TESTIMONY

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the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision

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My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. I represent solely myself at this hearing. I have attached a brief biographical summary at the end of this statement.

Thank you for the opportunity to testify at this important hearing on the Community Reinvestment Act of 1977 (CRA). I will not try to summarize the CRA or the extensive literature on it in this brief statement. I have written about the CRA in the past (White 1993, 2000, 2002, 2009a, 2009b). Recent comprehensive reviews of the CRA can be found in Apgar and Duda (2003), Barr (2005), and Bernanke (2007), and recent symposiums on the CRA can be found in the Western New England Law Review, Vol. 29, No. 1 (2006) and in Chakrabarti et al. (2009).

My views about the CRA surely differ from those of many of the other individuals who will testify at today's hearing. I believe that, despite the good intentions and worthwhile goals of the CRA's advocates, the CRA is an inappropriate instrument for achieving those goals.

Fundamentally, the CRA is a regulatory effort to "lean on" banks and savings institutions,[1] in vague and subjective ways, to make loans and investments that (the CRA's proponents believe) those depository institutions would otherwise not make. It is a continued effort to preserve old structures in the face of a modernizing financial economy. At base, the CRA is an anachronistic and protectionist effort to force artificially a local focus for finance in an increasingly competitive, increasingly electronic, and ever-widening realm of financial services. Further, ironically, the burdens of the CRA may well discourage banks from setting up new locations in low-income neighborhoods and thus providing local residents with better-priced alternatives to high-cost check-cashing and payday lending establishments.

There is a better way. First, to the extent that lending problems can be traced to discrimination against racial or ethnic groups or involving other categories of personal discrimination, the right tool is more vigorous enforcement of anti-discrimination laws -- notably, the Equal Credit Opportunity Act of 1974.

Second, vigorous enforcement of the antitrust laws, especially with respect to mergers, is

[1] For the remainder of this statement I will use the word "banks" to include both commercial banks and savings institutions, unless otherwise indicated.

necessary to keep financial markets competitive, so that banks and other lenders are constantly under competitive pressure to provide attractive services offerings to their customers. If, for some reason, enforcement of the antitrust laws is deemed not sufficient in this respect, then policymakers should open entry into the business of banking to companies that have a business model of providing good value to low- and moderate-income (LMI) households. Consistent with this focus on providing good value to LMI households, vigorous competition should not veer off into predatory practices, in which aggressive sales personnel take advantage of unsophisticated customers who are insufficiently aware of better alternatives.

Third, to the extent that there are socially worthwhile lending opportunities that somehow are not being satisfied by existing lending institutions, these projects should be funded through the public fisc, in an on-budget and transparent process. The Community Development Financial Institutions Fund, authorized by the Riegle Community Development and Regulatory Improvement Act of 1994 and managed by the U.S. Treasury, is a good example of this kind of public funding mechanism. To the extent that its current funding levels are inadequate, they should be increased.

Finally, if public policy persists with something that resembles the CRA, the annual local lending obligations of banks should be explicitly quantified. These obligations could then be traded among banks, so that a system could arise that is similar to the ”cap and trade” system that has proved so successful for dealing with sulfur dioxide emissions in a low-cost and efficient manner (Klausner 1995, 2009; Richardson 2002).

The remainder of this statement will expand on these ideas.

The Drawbacks of the CRA

Consider the basic concept of the CRA: Banks are somehow neglecting loan opportunities in the communities in which they have establishments -- primarily, in low- and moderate-income (LMI) communities -- and must be forced to lend in those communities. Another version of this argument is that a bank that gathers deposits from customers that are located geographically close to that bank’s physical location is “draining” deposits out of the community when it lends those funds elsewhere.

At its base, this concept rests on the notion either that (a) banks are lazy (or ill-intentioned) and are inefficiently passing up profitable opportunities to lend to creditworthy customers in LMI communities, and so they must be forced to do so; or (b) they are monopolies with market power and excess profits that can be used to cross-subsidize the unprofitable loans in the LMI community that they can be forced to make. Either version has the flavor of the pre-1970s world of banks and banking, where competition was not especially vigorous and state and national regulations often impeded entry and prevented banks from branching outside their home communities, which thereby often created pockets of local market power.

Further, the notions that banks have special obligations toward “their” communities and that the communities need and deserve this protection, again smack of that pre-1970s world of localized finance.

Let us instead consider lending in the context of the beginning of the second decade of the twenty-first century. In that context, there are at least five bases for questioning the wisdom of the CRA. First, if loans are profitable, profit-seeking banks should already be making them. In this case, CRA is redundant at best (but is still costly, because of the costs of compliance and of regulatory monitoring). Of course, banks make mistakes and may not be the perfect maximizers of introductory economics textbooks. But the CRA is based on the notion that banks systematically overlook profitable opportunities in LMI communities. And that seems unlikely in today's environment.

Alternatively, there may be spillover effects that cause single loans to be unprofitable but that would cause a group of loans to be profitable. In that case, we should expect to see banks forming joint ventures or other types of coalitions to "internalize" the externality and make these profitable loans.

On the other hand, if the loans are not profitable, then (a) they require a cross-subsidy from the excess profits from other (super-profitable) activities of the bank; but in the increasingly competitive environment of financial services there will be little or no excess profits; or (b) they will involve losses for the bank; or (c) they will be shirked and avoided, with accompanying cynicism. Neither of these last two prospects should be the basis for good public policy.

Second, why should a bank have a special obligation to lend to a specific local geographic area? What is special about local geographic areas or about the specific placement of physical bank locations? Should the bank also have an obligation to hire only employees who live in that same geographic area? Must it buy its desks from local merchants?

The localism orientation of the CRA is an anachronism that runs counter to the broad sweep of public policy in the financial services area, which has been to erase protectionist measures (such as restrictions on intra-state and interstate branching, and the forced compartmentalization of financial services) and to place more trust in competition.

Further, the "draining deposits" notion ignores the substantial value to a LMI community of a bank that offers primarily deposit services and a few related services (such as check-cashing and cash transfer, and perhaps some personal loans). To the extent that community leaders are concerned that the community's citizens are using higher-cost alternatives, such as check-cashing offices and payday lenders, they should welcome banks, even if the banks provide a limited menu of services. Ironically, the lending obligations of CRA (and the extra burden of exiting an area if the operations there turn out to be unprofitable) may well discourage the establishment of branches in LMI areas in the first place. <u>Barriers to exit are barriers to entry.</u>

Third, why place this special obligation on banks? After all, there are many other categories of lenders for most of the types of loans that banks make. Are banks special? If so, in what ways are they special, and are those ways relevant for CRA purposes?

Banks are special in at least two important ways: (a) They (along with credit unions) provide federally insured deposits, which is an important benefit for financially unsophisticated customers who seek a safe place for their transactions accounts and for simple savings; deposit insurance also provides stability for the overall banking system by forestalling the kinds of depositor runs on banks that plagued American banking before 1933; and (b) Commercial banks especially are important sources of credit for small and medium-size enterprises (SMEs).

Both special features are good arguments for vigorous antitrust enforcement, to ensure that bank mergers do not create anticompetitive environments in local markets for deposits and for SME lending. Neither provides an argument for imposing CRA requirements to make loans that they would not be inclined otherwise to make.

Fourth, in a dynamic setting, banks' choices of locations will surely be influenced by the regulatory burdens that accompany those choices. As was discussed above, to the extent that they see decisions to locate in LMI areas as carrying extra regulatory burdens (and as involving greater difficulties of exit in the event that the location proves to be unprofitable), banks are less likely to locate in those areas in the first place.

Fifth, the vagueness of the CRA's language -- that banks should meet "the credit needs of its entire community, including low- and moderate-income neighborhoods..." -- has led to vagueness and subjectivity of enforcement. Initially, enforcement focused on a bank's <u>efforts</u> toward serving its community and the documentation of those efforts; after 1995, enforcement focused more on documenting lending <u>outcomes</u>; in essence, pre-1995 regulation focused on inputs, while post-1995 regulation focuses more on outputs. Although the latter is surely an improvement over the former, nevertheless the inherent vagueness of "needs" inevitably leads to the vagueness and subjectivity of enforcement. This can't be the basis of good public policy.

In sum, the CRA is fundamentally at odds with the modern sweep of public policy with respect to financial regulation and with the reasons and arguments that underlie the direction that policy has taken. It emphasizes protectionism and localism and distrusts competition in an era when the sweep of policy is to reduce and eliminate local barriers and to rely more on competition than on forced lending. And, by discouraging entry in LMI areas, the CRA may well be contrary to the long-run interests of the communities that it is intended to help.

There have recently been broader critiques of the CRA: that it encouraged banks to make subprime mortgage loans (which were then securitized) and thus the CRA bears major responsibility for the housing bubble of 1999-2006, and then for the mortgage-related securities crisis of 2007-2008.

These broader critiques are badly aimed. The bulk of the subprime lending of the earlier years of this decade was made by nonbank lenders – that is, by "mortgage banks" that either securitized the mortgages themselves or that quickly sold the mortgages to securitizers. These nonbank lenders were not covered by CRA requirements. Further, the major financial difficulties that were related to investments in these mortgage securities were experienced mostly by investment banks (such as Bear Stearns, Lehman Brothers, Morgan Stanley, and Merrill Lynch) and by a large insurance conglomerate (AIG) – none of which were covered by the CRA. Where banks did experience difficulties that were related to subprime mortgages, such as CitiBank, Washington Mutual, Wachovia, IndyMac, and Countrywide, it appears that they were heavily involved in subprime lending because of its perceived profitability (and their under-appreciation of the risks) and not because of CRA pressures.

Recent empirical studies by Laderman and Reid (2009) and by Bhutta and Canner (2009) support the absence of a link between the CRA and the mortgage meltdown.

The CRA has multiple flaws, but responsibility for the subprime mortgage lending and securities debacle is not one of them.

<u>Better Public Policies</u>

These criticisms of the CRA should not be interpreted as a statement that no governmental actions are warranted. As I stated at the beginning of this statement, there is a better way to achieve the goals of the CRA's advocates.

First, discrimination by lenders of any kind with respect to racial or ethnic or other prohibited categories should be vigorously prosecuted under the Equal Credit Opportunity Act of

1974 and any other available statute, such as the Fair Housing Act of 1968.

Second, the antitrust laws should be vigorously enforced, so as to keep financial markets competitive. However, if enforcement of the antitrust laws is deemed inadequate for encouraging sufficient competition in banking, then policymakers should allow entry into the business of banking by more companies, including those that have a business model of providing good value to LMI households. It is indeed ironic that the same community groups that advocate for an expanded role for CRA so as to provide more banking services for LMI households were also those who lobbied the Federal Deposit Insurance Corporation (FDIC) and the Congress during 2005-2007 (in alliance with the banking lobbyists, with whom the community groups are usually at odds with respect to efforts to expand the CRA's burdens on banks) to thwart Wal-Mart's efforts to enter the banking business by obtaining an industrial loan company charter from the state of Utah.

Instead, Wal-Mart and other retailing and industrial companies should be encouraged to enter banking, preferably through a modification of the Bank Holding Company Act of 1970 or (as a last resort) through the granting of FDIC insurance to the otherwise qualified holders of Utah industrial loan company charters.[2] The potential problems for the safety and soundness of banks that might be posed by such companies' ownership of banks would be no more serious than the problems that are caused by current ownership structures, and they can be handled by the same regulatory tools that are currently used; see White (2009c).

Third, to the extent that there is a good social case for local lending and investment that local lenders somehow do not satisfy, those loans and investments should be funded through the public fisc, in an on-budget and transparent process. The Community Development Financial Institutions Fund is a good example of this kind of funding, and it should be expanded to replace whatever socially worthwhile projects would be eliminated if CRA were repealed.

Finally, if the CRA remains in force, its vague and subjective regulatory enforcement should be replaced by a set of specific annual lending obligations that would encompass both originations and portfolio holdings. These obligations would then be tradable among banks. Those banks that were less efficient at originating and holding these types of loans could pay other banks that were more efficient at the activities to take over these obligations. This system, in addition to making more transparent the obligations that are often opaque, could achieve the kinds of efficiencies that have attracted attention to the "cap and trade" system for controlling sulfur dioxide emissions by electric utilities.

Conclusion

The CRA is not a good public policy tool for achieving the goals of its advocates. There are better ways. I urge anyone who is interested in good public policy to consider those alternatives.

I would be happy to answer any questions that may arise from this testimony.

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[2] Unfortunately a provision (Sec. 603) of the Dodd-Frank Act would, if enacted, place a three-year moratorium on the granting of FDIC insurance to any new industrial loan company.

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Biographical Summary

Lawrence J. White is Arthur E. Imperatore Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern. During 1986-1989 he was on leave to serve as Board Member, Federal Home Loan Bank Board, and during 1982-1983 he was on leave to serve as Director of the Economic Policy Office, Antitrust Division, U.S. Department of Justice. He was Secretary-Treasurer of the Western Economic Association International, 2006-2009. He is currently the General Editor of The Review of Industrial Organization.

Prof. White received the B.A. from Harvard University (1964), the M.Sc. from the London School of Economics (1965), and the Ph.D. from Harvard University (1969). He is the author of The Automobile Industry Since 1945 (1971); Industrial Concentration and Economic Power in Pakistan (1974); Reforming Regulation: Processes and Problems (1981); The Regulation of Air Pollutant Emissions from Motor Vehicles (1982); The Public Library in the 1980s: The Problems of Choice (1983); International Trade in Ocean Shipping Services: The U.S. and the World (1988); The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation (1991); and articles in leading economics and law journals.

He is editor or coeditor of eleven volumes: Deregulation of the Banking and Securities Industries (1979); Mergers and Acquisitions: Current Problems in Perspective (1982); Technology and the Regulation of Financial Markets: Securities, Futures, and Banking (1986); Private Antitrust Litigation: New Evidence, New Learning (1988); The Antitrust Revolution (1989); Bank Management and Regulation (1992); Structural Change in Banking (1993); The Antitrust Revolution: The Role of Economics, 2nd edn. (1994); The Antitrust Revolution: Economics, Competition, and Policy, 3rd edn. (1999); The Antitrust Revolution: Economics, Competition, and Policy, 4th edn. (2004); and The Antitrust Revolution: Economics, Competition, and Policy, 5th edn. (2009). He was the North American Editor of The Journal of Industrial Economics, 1984-1987 and 1990-1995.

Prof. White served on the Senior Staff of the President's Council of Economic Advisers during 1978-1979, and he was Chairman of the Stern School's Department of Economics, 1990-1995.

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