Yale Journal on Regulation

Volume 17
Issue 2 Yale Journal on Regulation

2000

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Keith N. Hylton

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Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending

Keith N. Hylton

Why are 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. 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 even in the absence of discriminatory intent.

I claim that the existing framework of banking regulation is in part responsible for the difficulty in finding a solution to the lending shortfall problem. The existing regulatory framework makes it difficult for large scale development-oriented lending institutions to emerge. This is 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. 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.

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. This implies both that the CRA should be modified so that it no longer prevents the expansion of small development-oriented banks that have followed a conservative lending policy and that deposit insurance should be privatized.

In spite of the potential benefits from these changes, they are unlikely to be observed in the near future, because 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.

† Professor of Law, Boston University School of Law. A.B., 1982, Harvard College; J.D., 1982, Harvard Law School; Ph.D. (Economics), 1986, 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 benefited from many remarks by participants in that conference, especially George Kaufman and Bert Ely.

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regime for the CRA. More surprisingly, large banks enjoy some benefits and probably benefit overall from the existing CRA enforcement regime.

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 progressive banking laws impede the functioning of the lending market. 1 Drawing largely on the economic

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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
development literature, I elaborate an alternative explanation here. 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 regardless of actual risk, while restricting the amount that can be borrowed. The application of the asymmetric information theory in this Article yields the prediction that urban minority communities will be underserved by financial institutions—indeed, that minority loan applicants will experience discrimination, in the sense that they will be rejected more often and will 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 institutional and environmental constraints. 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 in 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. However, the existing regulatory framework makes it difficult for large-


I hasten to add that I am 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).

For examples of the application of the asymmetric information theory in the economic development literature, see sources cited supra note 1; and infra notes 41-49 and accompanying text. 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 Hylton & Rougeau, supra note 1, at 258-59; and Klausner, supra note 1, at 1566-68. I have gone into considerable detail here in applying the theory to inner-city lending 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.

On the South Shore Bank and Grameen Bank development lending models, see infra notes 105-16 and accompanying text.
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 examiners for the Community Reinvestment Act (CRA), give banks poor evaluations on the basis of a conservative lending policy. 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 because CRA records are taken into account in the review of expansion applications.

An ideal regime would encourage development-oriented banks to expand and would 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. A private insurance scheme would allow banks to break out of a one-size-fits-all safety regulation regime and would 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 both that the CRA should be modified so that it no longer prevents expansion by small development-oriented banks that have followed a conservative lending policy and, simultaneously, that deposit insurance should be privatized.

Despite the potential benefits from these changes, they are unlikely to occur in the near future. The current regulatory regime is likely to remain intact for many years, largely because 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 probably benefit overall from the existing CRA enforcement scheme. CRA 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

6 See, e.g., Macey & Miller, supra note 1, at 317-18.
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business. Given these advantages, 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.

The CRA, in other words, remains durable because it operates in a manner 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 of Jonathan Macey and Geoffrey Miller, who have presented the only other interest-group theoretic analysis of the CRA. Macey and Miller suggest that banks are uniformly opposed to the CRA but are unable to bring about reform because of political impotence. In contrast, I argue that 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. First, fracturing the dominant regulated interest group can 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 malleability of a statute reduces the likelihood of its obsolescence through technological change. While many commentators have complained about the uncertainty of the CRA, this uncertainty is a major reason for its continuing vitality. Other banking regulations that were more specific, definite, and clear than the CRA regulations, such as branching restrictions, were rendered obsolete by technological change well before they were repealed. Third, as a positive prediction, regulators will attempt to interpret the CRA in the future to prevent its being made obsolete by new technology and to continue to fracture opposition among established banks.

In Part I of this Article, I provide an overview of development-oriented banking legislation. In Part II, I discuss the economics of development lending in inner cities, applying the asymmetric information model to lending markets for the urban poor and identifying specific market imperfections and potential market-based solutions. Part III

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7 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, 283-87 (1993).
8 On the competitive benefits provided to large banks, see infra notes 133-42 and accompanying text.
9 See Macey & Miller, supra note 1, at 343-44.
10 See, e.g., Klausner, supra note 1, at 1561 (stating that the CRA is "a model of ambiguity"); Macey & Miller, supra note 1, at 326 ("CRA ratings are inexact and subjective.").
11 See infra notes 166-69 and accompanying text.
discusses existing regulatory obstacles to development lending, including regulations that worsen market imperfections and hinder market-based solutions. Part IV provides an interest-group analysis of the CRA, emphasizing general lessons for regulatory reform.

I. Regulatory Efforts To Promote Inner-City Development

Congress acknowledged the existence of an economic development problem in many of the nation’s cities when it passed the CRA in 1977.\textsuperscript{12} The Act’s purpose was to encourage commercial banks and savings institutions to help meet the credit needs of the communities in which they are chartered.\textsuperscript{13} Although the CRA is often described as a response to redlining,\textsuperscript{14} the legislative history suggests that Congress was equally concerned with reversing, or at least halting, a general pattern of disinvestment from older, inner-city communities.\textsuperscript{15}

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.\textsuperscript{16} The statute provides that regulators should evaluate a financial institution’s CRA performance 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 by such institution[].”\textsuperscript{17} In practice, this means that regulatory agencies consider CRA performance when a financial institution seeks approval for a charter,

\begin{itemize}
  \item \textsuperscript{13} According to 12 U.S.C. § 2901 (1994):
    \begin{enumerate}
      \item The Congress finds that—
        \begin{enumerate}
          \item 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;
          \item the convenience and needs of communities include the need for credit services as well as deposit services; and
          \item regulated financial institutions have continuing and affirmative obligation [sic] to help meet the credit needs of the local communities in which they are chartered.
        \end{enumerate}
    \end{enumerate}
  \item \textsuperscript{14} See, e.g., Hylton & Rougeau, supra note 1, at 241; Overby, supra note 12, at 1446. As Hylton and Rougeau explain, “Financial institutions were known to outline entire metropolitan geographic zones in red to indicate to lending officers that no loans should be made for houses in those regions. These redlined areas were disproportionately located in minority and low- to moderate-income neighborhoods.” Hylton & Rougeau, supra note 1, at 241.
  \item \textsuperscript{15} See Garwood & Smith, supra note 12, at 251; Hylton & Rougeau, supra note 1, at 241.
  \item \textsuperscript{16} See 12 U.S.C. § 2902(1)(A)-(D); Garwood & Smith, supra note 12, at 252.
  \item \textsuperscript{17} 12 U.S.C. § 2903(2).
\end{itemize}
a merger, an acquisition, a branch, an office relocation, or deposit insurance. There are four possible ratings given to financial institutions under the CRA: outstanding; satisfactory; needs to improve; and substantial noncompliance.

The statute's impact on bank behavior is difficult to assess, because it is only within the last ten years that agencies have begun to signal that CRA compliance may be a key issue in the expansion approval process. This change of stance has occurred in response to pressure from community organizations, not because the agencies simultaneously decided to take CRA enforcement seriously. The CRA does not create private rights of action on the part of individuals. However, community groups have taken advantage of greater public access to information on the banks' community lending performance to put pressure on regulators—and the banks themselves—in the course of public hearings. Regulators apparently have felt a need to respond to the community groups by forcing banks to make changes in order to alleviate the CRA concerns raised by these groups. This phenomenon, 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 CRA's impact on banks is uncertainty over the compliance standards. Banks have complained over the years of uneven and unpredictable CRA enforcement, and compliance standards were recently revised in 1995. In general, there are two models of compliance standards: a "soft" subjective evaluation process that permits a bank essentially to make its own case for a good CRA grade, and a "hard" quantitative process that examines numerical evidence on lending and deposits. 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. It is probably

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18 See Garwood & Smith, supra note 12, at 252.
20 See, e.g., Hylton & Rougeau, supra note 1, at 243-44.
21 See id. at 244.
23 On the involvement of community pressure groups in the regulatory approval process, see Macey & Miller, supra note 1, at 333-37.
24 See id. at 328.
26 See Hylton & Rougeau, supra note 25, at 167-70, 186 (discussing recent regulatory revisions and general approaches to evaluating CRA compliance).
27 See id.
too early to tell whether the recent shift has led to a change in the behavior of banks. Nonetheless, 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) conducting self-examinations for CRA compliance; (4) marketing progress in investment activity to the surrounding community; and (5) maintaining adequate documentation of community investment efforts.28

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 neutral parties as well as the statute’s critics and proponents.29 However, overall the empirical evidence is quite scant; there have been few rigorous empirical evaluations of the impact of the CRA.30 Much evidence has been presented that cities are on the rebound31 and that mortgage and business lending by banks has increased in depressed areas.32 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


29 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 & Michael Schroeder, Law Requiring Banks To Aid Poor Communities Faces Uncertain Future as Gramm Mounts Attack, WALL ST. J., July 27, 1999, at A24.

For an article suggesting that the CRA has had little, if any, effect on lending, see Jeffrey W. Gunther et al., Redlining or Red Herring?, SW. ECON., FED. RESERVE BANK OF DALLAS, May/June 1999, at 8, 11-12 (reporting that the share of home purchase loans by CRA-covered banks remained at approximately 11.5% from 1993 to 1997, while the share of such loans by non-CRA institutions increased from 11% in 1993 to 14.3% 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 1 (DIVS. OF RESEARCH & STATISTICS AND MONETARY AFFAIRS, FED. RESERVE BD., Finance and Economics Discussion Paper No. 1997-7, 1999).


31 For a survey of the state of American cities noting recent signs of improvement, see America's Cities: They Can Yet Be Resurrected, ECONOMIST, Jan. 10, 1998, at 17 [hereinafter America's Cities].

32 See, e.g., Schlesinger & Schroeder, supra note 29 ("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.").

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have declined considerably since 1980, with the prime rate falling from 15% to roughly 8%. Unemployment has declined over the same period from 7% to 4.2%. Wealthy individuals have shifted money out of bank accounts and into mutual funds, forcing banks to seek deposits from less wealthy customers. Lower income borrowers have emerged in recent years as the fastest growing segment of the home mortgage market. 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 typically are more interested in management today than in the 1970s and early ‘80s, and this has encouraged businesses to stay in or relocate to the cities improving, in turn, the prospects for lending in depressed inner cities. Any rigorous assessment of the CRA should control for these and other factors in attempting to measure the impact of the CRA 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 1994 created the Community Development Financial Institutions (CDFI) fund, which is housed in the Treasury Department. The CDFI fund was initially authorized to spend $382 million over four years on CDFIs, 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. The CDFI program is quite different from the CRA, in the sense that the former aims solely to subsidize development lending.

Regardless of whether these regulatory efforts have improved, or will

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35 See America’s Cities, supra note 31, at 19.
37 See, e.g., Cunningham, supra note 36, at 270.
38 See id. at 269.
40 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 282-86. 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 generally David E. Runck, An Analysis of the Community Development Banking and Financial Institutions Act and the Problem of “Rational Redlining” Facing Low-Income Communities, 15 ANN. REV. BANKING L. 517 (1996).
improve, matters, it remains important to understand the link between lending and economic development in cities. Understanding this link is critical to finding 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.

II. The Economics of Development Lending in the 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, and specifically on the CRA, makes heavy use of theoretical work on the economics of discrimination, in order to justify statutes regulating bank lending.\footnote{See, e.g., Hylton & Rougeau, supra note 1, at 253-62; Swire, supra note 1, at 814-29.} 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.\footnote{See, e.g., DEBORAH RAY, DEVELOPMENT ECONOMICS 540 (1998). To be sure, the CRA literature includes some discussions of the asymmetric information theory. See, e.g., Hylton & Rougeau, supra note 1, at 258-59; Klausner, supra note 1, at 1566-68. However, most of these discussions mention the asymmetric information theory as one of several plausible explanations for sub-optimal lending patterns in inner cities.}

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.\footnote{See, e.g., Hylton & Rougeau, supra note 1, at 253.} 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,\footnote{GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION (2d. ed. 1971).} discrimination theorists have distinguished two types of discrimination. One, “taste-based” (or irrational) discrimination, assumes that discrimination occurs because the discriminating actor experiences some disutility from associating with the group he dislikes.\footnote{See id. at 16-17.} 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.\textsuperscript{46}

Asymmetric information theory focuses on the lender’s inability to 
assess the creditworthiness of a particular applicant or the risk propensity 
of the applicant’s intended use for the loan.\textsuperscript{47} 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.\textsuperscript{48} Credit rationing takes the form of a refusal either to lend as 
much as some loan applicants would like or to lend at all to some 
applicants to cap the total credit available.

Both the discrimination and asymmetric information theories can 
explain why race creates a difficulty for the lender in correctly assessing 
the risk associated with a particular loan. The theories also provide 
competing explanations for systemic racial inequities. 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 
both seem to 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. 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.

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

\textsuperscript{47} See, e.g., RAY, supra note 42, at 532.
literature, I will use the term "formal sector" to refer to banks, savings institutions, and other traditional financial intermediaries.\textsuperscript{49} I envisage a lending market that consists of formal sector lenders, such as banks, that 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. Sub-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,\textsuperscript{50} 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.

A. 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.\textsuperscript{51} 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.\textsuperscript{52} I have adopted the implicit assumption that community development lending means lending primarily for businesses, and secondarily for homes.

1. 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.\textsuperscript{53} As a result, it has become important for credit applicants to be


\textsuperscript{50} 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 \textit{Sub-Prime Lenders: Trailer Trashed}, \textsc{Economist}, Apr. 11, 1998, at 56, 56-57.

\textsuperscript{51} For an insightful analysis of micro-lending in developing countries, see Jaffer, \textit{supra} note 49. My discussions of borrower creditworthiness and business lending below have attempted to extend Jaffer's analysis to the problem of lending in inner cities.

\textsuperscript{52} 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.

\textsuperscript{53} See, e.g., Peter Hurst, \textit{The Guide to Credit Scoring}, \textsc{Credit Mgmt.}, Oct. 1998, at 33, 33 ("One of the greatest changes in the consumer credit world in the last 20 years has been the
able to adequately answer standard form questions, in order satisfy the demands of the modern mechanized process. 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 disadvantaged residents of inner cities.

Low-income residents of inner-city communities often cannot meet the transparency demands of the modern lending process, due to poverty and associated ills. 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. 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 local convenience and liquor stores to convert checks into cash. In the course of doing so, they typically pay a large share, as much as fifteen to twenty-five percent of the check, to a cashier. Without a financial record, a bank without a 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 large metropolitan areas. Layoffs and job replacement of manual judgmental credit assessment with credit scoring techniques.

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54 See, e.g., Jaffer, supra note 49, at 6-7.
55 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 Lawrence B. Lindsey, Real Progress Without Unintended Consequences, Address Before the Federal Reserve Bank of Cleveland’s Community Reinvestment Forum 9-10 (Sept. 25, 1993) (transcript on file with author).
59 See, e.g., GERALD DAVID JAYNES & ROBIN M. WILLIAMS JR., A COMMON DESTINY: BLACKS AND AMERICAN SOCIETY 319-23 (1989) (discussing access to jobs in high-poverty urban
dismissals occur more frequently for these groups.\textsuperscript{60} This results in poor credit histories, because of the general lack of wealth in the form of savings, inherited money, or home equity.

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. For individuals 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 that 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.\textsuperscript{61} African-American city residents are segregated to an extent far beyond that observed among other racial and ethnic groups in America,\textsuperscript{62} which amplifies differences in the incidence of poverty in white and black urban neighborhoods.\textsuperscript{63} In the Chicago area, for example, four out of five poor areas); John D. Kasarda, \textit{Urban Change and Minority Opportunities}, in \textit{The New Urban Reality} 57-58 (Paul E. Peterson ed., 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\% for white males and 23.4\% for black males). One commonly offered reason for the higher unemployment rate for minorities in cities is the movement of businesses out of cities. On the "spatial mismatch" between the locations of jobs and city residents, see Harry J. Holzer, \textit{The Spatial Mismatch Hypothesis: What Has the Evidence Shown?}, 28 \textit{URB. STUD.} 105 (1991); John Kain, \textit{Housing Segregation, Negro Employment and Metropolitan Decentralization}, 82 \textit{Q.J. ECON.} 175 (1968); and Steven Raphael, \textit{Inter- and Intra-Ethnic Comparisons of the Central City-Suburban Youth Employment Differential: Evidence from the Oakland Metropolitan Area}, 51 \textit{INDUS. & LAB. REL. REV.} 505 (1998) (comparing unemployment rates in downtown and suburban Oakland). For a survey of the empirical literature on racial differences in employment, see Harry J. Holzer, \textit{Black Employment Problems: New Evidence, Old Questions}, 13 \textit{J. POL'Y ANALYSIS & MGMT.} 699 (1994).

60 See Francine D. Blau & John W. Graham, \textit{Black-White Differences in Wealth and Asset Composition}, 105 \textit{Q.J. ECON.} 321, 327-30 (1990) (arguing that blacks have less wealth than whites, and blacks living in cities have less wealth on average).

61 See \textit{DOUGLAS S. MASSEY & NANCY A. DENTON, AMERICAN APARTEIDH} 74 (1993) (defining five types, or "dimensions," of segregation and noting that African Americans are both more segregated than other groups on any single dimension of segregation and 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. \textit{WILLIAM JULIUS 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, \textit{America's Urban Crisis: Symptoms, Causes, Solutions}, 71 N.C. L. REV. 1351 (1993).

62 See \textit{MASSEY & DENTON, supra} note 61, at 74-78. On the economic implications of hypersegregation, see generally David M. Cutler & Edward L. Glaeser, \textit{Are Ghettos Good or Bad?}, 112 \textit{Q.J. ECON.} 827 (1997) (concluding that blacks in more segregated areas have significantly worse outcomes than blacks in less-segregated areas).

63 To illustrate, suppose that, in a particular city, the poverty rate among whites is 10\% and the poverty rate among blacks is 30\%. If the city were perfectly integrated, with equal numbers of whites and blacks, the poverty rate in every sector would be 20\%. However, if the city is perfectly
whites live in mixed-income areas, compared to only one in five poor blacks. This has several implications for access to credit.

First, the most important informal sector credit source, 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. Potential borrowers need to know who 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 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. 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.
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. 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 unavailable as a practical matter because of hypersegregation.

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 these sources about his creditworthiness. This would be an expensive undertaking, with an uncertain payoff. Given that the loan officer is unlikely to know anyone who knows the information sources, he cannot easily verify their reliability. Moreover, because the information sources are unlikely to have repeat dealings with the loan officer, they would have, at best, weak incentives to protect their own reputations for providing reliable information. The rational response of the loan officer is to discount heavily 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.

2. Small Business Lending, Segregation, and Risk Control

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

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*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 asset levels and probabilities of having self-employed fathers explain a large part (roughly 30%) 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, 96-97.*

*69 For observations on the importance of local information in the lending process and the constraint imposed by segregation, see Taibi, supra note 1, at 1482-83.*

*70 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. ECON. & BUS. 64 (1991) (finding that black-owned firms receive smaller loans than white-owned firms possessing identical measured characteristics). For a report on studies finding discrimination in small business lending, see Jeffery A. Tannenbaum, Small Business Lenders Rebuff Blacks, WALL ST. J., July 7, 1999, at A2.*

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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, the lender must still worry about the creditworthiness of the borrower. Put another way, even if the project itself is without risk, 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 also makes it difficult to assess the risks associated with a start-up business. If the business relies, as small businesses typically do, on 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 to assess independently 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 influential work on credit rationing demonstrates that, in the presence of informational asymmetry, a lender will ration credit. 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. The lender also limits his exposure by restricting 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.

There are methods a lender can use to limit risk and thereby meet the

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71 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. BLACK POL. ECON. 24, 40 (1989).

72 It would be worth noting that this loan officer has neither information regarding nor informal contacts with residents of the community.

73 See Stiglitz & Weiss, supra note 2, at 402-406; see also Ray, supra note 42, at 546; Jaffer, supra note 49, at 8.
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. Collateral sometimes has the effect of controlling or mitigating the adverse selection problem, and has 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. 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 who 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, 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 discussed in the literature on bankruptcy is the incentive of the debtor-in-possession to adopt risky projects. 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 a "Hail Mary" pass for a touchdown in the waning seconds of a football game. The same incentive is observed after a borrower has taken loan money and faces a choice to take or to avoid a

74 See Stefania Cosci, Credit Rationing and Asymmetric Information 29, 39-42 (1993); Stiglitz & Weiss, supra note 2, at 402.
75 See, e.g., Douglas Baird & Thomas Jackson, Cases, Problems, and Materials in 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.").
risky decision that could increase the project's profitability.\textsuperscript{76} 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 make "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 make decisions that are actuarially safer, in the sense that they increase the likelihood he will repay the loan in full.\textsuperscript{77}

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.\textsuperscript{78} A collateral requirement may have perverse incentive effects from the lender's perspective. It may induce borrowers to choose smaller projects, and if smaller projects have higher failure probabilities, increasing the collateral requirement may augment the risk propensity of the lender's portfolio.\textsuperscript{79} 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.\textsuperscript{80} 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.\textsuperscript{81}

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 less-wealthy borrowers to drop out of the market, increasing the risk of the lender's portfolio.\textsuperscript{82} 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.

This suggests one route through which hypersegregation may influence the lender's collateral policy. Given his lack of 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

\textsuperscript{76} For an illustrative numerical illustration of the incentive-alignment effect, see Jaffer, supra note 49, at 8-9. For more general discussions, see COSCI, supra note 74, at 42-44; and Stiglitz & Weiss, supra note 2, at 405-06.
\textsuperscript{77} See Stiglitz & Weiss, supra note 2, at 403.
\textsuperscript{78} See, e.g., COSCI, supra note 74, 42-44.
\textsuperscript{79} See Stiglitz & Weiss, supra note 2, at 402.
\textsuperscript{80} See id. at 405.
\textsuperscript{81} See COSCI, supra note 74, at 43-44 (citing Hildegard C. Wette, Collateral in Credit Rationing in Markets with Imperfect Information, Note, 73 AM. ECON. REV. 442 (1983)).
\textsuperscript{82} See Stiglitz & Weiss, supra note 2, at 403-05.
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.\textsuperscript{83} 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.\textsuperscript{84} 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 a 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 United States,\textsuperscript{85} wealth levels continue to remain far apart.\textsuperscript{86} 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 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.\textsuperscript{87} 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

\textsuperscript{83} A risk-averse individual would be unwilling to pay 50\$ to enter a lottery promising one dollar with probability two and zero dollars with probability two. He would demand a lower lottery price in order to compensate him for his aversion to risk. For an introductory discussion on risk aversion, see ANDREAU MASS-COLELL ET AL., MICROECONOMIC THEORY 185 (2d ed. 1995).

\textsuperscript{84} This assumes that the implicit insurance premium is set at the competitive or actuarially fair price. \textit{See id.} at 187-88 (discussing incentive of risk-averse decision maker to purchase insurance coverage).


\textsuperscript{87} This is easy to see. Suppose \( A \) and \( B \) both own cars worth $5000. The probability of theft in \( A \)'s neighborhood is 1\%, versus 15\% in \( B \)'s area. For someone who plans to take possession of the car at some future date, the expected value of \( A \)'s car is \((.99)(5000) = 4950\), while the expected value of \( B \)'s car is \((.85)(5000) = 4250\). Thus, being located in a high-theft area devalues \( B \)'s car by $750.

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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, generating 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.

3. Residential Lending, Social Capital, and Segregation

When one examines residential lending in poor urban areas, it becomes evident that there are informational barriers to residential lending as steep as those in the business context. First, there again arises the problem of assessing borrower creditworthiness. This is unavoidable, and the problems of hypersegregation discussed above make this assessment difficult for reasons already given. In second, as 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 the latter sense, a home mortgage gives the borrower a type of 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 at the fixed strike price. In the home mortgage contract, the relevant strike price to

88 In applying the asymmetric information model to residential lending, I do not intend to minimize the historical importance of intentional discrimination in the residential lending 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 EST. LIT. 15 (1999).

89 A put option on a stock gives the holder of the option the 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 & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE 432-33 (2d ed. 1984). On put options and mortgage contracts, see generally Jimmy Hilliard et al., Valuing Prepayment and Default in a Fixed Rate Mortgage: A Bivariate Binomial Pricing Technique, 26 REAL EST. ECON. 431 (1998); and Brent W. Ambrose & Richard J. Buttimer, Jr., Embedded Options in the Mortgage Contract (1998) (unpublished Univ. of Wisconsin-Milwaukee discussion paper on file with author).
the borrower is the outstanding amount of the loan. 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.

By comparison, a lender viewing the house as a security 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, creating 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 effect 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 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. For the purposes of this essay, I will treat social capital as 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. The borrower (or homeowner) will have relatively weak incentives to make investments in maintaining and improving his property when any of the following three conditions exist: first, the home is located in an area where a large percentage of families have dissolved; second, few residents have an ownership interest in their residences; and third, a relatively low state of public order pervades the neighborhood.

To illustrate, one would have weak incentives at best to 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,

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everything else the same, in poor communities where relatively few 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; 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 likely to be wandering outside will be those intending to commit a crime. Consider also the quality of local schools. Should a community lose faith in the quality of the schools, residents who are concerned about the education of their children will take their children out of the local schools, further diminishing the overall worth of the education system. 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 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 but it would be profitable for them if all banks were to lend. 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 on the help of a bank. Coordination problems can arise with respect to these investments. In order to maintain some types of

91 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 can obtain more information by observing the behavior of others. Rational herding is clearly relevant in explaining the decisions of people to move into or out of certain neighborhoods. On rational herding generally, see A. Banerjee, A Simple Model of Herding Behavior, 107 Q.J. ECON. 797 (1992); and David Scharfstein & Jeremy Stein, Herd Behavior and Investment, 80 AM. ECON. REV. 465 (1990).

92 See, e.g., Hylton & Rougeau, supra note 1, at 257-58; Swire, supra note 1, at 522; see also Klausner, supra note 1, at 1571 (discussing the tendency of banks to follow lending decisions of their rivals as contributing to investment declines in depressed communities).

93 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.
social capital within a community, given the probable necessity of these cheaper, continuous investments, it would be rational for a bank to make some assessment of the state of these investments before committing itself to lend within that community. 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. This social capital, in turn, 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.

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

94 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 of capital put at risk. For further discussion of social capital investment and risk, see infra text accompanying notes 98-99.

4. Summing Up

The asymmetric information theory developed so far arguably is superior to the alternative theories of market failure based on discrimination models. This 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. 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, and this seems implausible. Moreover, banks that consistently avoid profitable lending opportunities, because of taste-based discrimination, would suffer in the competitive process relative to non-discriminating banks. 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 lenders try more strenuously to screen out bad risks.

Consider also the statistical or rational discrimination theory. As I noted earlier, the statistical discrimination theory can be synthesized with the asymmetric information theory, a process that I have attempted to undertake 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 borrowers (e.g., diluting the incentive to appear creditworthy) or results in an inferior coordination equilibrium among lenders. But both of these arguments strain believability at times. The fundamental flaw in both arguments is

96 See Hylton & Rougeau, supra note 1, at 254.
97 See id.; see also Macey & Miller, supra note 1, at 308-09 (questioning the assumption that banks consistently would overlook local profit opportunities).
98 See J. Miguel Villas-Boas & Udo Schmidt-Mohr, Oligopoly with Asymmetric Information: Differentiation in Credit Markets, 30 RAND J. ECON. 375, 375 (1999) ("[W]ith 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.").
99 See, e.g., Hylton & Rougeau, supra note 1, at 254-59 (reviewing theory of statistical discrimination in application to credit markets). Swire argues that victims of lending discrimination will not invest as much in creditworthiness. See Swire, supra note 57, at 1537-41 & nn.39-40.
that they put too much emphasis on the role played by formal lenders in the formation of social capital and individual patterns of conduct.

B. 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 disadvantaged 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.

1. 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. 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. Indeed, the check-cashing process can be seen as a temporary loan, for which the bank seeks repayment from 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

100 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. REFORM 773, 785 (1994).

101 This is because of the risk of fraud. I thank George Kaufman for making this point to me in a conversation.
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, 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, currency exchanges 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 stores 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.

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. 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 wealth levels within the upcoming decades.

For an example of such co-location, see Susan Strom, E-Commerce the Japanese Way: Ubiquitous Convenience Stores Branch into Cyberspace, N.Y. TIMES, Mar. 18, 2000, at B1 (discussing integration of Internet commerce and banking with convenience stores in Japan).

See Swire, supra note 57, at 1538.

See, e.g., Glenn C. Loury, Opting Out of the Boom: Why More Blacks Don’t Invest, N.Y. TIMES, June 7, 1998, § 6 (Magazine), at 70. On the divergence in white and black wealth levels, see Blau & Graham, supra note 60, at 327-30.
2. Ownership, Entrepreneurship, and Risk

The long-term benefit from expanding the class of owners and entrepreneurs is the enhancement of social capital within relatively impoverished inner-city neighborhoods. Lending is the most obvious channel through which a bank could contribute to this process because lending 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 inner-city communities is the lack of what I described earlier as an informational infrastructure. Informal lenders need access to information on the trustworthiness of borrowers and, in addition, borrowers need access to information on the reliability of lenders because informal lending networks typically operate without the threat of legal sanctions. Formal lenders, such as banks, 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, such as an earthquake, a local economic shock, like the sharp decline in oil prices in Texas in the 1980s, or a riot, such as the one in 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 the services of 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 holding companies. For example, the Shorebank holding company includes affiliates specializing in housing development, business development, job training, and education. 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. 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 by 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. 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. 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 of ninety-seven percent, and programs based on the Grameen Bank model have had similar results. More importantly, the evidence suggests that the lending programs have had an effect on wealth accumulation and

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105 For an excellent discussion of the South Shore Bank, the Southern Development Bancorporation, and other community development banks, see Lento, supra note 100, at 782-99.
106 See id. at 786-88.
107 For a similar point, see Klausner, supra note 1, at 1578-79 (discussing the South Shore Bank).
108 For an excellent discussion of these associations and their implications for community development lending, see generally Lan Cao, Looking at Communities and Markets, 74 NOTRE DAME L. REV. 841 (1999).
109 See RAY, supra note 42, at 579; Jaffer, supra note 49, at 18.
110 See Jaffer, supra note 49, at 3.
111 See id. at 2.
behavior. A study by economists Mark Pitt and Shahidur Khandker finds that the Grameen Bank and similar programs in Bangladesh have led to significant increases in household expenditure and the probability that children would be enrolled in school.\(^{112}\)

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.\(^{113}\) Lending for business projects in cities involves different issues. The proceeds from harvesting a crop can be used to pay off a loan within a year. However, start-up businesses need more time to develop financially, and thus 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.\(^{114}\) 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.\(^{112}\) If the sanctioning mechanisms are weak, as they are in most relatively poor communities, no one will accept 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 serve the bank’s purposes;\(^{116}\) (2) transfer lending risk away from the bank, whether to borrowers (as in the case of group lending) or to third parties; and (3) coordinate 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


\(^{113}\) Jaffer notes that Grameen Bank loans must be repaid in equal installments over fifty weeks. See Jaffer, *supra* note 49, at 18.


\(^{115}\) I should note that bank-based keh systems have been proposed in the United States. See, e.g., Macey & Miller, *supra* note 1, at 345; Getreu, *supra* note 114, at 7.

\(^{116}\) On group lending and the economics of information, see Timothy Besley et al., *The Economics of Rotating Savings and Credit Associations*, 83 AM. ECON. REV. 792 (1993); and Timothy Besley & Stephen Coates, *Group Lending, Repayment Incentives and Social Collateral*, 46 J. DEV. ECON. 1 (1995).
progress on the third. 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 depositaries, 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 paid 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. Subsidization via 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 also could subsidize inner-city development lending by providing tax credits for development loans, or creating an equivalent to Freddie Mac or Fannie Mae that would facilitate the securitization of small business loans in depressed urban areas. These

117 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 BUS. J., Feb 19, 1990, at 23.


119 Fannie Mae is a federally-sponsored, privately-owned corporation that purchases 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 12 Federal Home Loan Banks, serves the same function, though focusing on conventional mortgages. For a basic description of this program, see id. at 755 & n.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 36, at 669. However, Shields’s 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. See 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, AM. BANKER, June 15, 1999, at 1. Marcus 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. Marcus, supra note 118, at 755-57. 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 Mac. For example, if banks that did
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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, a preferable regulatory regime 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 disadvantaged urban 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. But the existing regulatory regime makes this development unlikely.

III. 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 to a large-scale effort. A city-based development bank would experience conflicting pressures from fair lending regulations on one hand and safety and soundness constraints on the other. Moreover, subsidization at the municipal or federal level to support such a bank would be politically infeasible.

A. Conflict Between Fair Lending and Safety Regulation

Since a lending program that focuses on relatively poor and 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

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.

120 On the risk-taking incentives created by deposit insurance, see, for example, Better than Basle, ECONOMIST, June 19, 1999, at 80 (reviewing bank safety regulation).

121 For details on such an ideal regime, see infra text accompanying notes 135-36.

122 By "fair lending regulation," I refer specifically to the CRA. The conflict between safety and fairness regulation has been noted before. See, e.g., Macey & Miller, supra note 1, at 318-24. A recent empirical study confirms this conflict. See Jeffrey W. Gunther, Between a Rock and a Hard Place: The CRA-Safety and Soundness Pinch, ECON. & FIN. REV., 2d Qtr. 1999, at 32-41 (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 become evident in the text, I focus on the conflict between fairness and safety regulation from a different perspective.
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regulators, who generally require diversification in loan portfolios. Consequently, an institution that lends primarily to residents of the inner city probably would be constrained to extend fewer loans than it would like. Indeed, banks lending in inner-city markets will have a low loan-to-deposit ratio compared to banks operating outside of these areas. The fair lending constraint now enters. Given the bank’s low loan-to-deposit ratio, imposed in part by its 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. These low evaluations will lead regulators to reject future plans for expansion—since the regulators take into account community lending evaluation records—thus eliminating the bank’s ability to reduce risk in that fashion.123

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 engage in the additional lending that it desires. But banks do not ignore the safety and soundness regulations because bank charters can be and are effectively revoked for failing to meet them.124 A bank will, given the choice between meeting the CRA requirements and safety and soundness requirements, opt in favor of the latter if it wants to remain in business. Failing to meet the CRA requirements only prevents future expansion, while falling short in meeting 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 the geographically-associated risks that have been the primary sources of bank failures.125 Thus, in an ideal world, a bank that intends to do community lending would expand in order to reduce its risk and to take advantage of economies of scale. The CRA constraint, however, may prevent this desirable expansion, providing 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

123 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”).
124 On the disciplinary actions available to bank regulators, see JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 570-603 (2d ed. 1997).
125 See, e.g., PIERCE, supra note 33, 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.”).
Both constraints contribute equally to this paradox. On one hand, if we remove the CRA constraint, the bank could expand to a level at which conservative bank managers would accept additional risk. On the other hand, if we remove the safety and soundness restrictions, the bank could lend more and, perhaps, satisfy the requirements of the CRA. 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.

This paradox probably serves as a description of the bind that some community banks find themselves in now. Small banks are overrepresented among banks that have poor CRA ratings (either “needs to improve” or “substantial noncompliance”). The relative performance of small banks in the 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, seventy-two percent of the banks listed in Table 1 with low CRA grades were small banks.

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126 Cf. Leonard Bierman et al., The Community Reinvestment Act: A Preliminary Empirical Analysis, 45 Hastings L.J. 383, 397 (1994) (finding that highly-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 302-03 (noting that large banks on average have better CRA ratings).
Yet, many of the small banks are ethnic and minority-owned banks that were established with the primary aim of providing loans for business purposes within a small ethnic or minority community. Indeed, one of the ironies of the CRA as implemented is that minority-owned banks have received relatively poor grades.\(^{127}\)

What explains the relatively poor performance of minority-owned banks in the CRA evaluation process? Because the theory that community banks operating within cities discriminate against “their own kind” seems implausible, the most likely explanation is that this reflects the regulatory

\[^{127}\text{See Harold A. Black et al., }\text{Do Black-Owned Banks Discriminate Against Black Borrowers?}, 11 J. FIN. SERV. RES. 189, 202 (1997); see also Leslie Eaton, }\text{A Shaky Pillar in Harlem: Black-Owned Carver Bank Seeks Solid Financial Base, }\text{N.Y. TIMES, July 11, 1999, at 21 (noting conservative lending approach of Carver and other minority-owned banks).}\]
Catch-22 these banks have encountered. There are six 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, because they generally will have the strongest desire to expand, if only to keep up with their peers.128 Given that 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 often operate in riskier markets, without the economies of scale and revenue sources of the large banks, creating a higher cost of complying with regulatory lending demands.129 Third, to the extent large banks are compelled by the need to earn CRA credits to extend loans in depressed communities,130 they are likely to extend loans to the most creditworthy applicants in these areas. This choice leaves the riskier credit applicants to the smaller minority-owned banks, which, in turn, further 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 outside this particular community.131 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. Consider loan syndicates, for example. 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, it is not likely that the minority-owned banks will be included in these arrangements.

128 See Macey & Miller, supra note 1, at 303.
129 On the costs of compliance, see Anjan V. Thakor & Jess C. Beltz, An Empirical Analysis of the Costs of Regulatory Compliance, in CONFERENCE ON BANK STRUCTURE AND COMPETITION 549 (19th ed. 1983) (finding that net income and CRA compliance costs as function of asset size decline with institution size).
130 On the CRA’s competitive impact on minority-owned banks, see Macey & Miller, supra note 1, at 341; see also John R. Wilke, Giving Credit: Mortgage Lending to Minorities Shows a Sharp 1994 Increase, WALL ST. J., Feb. 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”).
B. The 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.

The current CRA framework 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. On the other hand, certain parties prefer the CRA regulatory regime as it presently stands. One group consists of direct beneficiaries: community pressure groups and politicians who seek a support base within these groups. The CRA authorizes regulators to consider community development efforts in reviewing the expansion plans of a regulated institution. Therefore, the CRA 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 to these groups. 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.

The current regulatory regime does not injure all lending institutions. As a method to assess the effect of the CRA regime, it is reasonable to divide banks 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-city neighborhoods 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 inherent to operating within the city.

Large banks, in comparison, benefit from the current regulatory regime. For many of them, the cost of complying with the CRA is

132 See Hylton & Rougeau, supra note 1, at 281-82; Macey & Miller, supra note 1, at 332-33.
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relatively small, as evidenced by their excellent compliance records. The burden of maintaining a compliance officer on staff is relatively small for large banks. Large banks earn profits in high-end service markets to subsidize lending and services, such as low-cost checking accounts, in low-end markets. In addition, 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, large banks have both the wherewithal and incentives to structure their lending programs in a manner that exposes them to the least amount of risk sufficient to satisfy their CRA obligations. The ex post distribution of compliance costs gives large banks a competitive advantage over their smaller rivals.

Today's regulatory regime, by rendering small bank expansion more difficult, generates an additional competitive advantage to large banks. Small banks are, for reasons already given, effectively prohibited from expanding in inner-city 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. This competitive barrier provides large banks an additional advantage in dealing with local political leaders. Given the city's reliance on the large banks for lending,

133 On the compliance abilities of large banks, see supra text accompanying notes 7-8.

134 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 & LORETTA J. MESTER, WHAT EXPLAINS THE DRAMATIC CHANGES IN COST AND PROFIT PERFORMANCE OF THE U.S. BANKING INDUSTRY? (Wharton Fin. Insts. Ctr., Univ. of Pa. Working Paper No. 99-1, 1999). The banks earned greater profits from fees connected to new services, such as mutual funds, derivatives, ATM networks, on-line services, and debit and credit cards. See id. at 27. see also Lawrence J. Radecki, Banks' Payments-Driven Revenues, ECON. POL'Y REV., FED. RESERVE BANK OF N.Y., Apr./June 1999 (finding that payment services bring in from one-third to two-fifths of the combined operating revenue of the 25 largest bank holding companies).

135 See Hylton & Rougeau, supra note 25, at 184-87 (discussing CRA "compliance stratagems"). Indeed, there is evidence suggesting that large banks have discovered ways to splinter lending pressure groups and preemptively to 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 eventually ignored the groups. See Yawu Miller, Mortgage Program Comes Under Fire, BAY STATE BANNER, June 17, 1999, at 1. Fleet had no incentive to continue to negotiate with the community groups after striking a deal with Marks for two reasons: first, because the Marks deal would help the bank meet its obligations; and second, because it would purchase Marks's support for future CRA hearings necessitated 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. See id.

136 Of course, no spokesperson for a large bank has, to my knowledge, offered this as a reason for supporting the CRA. However, it is not 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 that "[m]y 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, July 18, 1999 at 11 (quoting McColl).
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 benefiting large banks is buttressed by the process of CRA regulation. Large banks have two advantages 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, given the greater scope and complexity of large bank operations. The regulators are at an informational disadvantage in the case of large banks and must rely to some extent on the evidence they are given by the bank. In the case of a small bank, it is easier to evaluate independently the bank’s community lending efforts. Second, CRA examiners, unlike safety examiners, tend to be young and inexperienced. This use of novice examiners makes the informational disparity problem worse, suggesting that the examiners are likely to be a bit more humble in their dealings with large banks.

The competitive advantage also assists large banks in fending off competition from foreign banks and the new Internet banks. 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 with a high probability of CRA-related protests does not typically wait for the start of the merger or expansion process before 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 either merger or expansion applications are filed with the relevant regulatory body. 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; or if it is aware, it may not

137 One scholarly critique of the CRA noted that it provides an advantage to established banks relative to those trying to "reposition themselves in the market." Macey & Miller, supra note 1, at 315.

138 Bankers have noted the lack of training and inexperience of examiners in their complaints over the uncertainty surrounding CRA enforcement. See Hylton & Rougeau, supra note 25, at 167-68.

139 Both an informational disparity and a disparity in social status probably have 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 33, at 99.

140 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¢ using an ATM, and $1.27 using a bank teller. See How To Live with Falling Prices, ECONOMIST, June 12, 1999, at 57.
know how to identify or how to go about paying off the correct parties. In addition, a foreign bank might encounter some excessive demands, given the presence of local xenophobia. Pressure groups and politicians may also perceive that foreign banks are relatively inexperienced in local affairs and especially eager to enter the market. As for the new Internet banks, they too may be hobbled by the CRA, because it is unclear at this stage how the statute will be applied to them.

The three interest groups that have the most power to influence CRA legislation are local lending pressure groups, politicians, and banks. Yet of these groups, only one relatively small sub-group of banks 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 set of incentives, 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 effect is desirable, though it would be observed under an alternative regime in which development-oriented banks were given greater encouragement. The lending that does take place provides a large share of benefits to relatively undeserving parties, such as inner-city developers who gain by receiving favorable terms, creating yet another concentrated interest group in favor of the current regulatory regime. For example, the statute gives large banks incentives to compete aggressively in lending 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.

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

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141 I do not have in mind hatred of foreigners but a rational distrust that community-lending interest groups are likely to have in this case. They will tend to be skeptical of foreign banks, viewing them as even less concerned with the welfare of local residents than the typical large domestic bank.

142 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, U.S.L.W., May 11, 1999, at 2663. The tensions surrounding the regulation of branchless banking erupted into 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, AM. BANKER, July 8, 1999, at 2.
hazard problem generated by deposit insurance.\textsuperscript{143} 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 hazard.\textsuperscript{144} 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.\textsuperscript{145} However, not all banks are alike with respect to the risk generated by a particular activity, and not all borrowers of a certain type (for example, small firms or governments) are alike with respect to the risk that they may incur.\textsuperscript{146} 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 ideally should reflect the amount of driving the driver does and the 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.\textsuperscript{147} In this ideal system, the driver

\textsuperscript{143} See, e.g., Better than Basle, supra note 120.

\textsuperscript{144} On the moral hazard problem in banking, see Sudipto Bhattacharya et al., The Economics of Bank Regulation, 30 J. MONEY, CREDIT, & BANKING 745, 755-57 (1998).

\textsuperscript{145} 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). Based on this evaluation, the bank is assigned a numerical ranking from one through five, with five being the worst. See, e.g., Gunther, supra note 122, at 32. For a discussion of the difficulties of assessing safety and soundness under this system, see PIERCE, supra note 33, at 97-100. For large banks, the most important safety rules are the capital-adequacy standards applied to banks that operate internationally. See When Borrowers Go Bad, ECONOMIST, Feb. 28, 1998, at 79, 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 over safer corporations, because a risky government borrower will pay a higher interest rate but will not force the bank to set aside more capital. See id.

\textsuperscript{146} See When Borrowers Go Bad, supra note 145, at 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, ECONOMIST, Apr. 17, 1999, at 6-7 (discussing differentiation among banks). As Cookson observes, “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.

\textsuperscript{147} See, e.g., Steven Shavell, On Liability and Insurance, 13 BELL J. ECON. 120, 128-29 (1982) (proving optimal results when insurer can monitor conduct of insured, and premium therefore
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 analogy 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 it by classifying drivers into risk categories and, sometimes, rating insurance prices by driver experience. An optimal system of safety regulation for banks would attempt to approach this ideal. 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, because a closer alignment between the price and real cost of risk would benefit both parties to the insurance contract; it benefits 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 perfect 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. The Grameen Bank has demonstrated that lending to poor communities can be carried out in a relatively safe manner, 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 group lending model, or perhaps through the securitization of small business loans, could be developed as a general method to minimize 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 effectively to privatize safety regulation by requiring banks to insure deposits in the private insurance market. Such a regime would encourage specialization in methods of risk reduction and risk assessment for lending markets, and

148 See Jaffer, supra note 49, at 3 (noting Grameen Bank’s repayment rate of 97%).

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.150

Under the current regime, bank officers sometimes rely on safety regulators to provide warning about sources of risk in the bank’s operations.151 The regulators, however, do not have the best incentives to discover risk and issue optimally-timed warnings.152 Their fates are not tied to the health of the banks they regulate, and they are not always penalized for failing to act swiftly to prevent disasters.153 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, one 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.154

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

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150 One might object that this proposal 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.

151 Indeed, given federal deposit insurance, banks have incentives to take on excessive risk, see Better than Basle, supra note 120, so it naturally falls to regulators in many cases to provide the warnings. For an account of the savings-and-loan crisis attributing the crisis to lax supervision and bad incentives, see PIERCE, supra note 33, 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 Ely, supra note 149, at 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. See Allen Berger & Sally M. Davies, The Information Content of Bank Examinations, 14 J. FIN. SERV. RES. 117 (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. They 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. See id.

152 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 numerous incidents suggesting overzealous enforcement by bank regulators, see Terry Carter, Banking on Fear, A.B.A. J., July 1999, at 40.

153 See, e.g., Ely, supra note 149, at 5-6 (discussing absence of liability concerns among bank regulators).

154 The reason for this 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, because the private benefits of monitoring (for public regulators) may not be closely tied to the social benefits (avoided losses).
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. 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 the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA), the likelihood of moral hazard infecting their lending policies 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, 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. 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.

With some large banks and probably many small banks benefiting 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.

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155 See, e.g., PIERCE, supra note 33, at 74-75 (discussing lending policies of large banks and lending crises during the 1980s).
156 12 U.S.C. § 1823(c) (1994). For a review of the 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 E. Litan, Regulation: Disciplining Large Banks After FDICIA, 19 J. RETAIL BANKING SERV. 57, 58 (1997).
158 See id. at 5-6.
159 I should note that the FDIC recently introduced risk-based deposit insurance prices. See, e.g., Bhattacharya et al., supra note 144, 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, because any effort to move toward real risk-based pricing would generate complaints and political pressure from banks that would see their premiums rise.
C. **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. Intuitively, this is a sensible approach 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 like 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.\(^{160}\) 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. Residents of poor neighborhoods do not fund political campaigns. In addition, they have little incentive to invest time and resources into understanding community development issues, and generally lack the resources to make such investments. The result is a process that provides few, if any, incentives 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.\(^{161}\)

IV. 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.\(^{162}\) Concentrated, well-organized pressure groups often obtain legislation that favors their interests, even though it may harm a

\(^{160}\) I should note that at least a few cities have tried this approach, most notably Chicago in 1974. See Martin, *supra* note 117, at 23. However, the approach is not widespread, and the reporting regime in Chicago is largely unused today.

\(^{161}\) 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 61, at 1370-71. 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.

much larger group of disorganized individuals. 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.

Under this view of legislation, the likelihood of regulatory reform increases 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. 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 organized can change for many reasons, such as changes in technology or tastes. For example, interest rate ceilings on deposits were imposed after lobbying by savings-and-loan institutions, and benefited 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. In his application of private-interest theory to regulatory reform in the banking industry, Randall Kroszner has provided several other examples. 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 benefited from the competition barrier. 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

See id. at 10-13.

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 105-08 (1978).


See, e.g., PIERCE, supra note 33, at 57.


See Kroszner, supra note 165, at 8-9.
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.\textsuperscript{170}

A. 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.\textsuperscript{171} In the absence of the statute, they 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.\textsuperscript{172} 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.\textsuperscript{173} 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

\textsuperscript{170} See id. at 10.
\textsuperscript{171} 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 generally Christopher B. Barrett, The Microeconomics of the Developmental Paradox: On the Political Economy of Food Price Policy, 20 Agric. Econ. 159 (1999).
\textsuperscript{172} See Telephone Interview with Dina Ellis, Assistant to Sen. Phil Gramm (R-Tex.) (June 8, 1999).
\textsuperscript{173} See generally Thakor & Beltz, supra note 129.
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 factor making it 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 preemptively to strike the least burdensome deals with pressure groups, and there is some evidence that this occurs. 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 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. As a result, banks often agree to follow the lending policies they have been pursuing or planning to pursue all along. Moreover, the publicity surrounding CRA settlements

174 Recall the complaints leveled by community pressure groups against agreements between Bruce Marks and Fleet Bank in Boston. See supra note 135.

175 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.

176 See, e.g., Macey & Miller, supra note 1, at 332 (discussing dramatic pledges that merely reflect existing lending levels). 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 the banks' current levels of lending. See Yawu Miller, Activists Ask Feds To Block Fleet/BankBoston Merger, BAY STATE BANNER, 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
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 quid pro quo 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.\footnote{Perhaps the most explicit recent example of such bargaining has been observed in the Fleet-BankBoston merger negotiations over much of 1999. The merger would lead to Fleet divesting most of its branches. This generated the question of 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 U.S. Congressman 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, the Massachusetts congressmen apparently were 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 Vennochi, Unknowns in the Fleet-BankBoston Merger Formula, BOSTON GLOBE, June 22, 1999, at A15. The game is obvious: Fleet and 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.}

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.\footnote{These efforts culminated in the Gramm-Leach-Bliley Act §§ 711-715, S. 900, 106th Cong. (1999).} The legislation initially had three CRA-related goals: (1) to publicize CRA settlement agreements;\footnote{See id. § 711.} (2) to shift the burden of proof to protesters when a bank has had a satisfactory rating for three years;\footnote{See id. §§ 711-715.} and (3) to exempt small rural banks with deposits less than $100 million from the statute.\footnote{See id. § 712.} 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 its 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. 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. Like the initial provisions, the final provisions hardly touch the perverse incentive 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 of the CRA, 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 universally disdained problems associated with hush money. 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 to 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 that 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. 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.

183 See id.
184 See White, supra note 7, at 285.
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, 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.

B. 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 changes in consumer tastes. 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.

185 See supra notes 165-70 and accompanying text.
Restrictions on entry form a fixed barrier to competition that can be eliminated by 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 of changes in technology or consumer tastes, from 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 has been in place from the beginning: the finance producers (or, specifically, the banks). After the 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 generally are not in communication with each other and 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 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 anti-competitive conduct irrelevant. The Sherman Act
will always be viewed by some firms as providing a competitive weapon against rivals, 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 re-vote 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. 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 facilities in cities like Chicago. 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

186 For a discussion of the use of antitrust law by firms to block pro-competitive mergers, see William J. Baumol & Janusz A. Ordover, Use of Antitrust to Subvert Competition, 28 J.L. & ECON. 247 (1985).
187 Studies also suggest that such divisions exist 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).
political clout to maintain the current regime in the absence of support or acceptance within some subgroup of regulated banks. Third, given these features, a regulatory 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. 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 of the statute.

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, this 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.