RAND J. Econ. __ (1999) (With more differentiation (less competition), banks may screen credit applicants less intensively in equilibrium because they compete less aggressively for the most profitable customer. As a result, welfare may rise as competition becomes less intense.)

borrowers or results in an inferior coordination equilibrium among lenders.⁹⁸ But both of these arguments seem to strain credulity at times. The fundamental flaw in both arguments is that they put too much emphasis on the role played by formal lenders in the formation of social capital and individual patterns of conduct.

Possible Solutions: A Model of Inner City Development Lending

To this point, I have described the information-related risk barriers to development lending in inner cities. In this section, I briefly suggest a market-based solution. In order to overcome the information obstacles to bank lending in inner cities, an alternative bank model is desirable and probably necessary. An ideal development bank should have three goals: (1) integrating poor inner city residents into the formal saving and lending sector, (2) developing an independent entrepreneurial class, and (3) encouraging property ownership. The immediate payoff from these aims is material development, but the enhancement of social capital is equally important.

Integration

Integration is desirable because it transforms low-income consumers into transparent risks for credit assessment purposes. This is already being undertaken, to some extent, by sub-prime lenders. However, sub-prime lenders cannot carry out this transformation on the same scale as the banking sector. It is obviously cheaper to establish a financial record by setting up a bank account than by obtaining a loan from a sub-prime lender, provided the minimum balance for the account is sufficiently low.⁹⁹

Integration would separate some city residents from a relatively unprofitable relationship with currency exchange outlets, though it should be recognized that the outlets would not disappear. They provide convenience and access to check cashing services for consumers with low savings. Banks typically will not cash a check that exceeds the amount in the check holder's account balance, because the balance serves a source of collateral for the check.¹⁰⁰ Indeed, the check-cashing process can be seen as a temporary loan, for which the bank seeks repayment from

⁹⁸ Hylton & Rougeau, *supra* note 1, 254-259 (reviewing theory of statistical discrimination in application to credit markets).

⁹⁹ Several banks have responded to the need to integrate potential consumers by reducing service fees and minimum balances for accounts. For example, South Shore Bank in Chicago initially cut service fees and reduced the minimum balance for an account to one dollar, see Rochelle E. Lento, *Community Development Banking Strategy for Revitalizing Our Communities*, 27 U. Mich. J. L. Ref. 773, 785 (1994).

¹⁰⁰ This is because of the risk of fraud. I thank George Kaufman for making this point to me in a conversation.

the check writer. If the check writer cannot repay the loan, the bank seeks payment from the check holder's account. For consumers with low savings, cashing checks at banks is generally infeasible, because their balances will be lower than the amount they would like to cash. For these consumers the currency exchange provides an important service.

Moreover, the currency exchange is sometimes more convenient. Before ATMs became widespread, the currency exchanges had the advantage of being open for longer hours than banks, making it easier for someone who worked to get access to money. In addition, the currency exchange employees exercise discretion in a manner that benefits some repeat customers. They choose whether to cash a check, and will rely on the information garnered from repeat business and local information on individuals in the community to determine the likelihood a check is not fraudulent.

In order to separate some consumers from the currency exchange, an ideal community-development bank would have to mimic some of their functions, and adapt to or supplant others. ATMs now make some basic transactions easy at any hour of the day. However, the currency exchanges are obviously superior for people who have difficulty meeting the minimum balance required by a bank and who need to convert a check into cash immediately. And for some city residents they are often safer places to deal with money, since the consumer is not alone on the street. In order to encourage consumers to choose a relationship with a bank rather than a currency exchange, a bank would have to replicate these features of the currency exchange. Admittedly, this seems to go against the dominant trend toward ATMs and the internet as low-cost methods of transacting with bank customers. However, to the extent the internet makes it easier for banks to co-locate with convenience and liquor stores (common places for urban residents to cash checks), new technology may enable banks to supplant the currency exchange without mimicking their methods.¹⁰¹

Needless to say, integration should provide a tremendous upside for residents of low-income communities. The fact that blacks hold bank accounts at roughly the half the rate of whites suggests a large potential for gains to banks and minority city residents.¹⁰² While savings accounts do not offer high rates of growth relative to stock-indexed mutual funds, they are superior to simply holding cash, and an expansion of banking services may encourage saving. Moreover, many banks offer their customers access to mutual funds. Minority participation in mutual funds is extremely low, a fact that has led some commentators to worry that the gap between white and minority participation rates could fuel a considerably greater divergence in

¹⁰¹ For an example of such co-location, *see* Susan Strom, E-Commerce the Japanese Way; Ubiquitous Convenience Stores Branch into Cyberspace, New York Times, Business Day Section, March 18, 2000 (discussing integration of internet commerce and banking with convenience stores in Japan) at B1 and B4.

¹⁰² Swire, *supra* note 1, at 1558 (45 percent of black household hold checking accounts compared to 80 percent of white households).

wealth levels within the upcoming decades.¹⁰³

Ownership, Entrepreneurship and Risk

The long-term benefit from expanding the class of owners and entrepreneurs is the enhancement of social capital within relatively poor inner city communities. Lending is the most obvious channel through which a bank could contribute to this process; because it encourages property and business ownership, and puts the bank in contact with owners as a source of information and advice. Greater property and business ownership should, in turn, enhance incentives to provide neighborhood public goods.

The connection between entrepreneurship and social capital extends beyond the production of such traditional neighborhood public goods as safety and education. One of the key obstacles to informal and formal lending in poor inner city communities is the lack of what I described earlier as an informational infrastructure. Since informal lending networks typically operate without the threat of legal sanctions, informal lenders need access to information on the trustworthiness of borrowers and borrowers need access to information on the reliability of lenders. Formal lenders (banks) also rely on similar informal networks for information on prospective borrowers. Such an infrastructure can be viewed as a form of social capital that requires some minimal level of lending activity in order to be maintained.

Lending in poor communities requires taking on more risk than is commonly accepted in the banking industry. Large banks minimize correlated risks by lending to businesses in different geographical locations and sectors of the economy. Small business loans made by a community bank will tend to be geographically concentrated and failure risks will tend to be correlated. A natural disaster (e.g., earthquake), a local economic shock (e.g., sharp decline in oil prices, as in Texas in the 1980s), or a riot (e.g., South-central Los Angeles after the Rodney King verdict) could wipe out many local banks and businesses at the same time. Layoffs by a major area employer could sharply reduce the demand for services for many small businesses in a single community. While these risks are present in affluent areas as well, poor communities are both more vulnerable and less able to rebound, given the absence of an informational infrastructure to support informal and formal lending.

However, alternative banking models have shown that it is possible to lend to relatively poor customers without incurring an unacceptable level of risk. Community development banks, such as the South Shore Bank of Chicago and the Southern Development Bancorporation, have coordinated lending with other development activities undertaken by affiliates within their

¹⁰³ Glenn C. Loury, Why More Blacks Don't Invest, New York Times Magazine, June 7, 1998. On the divergence in white and black wealth levels, see Blau and Graham, *supra* note __.

holding companies.¹⁰⁴ For example, the Shorebank holding company includes affiliates specializing in housing development, business development, job training, and education.¹⁰⁵ Thus, Shorebank has avoided the coordination problems that affect the supply of local public goods by taking a large stake in the development of social capital.¹⁰⁶ By taking a large stake, South Shore effectively captures or “internalizes” a large share of the external benefits generated by its lending and investment projects.

The general implication of the Shorebank model is that the risk of development lending can be reduced to a tolerable level by harnessing local information and coordinating development activities. Risk reduction under the Shorebank model entails trading off two types of risk. Shorebank’s coordination efforts reduce the informational risks attributable to inadequate social capital (informational infrastructure, local public goods), while increasing the systemic or non-diversified risk that comes from concentrating resources in one area. An optimal coordination scheme would require making such tradeoffs until the marginal benefit from reducing informational risk just equals the marginal cost of increasing systemic risk.

“Group lending” under the Grameen Bank model suggests another approach to reducing the risk of development lending. Within this model I will also include the rotating credit associations (referred to as “ROSCA”) observed in some ethnic communities.¹⁰⁷ The Grameen Bank operates in Bangladesh and provides loans to groups, typically consisting of five borrowers from the same village, under agreements in which all members of the group are liable for the amount loaned to one member.¹⁰⁸ This transfers a large part of the risk to the borrower, and the parties themselves have incentives to monitor the borrower to make sure that he repays the loan. Moreover, groups will seek out members who are creditworthy, based on information they have from day-to-day experience in their communities. The Grameen Bank also provides counseling services to help borrower groups meet their obligations. Grameen Bank reports repayment rates

¹⁰⁴ For an excellent discussion of the South Shore Bank, the Southern Development Bancorporation, and other community development banks, see Lento, *supra* note 99, at 782-799.

¹⁰⁵ *Id.*, at 786-788.

¹⁰⁶ For a similar point, see Klausner, *supra* note 1, at 1578-1579 (discussing South Shore Bank).

¹⁰⁷ For an excellent discussion of these associations and their implications for community development lending, see Lan Cao, *Looking at Communities and Markets*, 74 *Notre Dame L. Rev.* 841 (1999).

¹⁰⁸ Ray, *supra* note 40, at 579; Jaffer, *supra* note 47, at 18.

of 97 percent,¹⁰⁹ and programs based on the Grameen Bank model have had similar results.¹¹⁰ More importantly, the evidence suggests that the lending programs have had an effect on wealth accumulation and behavior. A study by Mark Pitt and Shahidur Khandker finds that the Grameen Bank and similar programs in Bangladesh led to significant increases in household expenditure and the probability that children would be enrolled in school.¹¹¹

Although the Grameen Bank model has worked in developing countries, it is unlikely that it could be applied in American cities without significant modification. Hardly anyone in the city is involved in agriculture or projects with the relatively short horizons typical of those financed by the Grameen Bank.¹¹² Lending for business projects in cities involves different issues. The proceeds from harvesting a crop can be used to payoff a loan within a year. However, start-up businesses obviously need more time, and therefore raise obstacles to the monitoring and self-selection advantages that have made Grameen Bank's program successful. For long term investments, a group lending approach is likely to be feasible within a closely-knit ethnic community. Proof of this is provided by the Korean-American community's "keh" system, a rotating credit association in which the pooled savings of members is loaned to individual members with business plans.¹¹³ However, in the absence of an informational infrastructure similar to that underlying the keh system, it is unlikely that a bank could implement a group lending plan within any randomly selected poor community.¹¹⁴ If the sanctioning mechanisms are weak, as they are in most relatively poor communities, no one will accept take the risk of participating in a group lending program.

The general implication of the Grameen and South Shore Bank models is that information-related risk can be reduced by adopting methods that (1) harness local information to

¹⁰⁹ Jaffer, *supra* note 47, at 3.

¹¹⁰ *Id.* at 2.

¹¹¹ Mark M. Pitt & Shahidur R. Khandker, *The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?* 106 *J. Pol. Econ.* 958 (1998).

¹¹² Jaffer notes that loans must be repaid in equal installments over fifty weeks, *supra* note 47, at 18.

¹¹³ On the keh system and rotating credit associations generally, see Cao, *supra* note 98, at 874-884. See also Elyssa Getreu, *Taking a Lesson From Korea for Lending in the Inner City*, *Am. Banker*, June 29, 1992, at 7 (1992 WL 5264873)

¹¹⁴ I should note that bank-based keh systems have been proposed, see, e.g., Getreu, *supra* note 104; Macey & Miller, *supra* note 1, at 345.

serve the bank's purposes,¹¹⁵ (2) transfer lending risk away from the bank, whether to borrowers (as in the case of group lending) or to third parties, and (3) by coordinating lending with local efforts to promote business development, housing development, education, and job training. Group lending is a simple scheme that happens to implement the first two methods quite well, while making only slight progress on third method. The South Shore Bank model is particularly good at the first and third methods, while faring poorly on the second.

A community development bank's risk of failure can be reduced through public subsidies. For example, banks benefit from being designated municipal depositories, especially in large cities like Chicago that have millions to deposit. Holding municipal deposits can be a form of subsidy, if the terms are good, because the bank collects profits (the difference between market interest rates for loans and the amount payed to the city deposit holder) on a stable base of city deposits without incurring a risk that the deposit base will erode. The institutional risk associated with inner city lending could be reduced by making it a significant holder of municipal deposits. Each city should have an incentive to provide this subsidy, given the external benefits of integration into the formal financial sector and social capital formation.¹¹⁶ The subsidization through holding government deposits can be expanded to encourage further integration. State welfare payments could be deposited directly into this ideal community bank. In states that experiment with voucher schemes for education and other services, the bank could serve as a private administrator of vouchers designed for the poor.

The federal government could subsidize inner-city development lending by providing tax credits for development loans,¹¹⁷ or creating an equivalent to Freddie Mac or Fannie Mae that would facilitate the securitization of small business loans in depressed urban areas.¹¹⁸ These

¹¹⁵ On group lending and the economics of information, see Timothy Besley, Stephen Coate, and Glenn Loury, *The Economics of Rotating Savings and Credit Associations*, 83 *Am. Econ. Rev.* 792 (1993); Timothy Besley & Stephen Coate, *Group Lending, Repayment Incentives and Social Collateral*, 46 *J. Development Econ.* 1 (1995).

¹¹⁶ Indeed, the "fair lending" movement apparently began with an ordinance passed in Chicago in 1974 requiring banks bidding for city deposits to disclose records for residential, consumer, and commercial lending by census tract. See Ken Martin, *Erasing the Redline: How Community Groups and Banks are Changing Lending Practices Around the County*, *Austin Business Journal*, Feb. 19, 1990, p. 23.

¹¹⁷ See Craig Marcus, Note, *Beyond the Boundaries of the Community Reinvestment Act and the Fair Lending Laws: Developing a Market-Based Framework for Generating Low- and Moderate-Income Lending*, 96 *Colum. L. Rev.* 710, 753 (1996).

¹¹⁸ Fannie Mae is a federally-sponsored, privately-owned corporations that purchase mortgage loans from lenders and issues mortgage-backed securities. The U.S. Treasury stands behind all of Fannie Mae's obligations. Freddie Mac, which is wholly-owned by twelve Federal

programs introduce a new problem: lenders may accept too much risk. This tendency toward excessive risk can be particularly severe in an attempt to emulate Freddie Mac, given the moral hazard introduced by the implicit government guarantee supporting mortgage securities sold in the secondary market. But in the case of inner city lending, this may be a cost worth bearing. Given that competition and deposit insurance already combine to encourage banks to take excessive risks,¹¹⁹ a preferable regulatory scheme would encourage banks to channel their risk taking into activities that provide a substantial benefit for society.

While these proposals would reduce the risk associated with lending in relatively poor inner city communities, they obviously would not eliminate it. An ideal regime would involve institutions that could monitor the risk taking of community development banks, while permitting them to carry out their mission.¹²⁰ But the existing regulatory regime makes this development unlikely.

Home Loan Banks, serves the same function though focusing on conventional mortgages. For basic information see, e.g, Craig Marcus, *supra* note 117, at 755 and Note 244 (citing Robin P. Malloy, *The Secondary Mortgage Market -- A Catalyst for Change in Real Estate Transactions*, 39 Sw. L. J. 991, 992-1010 (1986)). Robert W. Shields notes that the CDFI Act encourages the securitization of CDFI loans by giving assistance to institutions that purchase CDFI loans, see Shields, *supra* note 33, at 669. However, Shields' review suggests that the limitations on assistance to firms that purchase loans from CDFIs probably will prevent this activity from growing to the size of the secondary markets in home mortgages, *id.* One promising innovation is a recent mutual fund designed to help banks meet their CRA obligations, see Barbara A. Rehm, *Mutual Fund Building a Portfolio to Ease Banks Over CRA Hurdle*, *American Banker*, vol. 164, No. 113, Tuesday, June 15, 1999, at 1. Marcus, *supra* note 117, at 755-757, proposes that participation in Freddie Mac and Fannie Mae be limited to those banks that can demonstrate a good record in terms of lending to low- and moderate-income borrowers. I am reluctant to endorse this proposal. There is nothing preventing banks and investors from establishing a parallel secondary market that does not have an implicit government guarantee supporting it. If compliance with the Marcus proposal were burdensome, such a market might be established, which would have troubling implications for the original secondary market created by Freddie Mac and Fannie Mae. For example, if banks that did virtually no lending to low-income home purchasers were excluded from the existing secondary mortgage market, their loans could be securitized and sold into an alternative secondary market. This would lower the average quality of securities in the original market, perhaps leading to a process of adverse selection.

¹¹⁹ On the risk-taking incentives created by deposit insurance, see, e.g., "Better than Basle, *The Economist*, June 19, 1999, at 80 (reviewing bank safety regulation)..

¹²⁰ For details on such an ideal regime, see *infra* text accompanying notes 134-135.

IV. REGULATORY OBSTACLES TO DEVELOPMENT LENDING

Although an inner city economic development bank along the general lines just described could be established, there are regulatory obstacles in the way of a large scale effort. A city-based development bank would experience conflicting pressure from fair lending regulations on one hand and safety and soundness constraints on the other.¹²¹ By “fair lending regulation” I refer specifically to the Community Reinvestment Act. Moreover, subsidization at the municipal or federal level to support such a bank would be politically infeasible.

Conflict between Fair Lending and Safety Regulation

Since a lending program that focuses on relatively poor, segregated communities entails a greater degree of risk than banks typically accept, a small community development bank probably would be constrained or at least carefully scrutinized by safety and soundness regulators, who generally require diversification in loan portfolios. An institution that lends largely in relatively poor inner cities probably would be constrained to extend fewer loans than it would like. Indeed, given the risk of lending in poor inner city markets, the bank would be limited more severely than banks operating outside of these areas, and would therefore have a comparatively low loan-to-deposit ratio. The fair lending constraint now enters. Given the low loan-to-deposit ratio imposed in part by the bank’s own prudence and in part by regulators, and given competition from larger rivals who must also meet their fair lending obligations, the bank would tend to fare poorly on community lending evaluations. The bank’s plans to reduce risk through expansion would therefore be rejected, since community lending evaluation records are taken into account by regulators who are asked to approve bank expansion plans.¹²²

Obviously, there are two constraints at work in this process: the safety constraint and the CRA constraint. One could suggest that the bank ignore the safety and soundness constraint and merely do the additional lending that it would like to do. But banks do not ignore the safety and soundness regulations because bank charters can be and are effectively revoked for failing to

¹²¹ The conflict between safety and fairness regulation has been noted before, see, e.g., Macey & Miller, *supra* note 1, at 318-324. A recent empirical study confirms this conflict, see Jeffrey W. Gunther, *Between a Rock and a Hard Place: The CRA- Safety and Soundness Pinch*, Economic and Financial Review, pp.32-41, 2d Quarter,1999 (showing that concentrating bank assets in loans and managing capital at relatively low levels tends to help CRA ratings while hurting CAMEL (safety and soundness) ratings). As will be clear in the text, I focus on the conflict between fairness and safety regulation from a different perspective.

¹²² See Macey & Miller, *supra* note 1, at 302 (noting that “an institution in the ‘substantial noncompliance’ category can assume that the banking agencies will look with disfavor at any application, even the most routine, for a deposit facility.”)

meet them.¹²³ A bank given a choice between meeting CRA requirements and safety and soundness requirements will choose the latter, if it wants to remain in business. Failing to meet the CRA requirements only prevents the bank from expanding, while failing to meet safety regulations can put an end to the careers of bank managers.

There is a paradox, already alluded to in this problem. Bank expansion often reduces the institutional risk of failure. By expanding, a bank can limit its exposure to geographically correlated risks, which have been the primary sources of bank failures.¹²⁴ Thus, in an ideal world, a bank that intends to do community lending should expand in order to reduce its risk, and also to take advantage of economies of scale. The CRA constraint, however, may prevent the bank from expanding in a way that would reduce risk. Thus, we have a regulatory Catch-22. In order to reduce risk and enhance community lending, the bank should expand. However, in order to expand, the bank must do more community lending according to one set of regulators, which may be prohibited by another set of regulators. Although the safety and soundness constraint would reduce the scale of the bank's operations, the combination of both safety and soundness and the CRA create a potential barrier to the expansion of a small development-oriented bank.

It might be easy to argue that this is an example of the CRA having a perverse effect. However, it is important to see that both constraints are responsible for the paradox. If we remove the CRA constraint, the bank could expand to a level at which additional risk becomes acceptable even to very conservative managers. On the other hand, if we remove the safety and soundness restrictions, the bank could lend more and perhaps thereby satisfy the requirements of the CRA. Further, although it may seem obvious that the CRA should be removed as a constraint, the safety and soundness constraint may be more burdensome for the bank in the long term.

Although I have presented this paradox as a hypothetical, it probably serves as a description of the bind that some community banks find themselves in now. Small community banks are over-represented among banks that have poor CRA ratings (either "needs to improve" or "substantial noncompliance").¹²⁵ The relative performance of small banks in the CRA ratings

¹²³ On the disciplinary actions available to bank regulators, see Jonathan R. Macey & Geoffrey P. Miller, *Banking Law and Regulation* 570 - 603 (2d ed., Aspen Publishers, 1997).

¹²⁴ See, e.g., Pierce, *supra* note 31, at.75 ("Far and away the largest number of failed institutions have been small banks in the farm and energy belts where the inability to diversify spelled disaster.")

¹²⁵ See, e.g., Leonard Bierman, Donald R. Fraser, and Asghar Zardhooki, *The Community Reinvestment Act: A Preliminary Empirical Analysis*, 45 *Hastings Law Journal* 383, 397 (1994) (finding that high-rated banks are significantly more likely to be part of a holding company and to have numerous affiliates than banks with low CRA ratings); Macey & Miller, *supra* note 1, at 302-303 (noting that large banks have better CRA ratings).

is illustrated by Table 1, which shows the distribution of CRA ratings by various supervisory agencies and asset size in 1992, as compiled by Griffith Garwood and Delores Smith. Of the 293 banks in Table 1 that received a “needs to improve” or “substantial noncompliance” rating, 212 were banks with less than 100 million in assets. In other words, 72 percent of the banks listed in table 1 with low CRA grades were small banks.

Table 1

Asset size of Institution (dollars)	Federal Deposit Insurance Corporation				Federal Reserve System				Office of the Comptroller of the Currency				Office of Thrift Supervision			
	O	S	N	SN	O	S	N	SN	O	S	N	SN	O	S	N	SN
Less than 100 million	149	969	38	4	37	245	24	4	23	256	65	2	16	248	71	4
100-250 million	30	84	3	0	15	37	4	0	21	94	15	0	25	118	28	1
250-500 million	9	16	1	0	3	15	1	0	5	29	1	1	8	46	11	0
500 million - 1 billion	3	4	0	0	3	8	1	0	6	19	1	1	5	27	1	0
1 - 10 billion	2	4	0	0	3	10	0	0	8	49	4	0	9	33	7	0
More than 10 billion	0	0	0	0	0	4	0	0	8	9	0	0	2	1	0	0
All	193	1077	42	4	61	319	30	4	71	456	86	4	65	473	118	5

Source: Griffith L. Garwood & Delores S. Smith, *The Community Reinvestment Act: Evolution and Current Issues*, 79 Fed. Res. Bull. 251 (1993), Table 1 at 257.

Yet among the small banks are many ethnic and minority-owned banks that were established with the primary aim of providing loans within a small ethnic or minority community for business development purposes. Indeed, one of the paradoxes of the CRA as implemented is

that minority-owned banks have received relatively poor grades.¹²⁶

What explains the relatively poor performance of minority-owned banks in the CRA evaluation process? Since the theory that community banks operating within cities are discriminating against “their own kind” seems implausible, the most likely explanation is that this reflects the regulatory Catch-22 these banks have encountered. There are several ways in which the minority-owned banks may run afoul of CRA examiners. First, to the extent the ratings are based on comparisons among banks, which seems unavoidable, large banks will have a greater incentive to score high on the CRA examinations since they generally will have the strongest desire to expand, if only to keep up with their peers.¹²⁷ Since the minority-owned banks are relatively small, they will suffer as a result of this competition, because high CRA marks are less valuable to them than to the large banks. Second, minority-owned banks are often operating in riskier markets, and without the economies of scale and revenue sources of the large banks. The cost of complying with regulatory lending demands is higher for them.¹²⁸ Third, to the extent large banks are compelled by the need to earn CRA credits to extend loans in depressed communities,¹²⁹ they are likely to extend loans to the most creditworthy applicants in these areas, leaving the riskier credit applicants to the smaller minority-owned banks; which, in turn, further

¹²⁶ See Harold A. Black, M. Cary Collins & Ken B. Cyree, *Do Black-Owned Banks Discriminate Against Black Borrowers?*, 11 *J. Fin. Serv. Res.* 189, 202 (1997). See also, Leslie Eaton, *A Shaky Pillar in Harlem: Black-Owned Carver Bank is Resistant to Profitability and Change*, *The New York Times*, Sunday July 11, 1999, at 19 and 20 (noting conservative approach of Carver and other minority-owned banks to lending).

The relatively poor record of minority owned banks is also reflected in the CRA ratings of Hispanic and Asian-owned banks. In the two year ratings period ending June 1992, 10 percent of all banks received a “needs to improve” or “substantial noncompliance” rating; while among Hispanic banks the figure was 20 percent, among Asian bank it was 36 percent, among black-owned banks it was 8 percent. See Robert B. Cox, *Minority Banks Seen Lagging in CRA Arena*, *American Banker*, vol. 158, August 20, 1993, at 1.

¹²⁷ See Macey & Miller, *supra* note 1, at 303.

¹²⁸ On the costs of compliance, see Anjan V. Thakor and Jess C. Beltz, *An Empirical Analysis of the Costs of Regulatory Compliance*, in *Bank Structure and Competition*, 549 - 568 (finding that CRA compliance costs as function of asset size and net income decline with institution size).

¹²⁹ On the CRA’s competitive impact on minority-owned banks, see Macey & Miller, *supra* note 1, at 341; John R. Wilke, *Giving Credit: Mortgage Lending to Minorities Shows A Sharp 1994 Increase*, *The Wall Street Journal*, Tuesday, February 13, 1996, at A1 (noting that minority-owned Boston Bank of Commerce was almost “knocked out of the mortgage market by a flood of cheap credit in the past two years from ... big banks that had been criticized over their community lending.”)

increases their costs of complying with the CRA. Fourth, the minority-owned banks may be victims of their own outreach efforts, to the extent these efforts lead to high rejection rates among loan applicants. Fifth, while a minority-owned bank may focus on serving a narrowly-defined community consisting of a particular minority group, CRA examiners may not draw the bank's service boundaries so narrowly. Thus, a bank serving an Asian-American community may receive relatively poor CRA grades for failing to reach out to potential borrowers who are not part of its chosen community.¹³⁰ Finally, in terms of the competition for high CRA grades, the minority-owned banks may sometimes be victims of discriminatory patterns of conduct that make it difficult for them to compete for CRA marks. For example, consider loan syndicates. When large banks form a syndicate to lend to a big inner city developer, all members of the syndicate receive CRA credit for the amounts they lend. However, since the banks that are invited to take part in these syndicates are chosen on the basis of past experience and social connections, the minority-owned banks are particularly likely to be excluded from these arrangements.

Difficulty in Finding a Solution

There are two obvious solutions to the conflicting regulatory incentives, and potential Catch-22, that a development bank would experience. One is to modify the CRA, the other is to modify safety and soundness regulation. Both solutions are politically difficult and perhaps impossible.

Let us start with the CRA. The current regime is particularly burdensome to one type of bank: a relatively small community development-oriented bank located in the inner city. Banks of this type do not constitute an interest group with the necessary clout to modify the CRA.

There are parties who prefer the CRA regulatory regime as it now stands. One group consists of direct beneficiaries: community pressure groups and politicians who seek a support base within these groups.¹³¹ The CRA as it currently stands provides benefits to both of these groups. The community lending groups vary quite a bit, with some seeking actually to influence lending policies and others merely seek cash payments, though they all benefit from the authority and legitimacy given to them by the statute. Because the statute authorizes regulators to consider community development efforts in reviewing the expansion plans of a regulated institution, it provides community-lending interest groups with a forum for airing their complaints and gaining the attention of bank officers and regulators. Politicians benefit because the CRA allows them to deliver payoffs to their support groups in the form of directed lending. A politician can make a credible claim to a pressure group that in return for its support (money and votes), he will apply

¹³⁰ See, e.g., Eugene D. O'Kelly, Comment: Small Banks Need Quick Relief from CRA Requirements, *American Banker*, vol. 158, December 2, 1993, at 7 (discussing, among other things, outreach requirements imposed on small minority-owned banks).

¹³¹ Hylton & Rougeau, *supra* note 1, at 281-82; Macey & Miller, *supra* note 1, at 332-33.

pressure on their behalf on regulated lenders and ensure that their demands will be met, or at least they will be rewarded with funding from the banks. The regulators themselves form an additional, though small, interest group in favor of the status quo, since much of their human capital is strongly tied to maintaining the current process.

Among banks, not all of them are hurt by the current regulatory regime. Let us divide them into three groups: small banks in cities, small banks outside of cities, and large banks (that are necessarily in cities). I have already noted that the CRA is quite burdensome for small banks in inner-cities, because they are placed in a bind between the demands of the CRA and those of safety and soundness regulators. The small banks outside of cities do not suffer like their counterparts in the cities, and some of them benefit. For example, a community-based small bank in a middle-class suburb can meet its community investment obligations by offering residential loans to moderate-income residents, many of whom work as local school teachers, policemen, and so on. For many of these banks, meeting the CRA obligations is simply a matter of carrying out their business plans. Moreover, these banks are largely immune from the CRA protests and complaints that come with operating within the city.

Consider the large banks. There are many reasons to believe that they benefit from the current regulatory regime. For many of them, the cost of complying with the CRA is relatively small, as evidenced by their excellent compliance records.¹³² The burden of maintaining a compliance officer on staff is relatively small for the large banks. The large banks earn profits in high-end service markets that can be used to subsidize lending and services (e.g., low-cost checking accounts) in low-end markets.¹³³ In addition, the large banks can satisfy their CRA obligations by lending to the most creditworthy applicants in the inner-cities, such as large developers, while leaving the riskier applicants to the small banks. Indeed, the large banks have both the wherewithal and incentives to structure their lending programs in a manner that exposes

¹³² On the superior compliance records of large banks, see *supra* text accompanying notes ___ - ___.

¹³³ Where are these profits coming from? A recent study of bank profitability concludes that during 1991-1997, cost productivity worsened while profit productivity improved. See Allen Berger and Loretta J. Mester, *What Explains the Dramatic Changes in Cost and Profit Performance of the U.S. Banking Industry?* Working Paper No. 99-1, Wharton Financial Institutions Center, University of Pennsylvania, February 1999. The banks earned greater profits from fees connected to new services, such as mutual funds, derivatives, ATM networks, on-line services, debit and credit cards, *id.*, at 27. See also, Lawrence J. Radecki, *Banks' Payments-Driven Revenues*, *Economic Policy Review*, Federal Reserve Bank of New York, vol. 5, No.2, April/June 1999 (finding that payment services bring in from one-third to two-fifths of the combined operating revenue of the twenty-five largest bank holding companies).

them to the least amount of risk sufficient to satisfy their CRA obligations.¹³⁴ Thus, the ex post distribution of compliance costs gives large banks a competitive advantage over their smaller rivals.¹³⁵

The current regulatory regime provides a barrier to entry in the market for inner-city lending, which generates an additional competitive advantage to large banks. Small banks are, for reasons already given, effectively prohibited from expanding in these markets to challenge the large ones. The large ones, all sharing roughly the same advantages (or disadvantages) with respect to inner-city lending, need not worry about competing against a bank with superior information or some other advantage in the market for inner-city lending. This competitive barrier provides the large banks an additional advantage in dealing with local political leaders. Given the city's reliance on the large banks for lending, the city leadership is bound to reciprocate with indirect subsidies, such as the placement of municipal deposits under terms suitable to the large banks.

The competitive barrier benefitting large banks is buttressed by the process of CRA regulation.¹³⁶ Large banks probably have an advantage in the evaluation process. First, assessment of lending is considerably easier in the case of a small bank than in the case of a large one. The regulators are at an informational disadvantage in the case of large banks, and must rely

¹³⁴ See Hylton & Rougeau, *Perverse Incentives*, *supra* note 22, at 184-187 (discussing CRA "compliance stratagems"). Indeed, there is evidence that with respect to the lending pressure groups, the large banks have discovered ways to splinter them and to preemptively strike the least burdensome deals. For example, several pressure groups complained that Fleet Bank in Boston entered into an agreement with Bruce Marks, a prominent CRA activist, and then ignored them. See *The Bay State Banner*, Thursday, June 17, 1999, at 1,8, and 19. Fleet had no incentive to continue to negotiate with the community groups after striking a deal with Marks, because the Marks deal would help the bank meet its obligations and also purchase Marks's support for future CRA hearings required by the bank's expansion plans. The community groups complained that the agreement between Marks and Fleet failed to address the real development concerns of the affected communities, *id.* at 8.

¹³⁵ Of course, no spokesperson for a large bank has, to my knowledge, offered this as a reason for supporting the CRA. However, it isn't difficult to find statements by officers of major banks suggesting satisfaction with the current regulatory regime. For example, the chairman of Bank of America, Hugh McColl, is reported to have said earlier this year, "My company supports the Community Reinvestment Act in spirit and in fact ... We're quite happy living with the existing rules." Philip Angelides, *Prosperity Hinges on CRA Loans*, *Sacramento Bee*, Metro Final, July 18, 1999 at 11.

¹³⁶ In their critique of the CRA, Macey and Miller noted that the CRA provides an advantage to established banks relative to those trying to "reposition themselves in the market", see Macey & Miller, *supra* note 1, at 315.

to some extent on the evidence they are given by the bank. In the case of a small bank, it is easier to question and independently assess community lending efforts. Second, CRA examiners, unlike safety examiners, tend to be young and inexperienced.¹³⁷ This makes the informational disparity problem worse, and suggests that the examiners are likely to be a bit more humble in their dealings with large banks.¹³⁸

The competitive advantage also probably serves to aid large banks in fending off competition from foreign banks and perhaps the new internet banks.¹³⁹ Foreign banks are likely to find it more costly, at least initially, to discover the rules of the game as played in a specific geographic market. A savvy bank located in an area in which CRA protests are likely does not wait for the merger or expansion process to begin before it starts addressing potential CRA issues. A sophisticated bank officer knows that he should make contributions to community-lending interest groups in advance, in order to quiet them before merger or expansion applications are filed with the relevant regulatory body. Moreover, such an officer probably knows the identities of the relevant parties, their salient concerns, and perhaps their strengths and weaknesses at the bargaining table. A foreign bank, attempting to enter an urban market, may not be aware of the practices of sophisticated incumbent banks, and if aware, may not know how to go about paying off the right parties or even the identities of the relevant parties. In addition, a foreign bank could be subjected to excessive demands, given some local xenophobia,¹⁴⁰ and the perception pressure groups and politicians will have that the foreign bank is relatively inexperienced in local affairs and especially eager to enter the market. As for the new internet banks, they too can be hobbled by the CRA, because it is unclear at this stage how the statute will

¹³⁷ Bankers have noted the lack of training and inexperience of examiners in their complaints over the uncertainty surrounding CRA enforcement, see Hylton & Rougeau, *Perverse Incentives*, supra note 22, at 167-68.

¹³⁸ There is both an informational disparity and a disparity in social status that probably has some effect on the behavior of examiners. James Pierce hints at the social status issue when he notes that “[g]overnment supervisors who interrogate bankers earn maybe sixty thousand dollars a year; the people they question often make ten or twenty times that and operate out of offices that make a regulator’s quarters look like a shelter for the homeless. How can regulators second-guess the management of these multinational corporations about the riskiness of a specific loan?” Pierce, supra note 31, at 99.

¹³⁹ Internet banking apparently has the potential to cut costs substantially. According to a study by Lehman Brothers, a transfer between bank accounts costs one cent over the internet, 27 cents using an ATM, and \$1.27 using a bank teller, see “How to live with falling prices,” *The Economist*, June 12, 1999, at 57.

¹⁴⁰ I have in mind not hatred of foreigners but a largely rational distrust that community lending interest groups are likely to have in this case. They will tend to view a foreign bank as even less concerned with the welfare of local residents than is the typical large domestic bank.

be applied to them.¹⁴¹

The three interest groups that have the most power to influence CRA legislation are the local lending pressure groups, politicians, and banks. But of these groups, only one relatively small sub-group of banks, specifically those small banks lending in poor inner-cities, has an incentive to modify the CRA to remove the obstacles to additional community development lending. Potential customers also have an incentive to see the regime modified, but they are too dispersed and uninformed to have an impact on the legislative process. Given this, the current regulatory structure is likely to remain for some time.

The current regime does, of course, generate some lending at preferable terms to inner-city residences and businesses. This is desirable, though it would be observed under an alternative regime in which development-oriented banks were given greater encouragement. Further, the lending that does take place provides a large share of benefits to relatively undeserving parties, along the way creating yet another concentrated interest group in favor of the current regulatory regime. For example, the statute gives large banks incentives to compete aggressively to lend to large inner-city developers, leaving the riskiest credit applicants to the small banks. The large banks gain by meeting their CRA obligations when they extend loans to a developer building a hotel or a theater. The developer gains by receiving favorable terms.

Now consider the second major regulatory obstacle to community development lending, safety and soundness regulation. Many commentators see a need for this type of regulation in view of the moral hazard problem generated by deposit insurance.¹⁴² Deposit insurance removes some of the institutional risk of lending to banks, and for this reason leads to more aggressive lending policies than would otherwise be observed, a problem often referred to as moral

¹⁴¹ On May 3, 1999 banking regulators published revised guidelines to help examiners and financial institutions comply with the CRA. However, the new guidelines did not address the issue of “branchless banking,” and stated that out-of-assessment area activities would be addressed in materials issued for public comment later in the year. See “Bank Regulators Revise Guidance on Community Reinvestment Act, vol. 67, No. 42, p. 2663, U.S. Law Week (Legal News), May 11, 1999. The tensions surrounding the regulation of branchless banking erupted into a public criticism by Senator Phil Gramm of Office of Thrift Supervision Director Ellen Seidman on May 7, 1999. Gramm complained in a letter to Seidman that she had gone too far in suggesting methods of applying the CRA to nontraditional banks in a speech she made on June 17th. Specifically, Gramm stated that the OTS did not have statutory authority to reinterpret the CRA in order to apply it to nontraditional banks. Seidman had suggested that assessment areas for CRA purposes could be defined by the location of the bank’s customers rather than the location of the bank’s branches. See Barbara A. Rehm, “Gramm Chews Out OTS Director over CRA Ideas,” *The American Banker*, Thursday, July 8, 1999.

¹⁴² See, e.g., “Better than Basle,” *The Economist*, *supra* note ____.

hazard.¹⁴³ Safety and soundness regulation is viewed as necessary in order to prevent banks from taking on an undesirably high level of risk.

While the moral hazard argument provides a reasonable case for regulation, there are many ways in which regulation for safety and soundness could occur. The current safety regime is one in which banks are judged according to a uniform set of criteria.¹⁴⁴ However, not all banks are alike with respect to the risk generated by a particular activity, and not all borrowers of a certain type (e.g., small firms or governments) are alike with respect to risk.¹⁴⁵ An ideal safety regime would provide incentives that respond to the specific level of risk generated by a bank's loan portfolio.

One can draw an analogy here to insurance markets. Consider liability insurance for automobile accidents. An ideal insurance regime would be one in which the insurance premium responds immediately to any slight change in the level of accident risk associated with a driver's conduct. The premium should ideally reflect the amount of driving the driver does, and the

¹⁴³ On the moral hazard problem in banking, see Sudipto Bhattacharya, Arnould W.A. Boot, & Anjan V. Thakor, *The Economics of Bank Regulation* 30 *J. Money, Credit, and Banking* 745, 755-757 (1998).

¹⁴⁴ Federal regulators use a safety and soundness rating system that examines six factors: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). From this evaluation the bank is assigned a numerical ranking from 1 through 5, with 5 being the worst, see, e.g., Gunther, *supra* note __, at 32. For a discussion of the difficulties of assessing safety and soundness under this system, see Pierce, *supra* note 31, 97-100. For large banks, the most important safety rules are the international capital-adequacy standards applied to banks that operate internationally, see "When Borrowers Go Bad," *The Economist*, February 28, 1998, at 79. The "Basle standards" require less capital to be set aside for loans to governments and financial institutions than for corporate loans. This has the perverse effect of encouraging banks to lend to risky governments in preference to safe corporations, since a risky government borrower will pay a higher interest rate but won't force the bank to set aside more capital. *Id.*

¹⁴⁵ See "When Borrowers go Bad," *The Economist* February 28, 1998, 79-80 (discussing capital requirements imposed on international banks, and proposals by banks to set up a more individualized regulatory regime by having them use their own credit-risk models to determine capital requirements). In addition to the problem that capital adequacy rules may not be sufficiently individualized, there is the additional difficulty of comparing risk levels across banks that focus on different markets. See, e.g., Richard Cookson, "On a Wing and a Prayer: Survey of International Banking," *The Economist*, April 17, 1999, at 6-7 (discussing differentiation among banks). "First Union, for example, has concentrated on consumers and small businesses; Bank One on credit cards, which account for 30 % of its assets....," *id.* at 6. Presumably, a bank that focuses on a specific market has invested more than the average bank in methods to control risks associated with that market.

amount of care he takes when driving. In an ideal regime the premium would move, second-by-second, to reflect each instantaneous change in the level of risk created by the insured party.¹⁴⁶ In this ideal system, the driver would have an incentive to adjust his risk-taking behavior in response to the change in the premium. A large upward increase in the instantaneous premium would lead the driver to take additional care.

Note that this implies a highly individualized and instantaneous approach to regulation. Of course, this ideal is infeasible because of transaction and measurement costs, but insurers try to approach this ideal by classifying drivers into risk categories, and sometimes experience-rating insurance prices.

An ideal system of safety regulation for banks would attempt to approach the ideal that insurance markets would move toward in the absence of transaction and measurement costs. Thus, an ideal safety system would charge each bank a risk premium that reflects the level of risk generated within a certain time period by the bank's loan portfolio. Such a system would permit and encourage specialists to examine the bank's level of risk taking, since a closer alignment between the price and real cost of risk would benefit both parties to the insurance contract; the bank by providing the lowest price for risk coverage, and the insurer by providing a competitive advantage relative to other firms.

An ideal decentralized and individualized safety regulation regime would mimic an insurance market, under ideal conditions. It is possible that in such a regime, community-development banks would be given greater freedom to lend than under the existing regime. Risk assessment specialists could reach conclusions that differ from those of regulatory bodies. As the Grameen Bank has demonstrated, lending to poor communities can be carried out in a relatively safe manner,¹⁴⁷ and yet it is doubtful that the Grameen Bank approach would have been viewed favorably by U.S. safety regulators. An individualized safety-regulation system would permit regulators and lending institutions to study their markets in order to understand the best methods to reduce risk while meeting credit demands. Risk-transference through the Grameen model (e.g., group lending) or perhaps through the securitization of small business loans could be developed as general methods of minimizing the risk of lending in low-income inner city areas.

Recognizing the need to control moral hazard in the banking industry, one obvious alternative to the current regime would be one in which safety regulation is effectively privatized

¹⁴⁶ See, e.g., Steven Shavell, *On Liability and Insurance*, 13 *Bell Journal of Economics* 120, 128-129 (1982) (proving optimal results when insurer can monitor conduct of insured, and premium therefore reflects precise level of risk generated by insured).

¹⁴⁷ Jaffer, *supra* note 47; at 3 (Grameen Bank's repayment rate of 97 percent).

by requiring banks to insure deposits in the private insurance market.¹⁴⁸ Such a regime would encourage specialization in methods of risk reduction and risk assessment for lending markets, and may be superior to the current regime in terms of safety regulation. And by reducing the risk of bank lending within poor urban areas, it would encourage greater specialization of banking services to these markets.¹⁴⁹

Under the current regime, bank officers sometimes rely on safety regulators to provide warning about sources of risk in the bank's operations.¹⁵⁰ The regulators, however, do not have the best incentives to discover risk and issue optimally-timed warnings.¹⁵¹ Their fates are not tied

¹⁴⁸ For a proposal to privatize deposit insurance, see Bert Ely, *Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance*, paper presented at Federalist Society Conference, page 3. On private deposit insurance schemes, see Charles Calomiris, "Deposit Insurance: Lessons from the Record," *Economic Perspectives*, Federal Reserve Bank of Chicago, May/June 1989, 15-19.

¹⁴⁹ One might object that this could result in more costly monitoring of lenders than under the current regime. However, the amount of resources devoted to monitoring should not be an issue under a private insurance regime, because private lenders and insurers presumably will engage in monitoring only when the benefit exceeds the cost.

¹⁵⁰ Indeed, given federal deposit insurance, banks have incentives to take on excessive risk, see "Better than Basle," *The Economist*, *supra* note __; so it naturally falls to regulators in many cases to provide the warnings. For an account of the savings-and-loan crisis that attributes the crisis to lax supervision and bad incentives, see Pierce, *supra* note 31, at 77. Bert Ely notes that bank regulators are often as well informed as bank officers about the risks associated with a bank's business policies, and perhaps better informed to the extent they have superior information on economic conditions outside of the bank's local market, see Bert Ely, *Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance*, paper presented at Federalist Society Conference, page 3. Whether better informed or not about operational risks, bank regulators certainly have better information as to the likelihood of a regulatory directive that affects the bank. One interesting perspective on this issue is suggested by a recent study of stock market returns in Allen Berger and Sally M. Davies, *The Information Content of Bank Examinations*, 14 *J. Financial Services Research* __, October 1998. Berger and Davies find that bank examination downgrades appear to reveal unfavorable private information about bank condition, given the stock market reaction to such downgrades. Berger and Davies note that this result supports the theory that banks hold substantial private information. However, given that bank examiners are likely to make the key decisions that harm investors, the results may also reflect the private information held by regulators.

¹⁵¹ For a model of safety regulation that allows for the possibility that bank regulators will have incentives that deviate from the social interest, see Arnaud W.A. Boot & Anjan V. Thakor, *Self-Interested Bank Regulation*, 83 *Am. Econ. Rev.* 206 (1993). For a report detailing

to the health of the banks they regulate, and they are not always penalized for failing to act swiftly to prevent disasters.¹⁵² On the other hand, there is little to ensure that they will not act too swiftly in some cases and revoke a bank charter unnecessarily. In other words, because of “agency costs” we cannot be sure that risk regulators have the best incentives under the existing regime. A privatized regime would provide risk overseers (insurance firms) with appropriate incentives to monitor and warn.¹⁵³

However, the current safety regulation regime is unlikely to disappear soon. Banks are charged insurance premiums for federal deposit insurance, but these premiums are affected by political considerations. It is doubtful that the prices charged banks to fund federal deposit insurance are the same as would be observed in a private market for deposit insurance. In particular, given that the insurance premiums are not sensitive to the management policies of the individual bank, it is clear that safer banks are providing a subsidy to risky banks under the current regime. Moreover, because small banks are generally not as well diversified as large banks, and therefore have relatively large failure probabilities, small banks are generally charged prices below the level that would be set in a private insurance market.

These subsidies suggest the presence of large interest groups in favor of maintaining the current safety regime, even though it is probably inferior in every measurable respect to a system in which deposits were privately insured. Many large banks have taken on risky lending strategies, even though they are heavily regulated.¹⁵⁴ To the extent they benefit both from the federal deposit insurance guarantee and the “too big to fail” policy generally accepted and explicitly embodied in FDICIA,¹⁵⁵ the likelihood of moral hazard infecting their lending policies

numerous incidents suggesting overzealous enforcement by bank regulators, see Terry Carter, *Banking on Fear*, 85 *Am. Bar. Assn. Journal* 40, July 1999.

¹⁵² See, e.g., Ely, *supra* note 119, at 5-6 (discussing absence of liability concerns among bank regulators).

¹⁵³ The reason is that all of the relevant costs are internalized among the contracting parties, which implies that divergences between actual and optimal regulatory policies will be minimized. Since insurers must pay for losses due to negligent conduct, they have incentives to monitor up to the point at which the marginal social benefit from monitoring (avoided losses) just equals the marginal cost of monitoring. We are unlikely to find the same incentives under a public safety regime, since the private benefits of monitoring (for public regulators) may not be closely tied to the social benefits (avoided losses).

¹⁵⁴ See, e.g., Pierce, *supra* note 31, at 74-75 (discussing lending policies of large banks and lending crises during the 1980s).

¹⁵⁵ For a review of FDICIA discussing the “systemic risk” exception, which protects deposits exceeding \$100,000 if the bank’s failure is deemed to present a serious risk to the financial system, see Robert A. Litan, 19 *J. Retail Banking Services* 57 (1997).

is greater than in the case of a small bank. Moreover, because consolidation in the banking industry has increased the deposit insurance fund's vulnerability to a large bank failure,¹⁵⁶ the moral hazard subsidy to large banks has probably grown in recent years. Small banks, on the other hand, have traditionally carried the highest failure risks.¹⁵⁷ To the extent small banks pay less than the actuarially-fair price for deposit insurance, they too are encouraged to lend beyond the economically appropriate level.¹⁵⁸

With some large banks and probably many small banks benefitting from deposit insurance, it is quite likely that the number of interest groups favoring the current safety regime exceeds the number opposed. Whatever the tally, it would be difficult to modify the existing safety regime without running into fierce opposition.

Obstacles to a Local Solution

I have suggested a local alternative to regulatory reform for the purpose of encouraging inner-city development: having cities subsidize development lending programs by choosing municipal depositories on the basis of their development efforts. This seems a sensible approach, intuitively, because it would involve using public funds to subsidize an effort with largely public rewards. Since cities become undesirable because of declines in the level and quality of public goods such as safety and education, city leaders should have incentives to use the resources they control to improve the welfare of residents in the poorest communities, where such public goods are poorly supplied.

As plausible as this may seem as a strategy for community development, it is unlikely to be implemented in a serious and widespread fashion.¹⁵⁹ The incentives of city leaders are skewed in a way that makes such a strategy unappealing to them. Mayors often seek and rely on the support of the large financial institutions and businesses operating within their cities. The residents in poor neighborhoods do not fund political campaigns. In addition, they have little

¹⁵⁶ See Robert Oshinsky, *Effects of Bank Consolidation on the Bank Insurance Fund*, Division of Research and Statistics, Federal Deposit Insurance Corporation.

¹⁵⁷ E.g., *id.*, at 5-6.

¹⁵⁸ I should note that the FDIC recently introduced risk-based deposit insurance prices, see, e.g., Bhattacharya, Boot, & Thakor, *supra* note 143, at 757. However, it is generally well-known that the FDIC's pricing system deviates from what would be observed in a private deposit insurance market, and the reason for this is any effort to move toward real risk-based pricing would generate complaints and political pressure from banks that would see their premiums rise.

¹⁵⁹ I should note that at least a few cities have tried this approach, most notably Chicago in 1974, see Martin, *supra* note 116. However, the approach is not widespread, and the reporting regime in Chicago is largely unused today.

incentive to invest time and resources into understanding the community development issues, and generally lack the resources to make such investments. The result is a process that provides few incentives if any to use public funds in creative ways to subsidize community development efforts. The dominant incentive is to use municipal funds in order to shore up support from individuals and institutions that are perceived to be influential in local politics.¹⁶⁰

V. THE POLITICAL ECONOMY OF REGULATORY REFORM: AN APPLICATION TO THE CRA

The regulatory obstacles that discourage development efforts in inner-cities probably are not accidental. They are consistent with a view of the legislative process that emphasizes the importance of private interests in shaping legislation.¹⁶¹ Concentrated, well-organized pressure groups often obtain legislation that favors their interests even though it may harm a much larger group of disorganized individuals.¹⁶² The classic example is provided by tariffs on imported goods. Tariffs are often imposed at the behest of organized domestic producers who fear competition from foreign producers. In most cases, however, the loss to domestic consumers from the imposition of tariffs and other import controls exceeds the gain to domestic producers.¹⁶³

The likelihood of regulatory reform increases under this view of legislation when the difference between the loss to the disorganized group and the gain to the organized group (note that the loss exceeds the gain) increases.¹⁶⁴ As this difference increases, the organized group's incentive to hold on to its legislative benefits falls relative the disorganized group's incentive to change the rules. The difference between the loss to the disorganized and the gain to the

¹⁶⁰ Perhaps the best evidence of this problem is the poor state of infrastructure in many cities, one of the urban problems described in Dreier, *supra* note 60, at 1370-1371. The infrastructure problems are the results of years of neglect by city leaders focusing on short term political gain rather than the long term economic health of their cities.

¹⁶¹ George Stigler, *The Theory of Economic Regulation*, 2 *Bell J. of Economics and Management Science* 3 (1971).

¹⁶² *Id.* 10-13.

¹⁶³ This is a basic result presented in many introductory microeconomics textbooks. For a particularly thorough discussion, see P.R.G. Layard & A.A. Walters, *Microeconomic Theory* 105-108 (McGraw-Hill, 1978).

¹⁶⁴ Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 *Q. J. Econ.* 371-400 (1983); Randall Kroszner, *On the Political Economy of Banking and Financial Regulatory Reform in Emerging Markets*, manuscript, University of Chicago, Graduate School of Business, April 1998, at 6.

organized can change for many reasons, because of technology or tastes. For example, interest rate ceilings on deposits were imposed after lobbying by savings-and-loan institutions,¹⁶⁵ and benefitted banks and savings-and-loans for several years. However, money market funds and other technological innovations caused banks to lose the benefits of interest rate ceilings, and as a consequence banks dropped their opposition to interest rate deregulation.¹⁶⁶ In an application of private interest theory to regulatory reform in the banking industry, Randall Kroszner has provided several other examples.¹⁶⁷ According to Kroszner, technological changes, such as the introduction of ATMs in the early 1970s, increased the elasticity of supply of depositors' funds, making geographical restrictions on bank entry less valuable to protected banks. As a result, the geographical restrictions were eliminated, though only after they had become virtually worthless to the banks that had earlier benefitted from the competition barrier.¹⁶⁸ Kroszner also notes that the manner in which banking markets have been opened is consistent with private interest theory; because foreign banks have been permitted to enter first through investment in existing banks, which permits existing banks to share in the benefits of entry by being bought out at a premium rather than being forced to exit because of competition.¹⁶⁹

The Economics of CRA Reform

The current impasse over the CRA can be analyzed in these terms. In other words, let us set aside for the moment the notion that the CRA enforcement regime remains in its current state because members of Congress really believe that it is the best way to promote community development in poor inner-cities. Let us assume that the statute remains in effect because the gains to organized beneficiaries are important enough for them to maintain the status quo.

Who are the beneficiaries and what are their gains? I have already discussed the lending pressure groups, politicians, and regulators, whose gains are easy to comprehend. Indeed, they should be viewed as "entrants" encouraged by the statute.¹⁷⁰ In the absence of the statute, they

¹⁶⁵ See, e.g., Pierce, *supra* note 31, at 57.

¹⁶⁶ See Pierce, *supra* note 31, at 71; R. Glenn Hubbard, *Money, the Financial System, and the Economy* 373 (Addison-Wesley, 1994).

¹⁶⁷ Kroszner, *supra* note 164. See also, Randall S. Kroszner & Philip E. Strahan, What Drives Deregulation? *Economics and Politics of the Relaxation of Bank Branching Restrictions*, __ *Q. J. Econ.* 1437 (November 1999).

¹⁶⁸ *Id.* at 8-9.

¹⁶⁹ *Id.* at 10.

¹⁷⁰ There are other cases in which a statute creates its own interest group lobbying for its maintenance. For example, agricultural policy often has the effect of creating interest groups, see Christopher B. Barrett, *The Microeconomics of the Developmental Paradox: On the Political*

would not exist, or they would exist in some other form. The statute has introduced a potentially profitable field in which they have entered, and to speak of profits in this area is not an exaggeration. Some of the pressure group members have reportedly amassed large sums from the proceeds of CRA settlements. Senator Phil Gramm's investigation of CRA settlements revealed that one pressure group leader had amassed roughly \$3.5 billion that he controls to finance community development programs, from which he earns substantial fees.¹⁷¹ Local politicians who often involve themselves in the merger process enter into implicit reciprocal agreements with the pressure groups and related groups. The politician promises to pressure a bank into meeting the demands of the pressure group, in exchange for support and financial aid from that group, and the politician typically uses that support to seek additional support from voters sympathetic to the pressure group's aims.

The banks form an interest group of incumbents, in the sense that they were in existence before the statute was enacted. In general, the CRA has been described as a very costly intrusion into the operating policies of banks, and the administrative costs are relatively high.¹⁷² However, the statute does provide benefits as well, in the form of competition barriers that favor the large banks operating in cities. In addition, to the extent the statute solidifies relationships between politicians and some of these banks, creating a closed circle in which a mild form of directed lending operates, it provides an additional competitive benefit. The small banks operating outside of the inner-cities face a comparatively light burden under the statute.

One reason it is difficult to modify the existing CRA enforcement framework is that the benefits to many large banks probably exceed the costs imposed on them. As technology makes it possible for foreign and possibly internet banks to compete against large domestic banks, the CRA provides one of the relatively few remaining competition barriers protecting markets for large banks. The large banks seem to have made their peace with the statute and have learned to use it to their advantage. There are several reasons to believe that the deals struck with pressure groups are probably not costly in terms of their effects on bank policies. First, banks have an incentive to preemptively strike the least burdensome deals with pressure groups, and there is some evidence that this occurs.¹⁷³ Given that the bank receives the same CRA credit whether it finances business start-ups within the poorest urban community or sets up a home loan program for low and moderate income borrowers, the bank will choose the least burdensome deal. And once the bank has arranged an agreement of sufficient size to satisfy CRA regulators, it no longer

Economy of Food Price Policy," *Agricultural Economics*, forthcoming 1999.

¹⁷¹ Telephone conversation with Dina Ellis, assistant to Senator Phil Gramm, on Tuesday, June 8, 1999.

¹⁷² See Thakor & Beltz, *supra* note 128.

¹⁷³ Recall the complaints leveled by community pressure groups against agreements between Bruce Marks and Fleet Bank in Boston, *supra* note 134.

has an incentive to deal with pressure groups representing the poorest affected parties. Second, there is a strong incentive on both sides to arrange sham deals. The pressure group leaders want to show some sign of success, the bank wants to move on with its expansion; and the general public is too unsophisticated to know whether the final agreement is really a substantial improvement upon the bank's previous plans.¹⁷⁴ As a result, banks often agree to follow the lending policies they have been pursuing or planning to pursue all along.¹⁷⁵ Moreover, the publicity surrounding CRA settlements can be used as free advertising by a bank. Third, and perhaps most important, the settlement process allows bank officers to make connections with and to gain "you owe me one" claims on local politicians involved in the process. Sometimes those claims involve a trade-off of community lending commitments in exchange for promises by local politicians to protect competitive barriers enjoyed by the banks.¹⁷⁶

¹⁷⁴ As is true of trade protection legislation, some degree of public ignorance or apathy is a necessary component of this process. The source of the problem is that the costs of investigating and understanding the issues – i.e., piercing the rhetoric of the interested parties – far outweigh the benefits to the individual city resident. If these costs were not present, affected citizens presumably would lobby for legislation *subsidizing* community development lending efforts and removing competitive barriers in current legislation.

¹⁷⁵ Occasionally a community pressure group will point this out publicly. For example, in the Fleet/BankBoston merger discussions, Massachusetts state Senator Dianne Wilkerson publicly criticized the banks' community investment commitment of \$14.6 billion because it was not significantly better than what the banks' current levels of lending. See Yawu Miller, "Activists ask Feds to Block Fleet/BankBoston Merger, The Bay State Banner, vol. 34, Thursday, July 8, 1999, at 1. Several private conversations with people in the banking industry confirm the claim that bank CRA commitments are often extremely conservative projections based on past lending records. For the opposing view (i.e., that the CRA has led to substantial changes in lending), see Taibi, *supra* note 1, at 1488 (citing Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, but Strengthened Federal Enforcement Is Needed*, 20 *Fordham Urban L. J.* 293, 298-300 (1993)).

¹⁷⁶ Perhaps the most explicit recent example of such bargaining has been observed in the merger negotiations between Bank of Boston and Fleet Financial Corporation over much of 1999. The merger would lead to Fleet divesting most of its branches. The question this generated is whether the branches would be purchased by a large out-of-state competitor or distributed widely among small, local community banks. Fleet and Bank of Boston have been working with US Representative Barney Frank and members of the Massachusetts congressional delegation to save the branches for the small banks. At the same time, the banks have been promising the congressmen that they will meet the community investment demands of local pressure groups. Indeed, Massachusetts congressmen were apparently successful in urging the Justice Department to back off from a plan to push regulators to ensure that a large bank would receive most of the cast-off branches. See Joan Vennoch, *Unknowns in the Fleet-BankBoston Merger Formula*, *Boston Globe*, Tuesday, June 22, 1999, A15. The game is obvious: Fleet and

This view of the durability of the existing enforcement framework is supported rather than undermined by the efforts to modify the CRA as part of the financial modernization legislation considered by Congress in 1999.¹⁷⁷ The legislation initially had three CRA-related goals: (1) to publicize CRA settlement agreements,¹⁷⁸ (2) to shift the burden of proof to protesters when a bank has had a satisfactory rating for three years,¹⁷⁹ and (3) to exempt small rural banks with deposits less than 100 million from the statute.¹⁸⁰ While there are strong arguments for each of these goals, one should note that they do not affect the central issue addressed in this paper, the discouragement of or failure to encourage private community investment efforts. The first two provisions have the combined effect of curtailing extreme and bad faith settlement agreements. Presumably lending pressure groups, in a regime in which settlements are made public, will seek cash payments that are clearly defensible in light of their programs and perhaps direct themselves toward agreements that actually control lending. Also, shifting the burden of proof requires certain claimants to come forth with evidence that the bank has a poor record. This requirement should permit banks to refuse a larger number of questionable settlement demands, though it remains to be seen what will happen in actual experience. The third provision deals with a problem that is largely irrelevant from the perspective of this paper.

The final version of the financial modernization bill contains three provisions dealing with the CRA: one barring a bank holding company from merging with an insurance or securities firm if any of its banks earned less than a satisfactory rating in the most recent exam, a second requiring disclosure of CRA settlements, and a third lengthening the period between exams for small banks (less than \$250 million in assets) that receive a satisfactory or outstanding grade in their last exam.¹⁸¹ However, there is an exception to the third provision permitting an earlier examination if a regulator thinks there is reasonable cause, or if a bank files a merger application.¹⁸² Like the initial provisions, the final provisions hardly touch the perverse incentive

Bank of Boston are agreeing to work with local politicians in meeting demands for additional lending, in exchange for efforts by those politicians to preserve certain competitive advantages. If, as often happens, the “new lending commitment” that emerges from this process is largely a plan to follow previous lending policies, then the banks will clearly have gained from their deal with the politicians.

¹⁷⁷ These efforts culminated in the Gramm-Leach-Bliley Act, 106th Cong. (1999).

¹⁷⁸ S. 900, 106th Cong., § 312 (1999)

¹⁷⁹ S. 900, 106th Cong., § 303 (1999)

¹⁸⁰ S. 900, 106th Cong., § 308 (1999).

¹⁸¹ At a Glance: Gramm-Leach-Bliley Act of 1999, *Am. Banker*, November 12, 1999, at 4.

¹⁸² *Id.*

issues under the current enforcement regime.

The conclusion suggested by recent reform efforts is that the heart of the statutory regime remains intact. Indeed, the CRA reform efforts have for the most part been exercises in chiseling around the corners of the statute. No reforms have been suggested to control the perverse effects, such as the incentive to satisfy CRA requirements by offering the most attractive terms to wealthy city developers. No reforms have been suggested to remove disincentives to entry in poor communities. The disclosure requirement, the only one of the initial CRA-related goals to survive the enactment process, may serve as a solution to the “hush money” problem, which is probably the one issue on which all banks agree. Beyond this, however, the banks apparently fracture, as evidenced by the dilution of the initial set of CRA reform provisions.

Thus, the enforcement regime we see today appears to be an equilibrium, in the sense that no party who can effectively control the outcome has an incentive to deviate from the existing practice. The large banks calculate their willingness to support or tolerate the current regime by trading off the benefits from competition barriers against the costs of regulation. For them, the marginal benefits probably exceed the marginal costs. The entrant groups all support the statute for obvious reasons.

Is there any likelihood this equilibrium will change? Lawrence White, in a perceptive critique of the statute, argued that it results in cross-subsidization by large banks, and that competition would eventually make this equilibrium unsustainable.¹⁸³ Thus, applying White’s thesis within the framework developed here leads to the suggestion that the current enforcement framework will remain in effect as long as large banks can profitably comply with the statute by cross-subsidizing inner-city lending. Any technological change that makes this cross-subsidization infeasible should result in large banks opposing the current regime, leaving only the entrant groups in support. Although the entrant groups may be strong enough to keep the existing framework for a period of time, they will eventually lose as the costs borne by banks, an organized interest group, grows relative to their benefits.

To make cross-subsidization by large banks unsustainable, some event must take place that eliminates advantages large banks have in the community investment regulatory process. One such event might be elimination of the scale-economy benefits of size. If large banks enjoyed no scale economies, they would no longer have an advantage over the small banks in subsidizing lending. However, it is unclear how scale economies could be eliminated in the banking industry. The internet may one day reduce the importance of scale economies in banking, but so far this has not happened. In addition, if internet banks are subjected to more onerous regulations, they may not be able to compete against large banks at all.

Since the advantages of size are likely to remain for some time in the banking industry,

¹⁸³ Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 *Fordham Urb. L. J.* 281, 285 (1993).

perhaps the only general prediction of the point at which the CRA is vulnerable to reform is that it will happen when large banks find that the competition benefits are not worth the regulatory costs. This is an open question, because it depends on how the CRA will be applied to internet banking and new competitive threats. To the extent large banks can control this, they have incentives to enter into political coalitions with other interest groups (specifically regulators and perhaps some lending pressure groups) to seek regulations that maintain the advantages enjoyed by large banks. Regulators have incentives to support such rules because the value of their human capital is dependent upon the maintenance of the existing regulatory process. Lending pressure groups have strong reasons to support such rules, because their long term interests are tied to those of the large banks they file protests against.

Some General Lessons for Regulatory Entrenchment and Reform

This discussion suggests some general observations on the economic theory of regulation. The theory predicts that reform is likely to occur when the gains to concentrated beneficiaries have disappeared, as a result of technological change or consumer tastes.¹⁸⁴ This explanation seems to fit the facts in the case of geographical restrictions in the banking industry and in the case of interest rate ceilings. However, the CRA is distinguishable from these examples.

Restrictions on entry form a fixed barrier to competition that can be eliminated by a technological change. For example, if consumers can carry out their banking transactions over a phone, or at an ATM machine, then rules preventing banks from setting up branches outside of their own geographical markets will do little to protect banks from having to compete with rivals outside of their geographical markets. Short of prohibiting the new technological innovation, there is nothing a legislator or regulator can do to prevent this outcome. Once technological change makes the physical location of a bank irrelevant in terms of its effect on competition, regulators cannot reinterpret geographical banking restrictions in a way that preserves competition barriers.

This vulnerability to technological change may not be observed in the case of other rules. The CRA is a malleable statute that can be modified and reinterpreted in ways that redistribute the benefits and costs among affected parties, and this feature gives the statute some resiliency in the face of technological change. Put another way, the economic theory of regulation should be modified to distinguish rules that are brittle, in the sense that they are vulnerable to obsolescence as a result changes in technology or consumer tastes, and rules that are capable of being modified over time to maintain political support.

In particular, a malleable statute such as the CRA is capable of being modified or reinterpreted, over time, in a manner that fractures opposition among concentrated interest groups. In the banking sector, as in most industries, there is one concentrated, well-organized group that is there from the beginning: the producers (or, specifically, the banks). After the

¹⁸⁴ Krozner, *supra* note 164.

statute has been enacted, various entrant groups, such as the lending pressure groups, emerge and form concentrated groups as well. However, entrant groups are unlikely to be, as a rule, as well-organized as the producers. For example, in the CRA context the lending pressure groups are not in communication with each other generally, and they are dispersed all over the country. Given this, maintaining a regulatory statute that burdens banks probably requires some fracturing or division among the banks. We see such a division with respect to the compliance costs of the CRA. To the extent that the statute provides a competitive advantage to some banks, it fractures the most reliably-concentrated interest group, and produces a sub-group among them that is willing to tolerate the statute.

There is enough here to sketch a general theory of regulatory entrenchment. A malleable statute can be defined generally as one that is either invulnerable to technological change or one that can be modified in order to maintain its regulatory force. Thus, the Sherman Act could serve as an example of an extremely malleable statute, because it is unlikely that changes in technology or tastes will ever make the Sherman Act's prohibition against anticompetitive conduct irrelevant. The Sherman Act will always be viewed by some firms as providing a competitive weapon against rivals,¹⁸⁵ whether or not those rivals are acting in a manner that actually harms competition. Minimum wage legislation serves as an example of the second type of malleable statute, one that can be revised over time to maintain its regulatory force. The minimum wage can easily become obsolete over time, as inflation erodes the real value of the wage floor. For example, while a minimum wage of \$2.00 per hour may have constrained some firms thirty years ago, it would have little regulatory force today, given that most firms pay workers well above \$2.00 per hour. However, obsolescence through inflation is not a serious problem for the interest groups that benefit from minimum wage legislation, because the legislature can always return to increase the minimum.

The CRA, the Sherman Act, and minimum wage legislation have in common the feature that they create divisions among the burdened regulatory group.¹⁸⁶ I have already discussed the divisions created by the CRA. The Sherman Act's passage was heavily influenced by pressure from rural cattle producers who were being put out of competition by large meat-processing

¹⁸⁵ On the use of the Sherman Act as a competitive weapon, see *THE CAUSES AND CONSEQUENCES OF ANTITRUST: THE PUBLIC CHOICE PERSPECTIVE* 180-181 (Fred S. McChesney & William F. Shugart II eds. Univ. Chicago Press, 1995) (discussing incentives of weak competitors to use antitrust laws); see also, William J. Baumol & Janusz A. Ordover, *Use of Antitrust to Subvert Competition*, 28 *J. L. & Econ.* 247 (1985).

¹⁸⁶ For a study suggesting the existence of such divisions among firms regulated by OSHA, see Ann P. Bartel & Lacy G. Thomas, *Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact*, 28 *J. L. & Econ.* 1 (1985) (presenting evidence that OSHA's enforcement of health and safety regulations favor large, unionized firms at the expense of small, non-union firms).

facilities in cities like Chicago.¹⁸⁷ Thus, at least some portion of the firms affected by the Sherman Act anticipated that it would become a competitive weapon. Minimum wage legislation creates divisions among affected businesses because it provides a competitive barrier against low-wage domestic competitors for firms in certain markets.

The general lesson for regulation suggested by experience with the CRA can be summarized as follows. First, a regulatory statute must be malleable in order to be durable. Otherwise, changes in technology and consumer tastes will render the statute obsolete. Second, the statute's durability is enhanced greatly if it fractures or creates divisions among the regulated firms. Fracturing the regulated interest group is important, because the firms are generally the most well-organized interest group. I have mentioned entrants as another organized interest group -- for example, the regulators and local politicians whose human capital is tied to maintenance of the existing regulatory regime -- but I doubt that the entrant groups associated with the CRA have the necessary organization and political clout to maintain the current regime in the absence of support or acceptance within some subgroup of regulated banks. Third, given these features, the statute can remain in force indefinitely as long as regulators and legislators reinterpret and alter the statute over time in a way that maintains political support, which may require the maintenance of divisions among regulated firms (i.e., splitting the opposition). Indeed, regulators should, under this theory, reinterpret a regulatory statute in a way that maintains support from the smallest subgroup of regulated firms necessary to maintain a dominant legislative coalition in support the statute.

V. CONCLUSION

Borrowing largely from the economic development literature, I have tried to set out a detailed theory of market failure that explains the shortage of credit and capital extended by financial institutions to residents of low-income urban communities. The asymmetric information theory yields predictions that are quite consistent with observations in the lending market, and unlike discrimination theory is not vulnerable to the critique that competition should provide a sufficient cure.

The second goal of this paper was to examine regulatory obstacles to development lending. The general framework of banking regulations, fairness coupled with safety and soundness regulation, inhibits the growth of large scale development lending efforts in the private sector. A superior regulatory regime would modify both forms of regulation with a view toward encouraging economic development.

¹⁸⁷ See Donald J. Boudreaux, Thomas J. DiLorenzo, and Steven Parker, *Antitrust Before the Sherman Act*, in *McChesney & Shugart*, *supra* note 164, 255- 270.