Changing Financial Markets and Community Development: An Overview

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Access to credit and financial services is generally seen as critical to the economic success of both individuals and communities, but such access is far from universal. Barriers to credit and services limit the economic opportunities available to low-income and minority individuals and communities. Over the years, various public- and private-sector programs have tried to break down these barriers. However, the success, and even the appropriateness, of many of these efforts remain contentious. Some of this contention reflects philosophical differences. But much is due to the absence of quantifiable results and careful analysis. Moreover, where programs have undergone rigorous scrutiny, the findings may be known only to a relatively small circle of researchers. This lack of solid information allows even parties who agree on objectives to engage in prolonged and frustrating debates about whether programs have had any impact and the magnitude of the associated costs and benefits.

To help rectify this lack, the Community Affairs Officers of the Federal Reserve System are sponsoring a series of research conferences. The goal of these conferences is to encourage more – and more careful – analysis of how financial institutions affect the economic well-being of communities and individuals and to draw attention to the research that is already being undertaken. The first of these conferences, *Business Access to Capital and Credit*, took place in 1999. The second, *Changing Financial Markets and Community Development*, was held in the spring of 2001; the dominant issues were the effectiveness of the Community Reinvestment Act (CRA) and the implications of several recent financial sector developments for low- and moderate-income individuals and communities.

This conference volume includes the shorter, less technical papers presented at the conference, discussants' comments, keynote addresses, and executive summaries of the longer, more academic conference papers. Most of the longer papers will appear in professional journals; until that time, they may be viewed on the CEDRIC web site offered by the Federal Reserve Bank of Chicago (www.chicagofed.org/cedric/).

A major conclusion of the conference was that the CRAdoes appear to have increased bank lending to low- and moderate-income borrowers and communities, at least in the 1990s; and for the most part, this CRA-lending has been profitable or has at least broken even. Evidence was presented suggesting that working with community development organizations may facilitate CRA-related lending.

The success of the CRA notwithstanding, nonbank financial institutions have made inroads in serving low- and moderate-income populations. The conference highlighted recent studies of the use of financial services by people who do not have bank accounts. One implication of this work is that efforts to encourage the "unbanked" to use banks should emphasize the value of establishing a pattern of saving and the long-term benefits of a relationship with a traditional financial institution, and not the low cost of basic banking services. Banks may not be the lowest-cost providers of the services most valued by those presently "unbanked."

The importance of helping low- and moderate-income individuals to accumulate assets was a recurring theme in the conference. Assets provide a cushion against economic vicissitudes and a foundation for climbing out of poverty. Research presented at the conference indicates that the poor can indeed save under the right circumstances.

Another thread weaving through the program was the tension between ensuring that low- and moderate-income individuals have access to credit and protecting them from exploitation. Predatory lending is broadly condemned. Yet efforts to curb predatory lending can limit the availability of credit to individuals whose risk profiles make them ineligible for traditional loan products from depository institutions. An intriguing suggestion advanced at the conference was that the concept of "suitability," which has been used to curb abuses in the securities industry, could be applied to lending and that making unsuitable loans could be the basis for legal action leading to loan forgiveness and damages.

Following is a brief review of the papers presented in each of the conference sessions.

The Unbanked and the Alternative Financial Sector

Two major studies of the use of financial services by individuals lacking bank accounts were presented at the conference. **Constance Dunham** reported on a survey of the unbanked in New York and Los Angeles conducted by the Office of the Comptroller of the Currency. **Sherrie Rhine** reported on work (in conjunction with co-authors) on the use of check-cashing outlets in the Chicago area. **John Caskey**, who has done much pioneering research on the unbanked and the institutions serving them, presented a proposal for encouraging the unbanked to join the financial mainstream.

In general, the unbanked have lower incomes than those who have bank accounts. They are more likely to be women, African-American, and Hispanic and to live in low-income and minority areas. They are less likely to work; they tend to be younger.

For many of the unbanked, expenditures on financial services are minor. Checks can frequently be cashed free of charge at issuing banks. For services imposing a charge on the unbanked, banks are not always the lowest-cost source. Bank fees for money orders, a convenient way of remitting funds to other countries, tend to be high. And while a checking account can be a lower-cost way of making payments than money orders and bill payment services, fees for occasional bounced checks can wipe out any cost advantage.

A bank savings account, however, is a safe and convenient vehicle for people of limited means to accumulate assets. Thus, attempts to bring the unbanked into the financial mainstream might be more effective if they emphasized the benefits of savings accounts rather than the more questionable cost advantages of checking accounts. **Caskey** presented a proposal whereby banks actively reach out to the unbanked by offering a package of services tailored to meet their needs. The centerpiece would be a “Christmas Club” saving account, but other services such as check-cashing and money orders would also be available. The goal would be to assist the currently unbanked in building savings and, ultimately, establishing a credit history and a greater comfort level in dealing with mainstream financial institutions.

New Industry Developments

Credit scoring, predatory lending, and community development venture capital funds were addressed in the session on new industry developments. None of these is truly a new development, but all grew in importance in the 1990s.

Credit scoring, which has long been used to assess creditworthiness for consumer credit, is increasingly being used in mortgage and small business lending decisions, according to **Cary Collins**, **Keith Harvey,** and **Peter Nigro**. While credit scoring may permit lower cost, faster, and more objective decision-making, some believe that credit scoring models understate the creditworthiness of nontraditional borrowers by omitting indicators, such as utility bill records, that are particularly indicative of this group's ability to service debt. **Collins** and his co-authors focused on customized credit-scoring models, which combine credit bureau information with information from the borrowers' loan applications and are validated using the lending institution's pool of approved applicants. They found that certain variables included in these models may disadvantage low- and moderate-income borrowers relative to the outcomes obtained from either a more judgmental approach or a strict application of a generic credit bureau scoring model. They urge banks to be sure that variables in their customized models that adversely affect lower-income groups do, indeed, relate strongly to loan performance, and to consider whether other variables might be equally predictive but affect these groups less negatively.

Increased lending to low-income and minority borrowers has been accompanied by increased concern about predatory or abusive lending. Predatory lending has been hard to address, in part because it has been hard to define. **Kathleen Engel** and **Patricia McCoy** have provided a definition based on six broadly defined problems, including violating common underwriting norms to borrowers' detriment and requiring borrowers to waive legal redress. They discussed how securitization has increased the incentives to engage in predatory lending. Key elements of their argument are the entry into the mortgage market of thinly capitalized lenders and reduced incentives to evaluate creditworthiness carefully. Rising property values in low-income and minority neighborhoods are also a factor. The authors reviewed the various remedies to predatory lending that have been proposed and found them generally inadequate. They recommend the adoption of a suitability approach similar to that employed by the Securities and Exchange Commission to combat high-pressure telephone sales of securities. Under this approach, lenders and brokers would be prohibited from making subprime loans that exceed borrowers' risk thresholds, from steering borrowers who qualify for prime loans to subprime lending subsidiaries, and from requiring borrowers to agree to mandatory arbitration. Suitability would be enforced by private action in the courts and by federal agency intervention.

Community development venture capital funds (CDVCs) make equity and near-equity investments in small businesses, with the goals of creating good jobs and fostering community economic development.

Julia Sass Rubin provided a detailed description of the structure and functioning of these entities. An assessment of their success is not yet possible because so many CDVCs are very young. Although their origins date back to the 1960s, the formation of a trade association in 1994 spurred their expansion.

Wealth Creation

As **Mark Schreiner** and his co-authors pointed out, the accumulation of assets, financial, human, or social, is essential if low-income households are to improve their economic situation. As noted above in discussing the unbanked, perhaps the greatest benefit of a banking relationship is a convenient vehicle for accumulating savings. However, some doubt whether the poor, whose resources are limited relative to their needs, are capable of saving. **Schreiner** reported on an experimental program designed to address this and related questions by offering low-income participants the opportunity to build assets through Individual Development Accounts (IDAs). The American Dream Demonstration matches the savings of participants in the program at roughly a 2:1 rate if participants use these savings for buying a home, post-secondary education, or self-employment. The results indicate that the poor can save. Participants made relatively regular deposits and succeeded in accumulating savings; some were able to take advantage of the match. Within the group, the level of saving was not linked to income; the very poorest actually saved larger shares of their income than the less poor.

The other papers in this session looked at asset-building from a business perspective. A number of institutions have been formed in recent years to finance business activity in low-income and minority areas. **Timothy Bates** argued that the experience of Minority Enterprise Small Business Investment Companies (MESBICs), which have existed for roughly 30 years, offers useful lessons for these newer organizations. Most MESBICs failed. Successful MESBICs have tended to be asset-based lenders or, less frequently, venture capital firms that have focused on larger minority-owned companies with growth potential. Bluntly, successful MESBICs are hard-nosed. **Bates** cautioned against investment strategies oriented to small equity investments and working capital loans; administrative costs and risk of loss are high.

Brian Uzzi explored the role of social attachments in the lending relationship. He argued that social interactions between banker and entrepreneur result in greater trust and cooperation, reducing the need for formal governance arrangements and facilitating information flows. His statistical analysis suggests that such relationships can lead to tangible benefits for firms in the form of lower interest rates and collateral requirements. For minority and women entrepreneurs, establishing such social links may be challenging, as loan officers are predominantly White men.

Evaluation of the Community Reinvestment Act

The Community Reinvestment Act requires that banks and other depository institutions help meet the credit needs of their local communities, including low-income neighborhoods, and that the federal supervisory agencies consider an institution's CRA record in approving merger and other applications. Although the CRAwas enacted in 1977, a confluence of forces caused lenders to take their obligations under the CRA more seriously in the 1990s.

The CRA is controversial. Some observers see it as successful social policy, having increased access to credit for large numbers of low-income and minority households at modest cost. Others see it as an unfair tax on banks and other depository institutions, forcing them to make uneconomic loans or to devote substantial effort to documenting activities they would have done anyway. Despite the strong feelings it arouses, the CRAhas been relatively little studied. Views of its success and the costs it imposes are heavily impressionistic. Two papers presented at the conference help to remedy this deficiency.

Eric Belsky reported on work he has undertaken with several co-authors comparing the lending behavior of institutions subject to the CRA with that of institutions not under CRA's jurisdiction. For the period from 1993 to 1999, they found that home purchase loans to low- and moderate-income borrowers and areas (LMI loans) grew faster for CRA-covered institutions than for institutions not covered by the CRA. In addition, regression analysis indicated that the fraction of LMI loans made by CRA-covered institutions in 180 metropolitan areas was positively affected by variables representing regulatory pressures arising from the CRA. Taken together, these results suggest that the CRA did encourage institutions under its jurisdiction to increase lending to low- and moderate-income individuals and areas more than they would otherwise. The authors cautioned that it is less clear that overall LMI lending increased, as the gains of the CRA-institutions could have been at the expense of lending by non-CRAinstitutions. It is also possible that CRA-induced competition encouraged non-CRA institutions to expand their LMI lending as well.

If the CRA has caused institutions to increase their LMI lending, why did they not do so before? Many supporters of the CRAbelieve that lack of information and cultural barriers caused banks to ignore profitable opportunities available in serving low- and moderate-income areas. The pressure of the CRA forced banks to surmount these barriers. Opponents believe that the CRA lending is not profitable. Such concerns led the Congress, as part of the sweeping banking reforms in 1999, to direct the Federal Reserve Board to conduct a survey of the profitability of CRA lending.

The results of this survey, presented by **Bob Avery** (representing several co-authors), suggest that much CRA lending has been profitable or has at least broken even. Some institutions have had losses on some loan products, although institutions with both losing and profitable products are common. Home purchase lending is more likely to be associated with losses than other products; community development lending has generally been profitable.

On balance, these two papers suggest that the CRA has increased lending to low- and moderate-income borrowers and areas and that much, but not all, of this lending has been profitable.

Papers by **Thomas Holyoke** and by **Jim Campen** and **Tom Callahan** explored the role of community organizations in CRAlending. **Holyoke** looked at the role of political activism and capacity in encouraging lending by the CRA-covered institutions in different parts of the District of Columbia. Using voter turnout to measure activism, he found little effect. However, the number of nonprofit organizations that are focused on economic development or financial stability was positively associated with higher volumes of some types of loans. A possible interpretation is that the presence of community development corporations and related organizations may facilitate lending and, to the degree that it signifies a neighborhood commitment to economic development, may reduce the likelihood of default.

Campen and **Callahan's** paper focused on a mortgage program developed in Boston to make homeownership possible for households of very modest means. A combination of below-market interest rates and a variety of public subsidies significantly reduces monthly payments to participants in this program. Education classes for those who have bought homes through the program and careful monitoring of loan performance have resulted in very low delinquency rates. The authors hope that others will follow this model; but in sharing their experience, they also showed the critical role played by community organizations. It took a great deal of advocacy, negotiation, and persistence to bring this program about. However, the benefits accumulate. The partnerships formed in developing this program have sponsored other initiatives.

Among the reasons for greater attention to the CRA in the 1990s were public disclosure of banks' CRAratings and the availability of data on banks' approval and denial of mortgage loans. With more public information came more public pressure. In 1995 new CRA regulations were established requiring the reporting of geographic data on small business lending. **Katherine Samolyk** and **Christopher Richardson** have used this information to analyze how bank consolidation has affected small business lending. Their results suggest that merger activity, whether involving the bank itself or its holding company, had a negative effect on small business lending, including lending specifically targeted under CRA regulations. These patterns were strongly driven by changes in commercial lending overall, however, and their strength varied by time period.

Discussion

The Federal Reserve System's second Community Affairs research conference highlighted some interesting and provocative papers on issues of importance to the nation's low- and moderate-income communities. Research on the Community Reinvestment Act suggested that banks have increased their lending to low- and moderate-income borrowers and areas and that much of this lending is profitable or at least breaks even. Community organizations can be useful to banks in developing CRA-lending programs. Several papers stressed the role of banks as vehicles for saving as well as sources of credit. Helping the poor build assets is critically important. The conference also struck a cautionary note: increased access to credit can mean increased vulnerability to abusive lending.

The conference also provided a forum for policymakers, bankers, representatives of community organizations, and researchers to exchange views and learn from one another. The constructive tone of the discussions and the high level of interest seemed to validate the premise underlying this conference series – that more solid information and careful analysis are needed in order to design policies and programs that will bring everyone into the financial and economic mainstream.

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