A Tradable Obligation Approach to the Community Reinvestment Act

Michael Klausner

John M. Olin Program in Law and Economics
Stanford Law School
Working Paper No. 375
May 2009

Michael Klausner[*]
Stanford Law School

Published in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,* Federal Reserve Banks of Boston and San Francisco, February 2009

This chapter revisits a proposal I made fifteen years ago to redesign CRA in a way that harnesses market forces. Specifically, I proposed that banks be permitted to trade their CRA obligations with one another in a manner analogous to "cap and trade" regimes used to address environmental pollution. A tradable obligation approach to CRA has the potential to enhance the provision of financial services to low- and moderate-income communities. The potential advantages stem from three sources: The allocation of CRA obligations to banks best able to fulfill them; the promotion of specialization in serving CRA-qualified communities; and increased concentration of lenders in CRA-qualified communities. Specialization and concentration could promote cost efficiencies, the amelioration of information-based market imperfections, and the internalization of externalities associated with CRA-qualified services.

Changes in the financial services sector and in community development institutions make this approach potentially more attractive today than it was when I first proposed it. Banks' lending outside the areas in which they are physically located has expanded substantially; other types of financial institutions not currently subject to CRA now make a high volume of home mortgage loans; and community development financial institutions have developed that could facilitate the allocation of services to CRA-qualified communities.

[*] I am grateful to Larry White for comments on an earlier draft.

A Tradable Obligation Approach to the Community Reinvestment Act

Michael Klausner
Stanford Law School

In articles published in 1994 and 1995, I proposed that the Community Reinvestment Act (CRA) be modified to allow banks to trade their CRA obligations with one another in a manner analogous to cap-and-trade regimes used to address environmental pollution.[1] As in the environmental protection context, a tradable obligation approach to CRA has the potential to enhance the provision of financial services to low- and moderate-income communities at lower cost than does the current command-and-control approach. This chapter revisits that proposal in light of developments in the financial services sector and in community development over the past decade, and assesses whether the proposal still warrants reconsideration today.[2] I conclude that the proposal does warrant consideration, but I also discuss a number of empirical and practical questions that should be addressed before one can conclude that the proposal would in fact enhance the effectiveness of CRA.

Although the objective of CRA is to induce banks to provide services they otherwise would not provide to low- and moderate-income communities, the Act is

---

[1] Michael Klausner, A Market-Oriented Reform Proposal for the Community Reinvestment Act, University of Pennsylvania, vol. 143, pp. 1561 (1995); Michael Klausner, Letting Banks Trade CRA Obligations Would Offer Market-Based Efficiencies, American Banker, January 21, 1994.

[2] For commentary on the proposal, see Jonathan A. Neuberger & Ronald H. Schmidt, A Market-Based Approach to CRA, FRBSF Weekly Newsletter, May 27, 1994, p. 1; J.I. Brannon, Renovating the CRA, Regulation, Vol. 24, No. 2, Summer 2001; Christopher A. Richardson, The Community Reinvestment Act and the Economics of Regulatory Policy, Fordham Urban Law Journal, April, 2002; Lawrence J. White, Focusing More on Outputs and on Markets: What Financial Regulation Can Learn from Progress in Other Policy Areas(November 2006). Networks Financial Institute Policy Brief No. 2006-PB-18, available at SSRN: http://ssrn.com/abstract=947895, The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain, Statement of Lawrence J. White before the Financial Services Committee of the U.S. House of Representatives, February 13, 2008.

unclear with respect to whether it is intended to address market failures that impair the provision of financial services in these communities, or to redistribute wealth from bank shareholders to residents of these communities, or both.[3] A "tradable obligation" approach to CRA is potentially attractive with respect to both rationales.

I. The Tradable CRA Obligation Proposal: A Market-Oriented Approach

The current CRA regime follows the conventional command-and-control approach to regulation. Banks are, in effect, required to serve low- and moderate-income communities throughout the areas in which they do business.[4] As discussed in Part II, this approach has drawbacks. Some banks may be less able to provide the same service to CRA-qualified communities than are other banks. From a social welfare point of view, banks that can provide the same service at lowest cost should be the ones that serve these communities. In addition, CRA's mandate that a bank provide CRA services throughout its area of operation (referred to as its "assessment area"), makes it difficult for banks to gain efficiencies that may be available through specialization in particular neighborhoods and through having fewer banks serve a given neighborhoods.

The tradable obligation approach would have two elements. First, all banks would be assigned annual quotas of CRA obligations. These quotas would be stated in

---

[3] Congress's stated purpose in enacting CRA was to have banks "meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions." U.S. Code, Title 12, Section 2901(b).

[4] Technically, CRA is not a requirement. It requires the bank regulatory agencies to assess whether a bank is "meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution" and to take that assessment into account in ruling on the bank's applications for mergers, branch openings, or expanded activities. Because banks may make such applications in the future and because a poor CRA rating has reputational costs for a bank, most banks treat CRA as a requirement. For simplicity I will refer to CRA as a requirement here.

objective and verifiable terms for each type of CRA service—for example, a quota for lending, a quota for investment, and a quota for other services. This approach is quite different from the current approach to CRA enforcement, which relies on broad standards and *ex post* evaluation by bank examiners. Reportedly, the increased specificity in CRA regulations that occurred in 1995 was difficult to achieve and may have exhausted the potential for specificity under the current structure of CRA.[5] Nonetheless, with a tradable obligation regime, greater specificity in regulations may be possible. Under CRA as currently administered, different standards apply depending on whether a bank is large or small, and on whether it is a retail, wholesale, or limited purpose bank. In addition, bank examiners take into account the nature of a bank's business and the markets in which it operates. In a tradable obligation regime, however, the nature of the bank's business, its market, and the location of its operations would be less important than they are under the current approach. Because a bank could pay another bank to perform its CRA obligations, CRA obligations would not have to be tailored to each bank. Market trades would replace regulatory tailoring in matching banks' capabilities with CRA-qualified communities.

In addition, some individualization of a bank's obligation would be possible. Rather than evaluating a bank's performance retrospectively, an examiner could make essentially the same assessment but use its analysis to prescribe a prospective obligation. For elements of CRA obligations that are not fully specified by regulation, the examiner would objectively specify the bank's annual obligations in objective terms. Individual specification would depend on the needs of the community and the estimated costs of

[5] Michael S. Barr, Credit Where It Counts: the Community Reinvestment Act And Its Critics, New York University Law Review, vol. 75, p. 513, 2005.

meeting those needs rather than the capabilities of the bank that is assigned the obligation.[6] A bank's annual obligation would remain constant until the bank's next examination.

The mix between generalized and individualized obligations is a detail that would have to be worked out with experience. We might discover, for example, that CRA's lending and investment requirements are more suitable for generalized quantification than is the service requirement. If so, lending and investment obligations could be set out more specifically by regulation, and the service obligation could be specified more individually by examiners.

The second element of a tradable obligation approach would be trading. Any bank would be allowed to pay another bank to take on its CRA obligations, in whole or in part. If Bank A can meet some or all of Bank B's CRA obligations, then Bank B could pay Bank A to do so. By allowing banks to pay others to take on their CRA obligations, a market for acquiring these obligations would develop. Some banks would choose to be suppliers of CRA services, others would choose to be buyers, and some might choose to be both. For example, a bank might make its requisite volume of CRA-qualified loans itself and take payments from other banks to make additional loans, but the same bank might pay other banks to fulfill its investment and service obligations under CRA. Or a bank might make loans amounting to one half its lending obligations and pay others to make the rest. As discussed below, maximum liquidity would argue for nationwide trading, but an interest in geographic distribution of CRA services would argue for trading within defined regions.

---

[6] That is, the objectives would be to have the needs of CRA-qualified communities met and to have the cost distributed fairly among banks.

The tradable obligation approach, if successful, would harness market forces to promote better service to CRA-qualified communities at lower cost. Those banks that establish expertise in serving one or more CRA-qualifying communities could well see business opportunities in taking on other banks' CRA obligations. Other banks would impose a market discipline on these specialists by transferring their obligations to the lowest bidder and by providing CRA services themselves when opportunities arise that are less costly than paying another bank to do the job. The result would be markets for CRA services, with prices for CRA obligations would be established by supply and demand among banks.

This approach to CRA mirrors the emissions trading approach provided for under the Environmental Protection Agency's Acid Rain Program, and cap-and-trade regimes that have been adopted to address carbon emissions. In the Acid Rain Program, polluters are assigned quotas for the emission of sulfur dioxide and nitrogen dioxide. If a polluter can reduce its emission of one of these pollutants below its quota, it can sell the unused portion of its quota to another polluter for cash. Conversely, if a polluter wants to emit more than its quota, it must buy the unused quota of another polluter. Under this system, polluters have incentives to develop technologies and processes that produce high output for each unit of pollution emitted. Under the CRA proposal outlined above, banks would have similar financial incentives to meet the needs of low- and moderate-income communities.

II. Multiple Rationales for Tradable Obligations

The potential advantages of a CRA trading regime stem from three sources: The allocation of CRA obligations to banks best able to fulfill them; the promotion of specialization in serving CRA-qualified communities; and increased concentration of lenders in CRA-qualified communities. Specialization and concentration could promote cost efficiencies, internalization of information-based market imperfections, and internalization of physical neighborhood externalities associated with CRA-qualified services.

A. *Wealth Redistribution and the "Leaky Bucket"*

To the extent that the objective of CRA is to redistribute wealth from bank shareholders to residents of low- and moderate-income communities, the secondary objective should be to do so at minimal social cost. As Arthur Okun observed, when wealth is redistributed from rich to poor, there will be a social cost involved, so that $10 taken from the rich does not mean a full $10 given to the poor. There will be some leakage. In Okun's terms, any redistribution occurs via a "leaky bucket." Good public policy requires mechanisms that minimize the leakage.[7]

In the case of CRA, if one bank is poorly equipped to provide financial services to CRA-qualified communities and another bank is well equipped to provide those services, then the social cost of the redistribution will be lower if the latter bank does the job. One bank may be better than another at providing CRA services because of the experience and

[7] Arthur Okun, Equality and Efficiency: The Big Tradeoff, Brookings Institution 1975.

skills of its employees, or because of the nature of its other businesses. Nonetheless, the current approach to CRA requires all banks to provide CRA services.

A tradable obligation regime would use market forces to allocate CRA responsibility to the banks able to provide CRA services at lowest cost. In addition, as discussed below, it would promote the achievement of additional efficiencies for banks that choose to become providers of CRA services.

B. *Asymmetric Information and Credit Rationing*

CRA responds to market imperfections as well and therefore has an allocative efficiency rationale in addition to a redistributive rationale. One market imperfection is the inherently asymmetric information between a lender and borrower. This asymmetry can lead to "credit rationing," a dynamic in which a lender rationally declines to make loans to particular groups of potential borrowers at any interest rate.[8] Low- and moderate-income communities are especially at risk of experiencing credit rationing. CRA, as now implemented, responds to this problem by forcing banks to lend, but a CRA with tradable obligations may respond more effectively.[9]

When a bank makes a loan, it does so based on information regarding the default risk of the borrower. Borrowers, however, have better information regarding their default risk than the bank has, and the bank knows this. The bank can reduce this information

---

[8] Joseph E. Stiglitz & Andrew Weiss, Credit Rationing in Markets with Imperfect Information, 71 American Economic Review 393 (1981).

[9] Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending by Depository Institutions (1993), pp. 3, 8, 34, 36, 54; Julia A. Parzen & Michael H. Kieschnick, Credit Where It's Due (1992) 143-48, 173-78.

asymmetry by making detailed, individualized lending decisions and setting interest rates on an individualized basis, but doing so is costly and may not be justified by the bank's expected return on loans. Therefore, banks always rely to some degree on aggregate determinations; they charge interest rates that reflect the average default risk of a type of borrower—based for instance on the borrower's current assets and income and on the size of the loan.

Credit rationing occurs when a lender must make lending decisions based largely on default-risk characteristics of a group of potential borrowers, rather than on each borrower's individual characteristics, and when the default risk of individuals in the group span a wide range. When a bank sets an interest rate for a certain type, or pool, of borrowers, some members of the pool will inevitably be overcharged with respect to their actual default risk, and others will be undercharged. Loans across the full range of borrowers in the pool should yield a risk-adjusted return for the bank in the aggregate. But especially if the divergence of risk within the pool is large, there is a danger that those who are less risky will decline the higher rate loan and seek alternatives such as rental housing rather than home ownership. If this occurs, the composition and therefore the average default risk of the pool as a whole will increase, and the bank will have to increase the interest rate it charges to borrowers remaining in the pool. This adverse selection spiral can continue to a point at which the increased revenue that would come from raising the interest rate further is more than offset by the increased default risk of borrowers that remain in the pool. If the bank believes that this will occur, it will rationally choose not to make loans to any borrower in the pool at all.[10]

[10] For a model of this phenomenon, see Joseph E. Stiglitz & Andrew Weiss, Credit Rationing in Markets with Imperfect Information, American Economic Review, vol. 71, p. 393 (1981) and Dwight Jaffee &

The danger of credit rationing is substantial for low- and moderate-income communities. Credit rationing occurs because the cost to the lender of distinguishing between high- and low-risk borrowers is not worth the gain. Credit analysis entails fixed costs in assessing and monitoring the economic conditions of a neighborhood and becoming familiar with the neighborhood's residents and businesses. These costs are reflected in empirical evidence of economies of scale in lending within neighborhoods.[11] There are also significant fixed costs in evaluating any single loan application and monitoring repayment. The costs associated with a $50,000 loan are not very different from those associated with a $500,000 loan. Moreover, in CRA-qualifying communities, credit analysis and loan servicing is more costly than in other neighborhoods. Borrowers are less likely to have prior borrowing experience and are more likely to need assistance in making loan applications and repaying their loans. Information regarding their creditworthiness may not conform to the standards that banks use to assess creditworthiness in other parts of their business, and the response to a default may need to be different from the response in other settings.[12] These heightened fixed costs of lending in CRA communities must be spread over relatively small loans and a relatively low volume of loans.[13] Consequently, these communities are particularly vulnerable to credit rationing.

Joseph A. Stiglitz, Credit Rationing, in Benjamin M. Friedman & Frank H. Hahn, Handbook of Monetary Economics, vol. 2, pp. 839, 853-60 (1990). In addition to the limits on raising interest rates inherent in the model, there may also be legal and political limits on banks' ability to raise interest rates.. See John V. Duca & Stuart S. Rosenthal, Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence of Rate Sorting and Credit Rationing, Journal of Real Estate Finance and Economics, vol. 8, p. 99 (1994).

[11] McKinley Blackburn & Todd Vermilyea, The Role of Information Externalities and Scale Economies in Home Mortgage Lending Decisions, Journal of Urban Economics, vol. 61. p. 71.

[12] Julia A. Parzen & Michael H. Kieschnick, Credit Where It Is Due, pp. 143-148, 173-178 (1992).

[13] Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending By Depository Institutions, pp. 7-8, 21, 34 (1993).

CRA responds to the danger of credit rationing by forcing banks to make loans in low- and moderate-income communities. But by requiring banks to spread their services throughout the areas in which they operate, the current approach deters specialization in particular neighborhoods. Consequently, gains that might come from familiarity with a neighborhood and from economies of scale within a neighborhood are lost.

A tradable obligation approach to CRA could respond more effectively to the asymmetric information problem by encouraging banks to specialize in lending to particular neighborhoods and, using other banks' CRA obligations to lend in higher volumes in those neighborhoods, thereby developing economies of scale. Such specialized banks could develop the capacity to make more precise, individualized risk assessments and thereby avoid credit rationing. In addition, with higher volume, they could spread the fixed cost of serving a community over a greater volume of loans.

C. *Information Externalities*

A second market imperfection that affects lending is the presence of positive externalities that flow from information associated with past loans. Especially when making home loans, banks rely on appraisals, which are dependent on past sales of similar properties. Past sales, however, exist only because financing was available to earlier home buyers—and of course the appraisals that supported those earlier sales were

based on yet earlier sales. The home loan market is thus dependent on the positive externality created by a continuous series of comparable sales.[14]

If home sales in a community are interrupted or their volume is substantially reduced, for whatever reason, a self-reinforcing dynamic can occur in which loans that should be made are not made, and sales that should occur do not occur. In order to support an appraisal on a home or other piece of real estate, an appraiser needs several recent comparable sales in the same community. Without those comparable sales, the appraisal will be less reliable, and a lender may not finance the purchase at the seller's asking price. Unless the buyer can make up the difference with cash, or the seller reduces the price, the sale will fall through. The result is a further slowdown in sales and a concomitant reduction in information to fuel lending for future sales. This self-perpetuating decline in sales can occur regardless of the fundamental value of homes in a neighborhood or the potential of the local economy. What would otherwise be a transient decline in sales becomes a protracted period of illiquidity and decline in real estate values. Making the situation even worse, physical deterioration may occur as would-be sellers defer upkeep and leave homes and shops vacant.

Appraisals are used in some commercial lending as well, but in addition, banks monitor their outstanding loans to acquire information regarding business conditions in a community. That information is used to make current loan determinations.

---

[14] Leonard I. Nakamura, Information Externalities: Why Lending May Sometimes Need a Jump Start, Business Review, Federal Reserve Bank of Philadelphia, Jan.-Feb. 1993, pp. 3-7; William W. Lang & Leonard I. Nakamura, A Model of Redlining, Journal of Urban Economics, vol. 33, pp. 223-224, 1993; David C. Ling & Susan M. Wachter, Information Externalities and Home Mortgage Underwriting, Journal of Urban Economics, vol. 44, p. 317, 1997; Paul S. Calem, Mortgage Credit Availability in Low- and Moderate-Income Minority Neighborhoods: Are Information Externalities Critical?, Journal of Real Estate Finance and Economics, vol. 13, p. 71, 1996. McKinley Blackburn & Todd Vermilyea, The Role of Information Externalities and Scale Economies in Home Mortgage Lending Decisions, Journal of Urban Economics, vol. 61. p. 71, 2007.

Consequently, once commercial lending dries up in a community, there will be an impediment to reviving it, and a downward spiral can occur just as in the housing market.[15]

Downward spirals stemming from what otherwise would be transient slowdowns can occur in any market, but low- and moderate-income communities are especially vulnerable. Home buyers in these communities are less likely to have additional cash to make up the shortfall between the amount a bank is willing to loan and the price a seller is willing to accept. Similarly, businesses are less likely to have the internal funds to fill a shortfall in commercial lending. Regulatory intervention, therefore, could be beneficial.

CRA responds to the danger of such a downward spiral by forcing banks to make loans. But, again, in contrast to a tradable obligation approach, CRA requires banks to spread their activities throughout the area in which they operate. As a result, it deters specialization and market concentration, both of which can reduce the impact of lost information externalities that occur as a result of a slowdown in home sales and lending. A bank is more likely to learn about a neighborhood, and will have more sources of information, if it can concentrate resources there as opposed to spreading those same resources across its all areas in which it operates. The bank will therefore be less dependent on information flowing from a continuous stream of past home sales and commercial loans. Furthermore, if a bank has a larger market share in a neighborhood, it will reap more of the positive information externalities that it produces by continuing to lend despite a slowdown in sales. Because a tradable obligation approach to CRA would

[15] William W. Lang & Leonard I. Nakamura, Information Losses in a Dynamic Model of Credit, Journal of Finance, vol. 44, pp.731-744.

promote specialization and concentration, it has the potential to reduce the vulnerability of low- and moderate-income communities to local interruptions in sales and lending.

D. *Neighborhood Externalities*

In addition to information-related market imperfections, there are physical externalities that can impair lending in low- and moderate-income communities. The value of any property is dependent on the condition of neighboring properties. Thus, the deterioration of a neighborhood will reduce the value of even well-maintained properties. Consequently, a lender may decline to make loans in a neighborhood that is in decline or that it fears will go into decline, regardless of the quality of particular homes being offered for sale or the creditworthiness of particular loan applicants. A reduction in lending will exacerbate the deterioration. Conversely, lending can have positive externalities on a neighborhood, as proceeds are used to rehabilitate properties.[16]

Once again, CRA responds to this problem with forced lending across a bank's entire assessment area. Forced lending can help, but it would help more if a bank could concentrate its lending on particular neighborhoods and thereby internalize the positive externalities of continued lending.

A tradable obligation regime would promote concentration within neighborhoods. Consequently, it could allow banks to lend in sufficient volume within a neighborhood to internalize at least some neighborhood externalities that their own lending creates.

---

[16] For discussions of neighborhood externalities, see Jack M. Guttentag & Susan M. Wachter, Redlining and Public Policy, p. 39 (1990); Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending By Depository Institutions, p. 9 (1993).

E. *Summary*

As discussed in Section IV, there are a number of caveats and questions that must be addressed before a tradable obligation regime for CRA ought to be adopted. Leaving those issues aside for the moment, however, the potential virtue of a tradable obligation approach to CRA is that market forces would be harnessed to accomplish several objectives. First, the most efficient providers of financial services to low- and moderate-income communities would emerge in each community. Second, banks that serve a particular CRA-qualified community would tend to specialize in that community. Third, there would be greater concentration in banks serving particular CRA-qualified communities, meaning that each bank would provide a higher volume of service than it does under current law.

As a result of this specialization and concentration, banks would be well positioned to make more individualized credit decisions and thereby avoid credit rationing. They would also internalize the information externalities generated by their own lending and thereby better weather periods of illiquidity. Furthermore, by bearing a greater cost of physical neighborhood externalities and reaping a greater benefit from positive externalities associated with lending, banks serving a community would have a greater stake in averting physical deterioration and more to gain by working to promote rehabilitation.

III. Developments Since the 1990s

I originally proposed this tradable obligation approach to CRA in 1994. The question now is whether anything has changed that makes it worth further consideration. This Part III discusses developments since the 1990s that potentially make the proposal more attractive than it was in the 1990s, while Part IV discusses continuing concerns.

A. *The Effect of Out-of-Area Lending*

CRA, enacted in 1977, was designed for a banking industry in which a bank's market is largely local, and defined by the locations at which the bank collects deposits from brick-and-mortar branches. A bank's obligation under CRA is to meet the needs of low- and moderate-income communities in which the bank was physically located. Since CRA's enactment, its geographic orientation has become increasingly ill-suited to the evolving banking market.[17] Today, the area in which a bank makes loans is often quite different from the areas in which the bank has branches or even ATMs. Yet a bank's assessment area for CRA purposes is still based on the physical locations from which it collects deposits (including ATMs). Consequently, the impact of CRA is relatively weak in areas that receive relatively high volumes of out-of-area bank loans.

---

[17] For a discussion of this, see The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System, a report of The Joint Center for Housing Studies, Harvard University (2002), p 15, 27-31. For a contrary view, see Michael S. Barr, Credit Where It Counts: the Community Reinvestment Act And Its Critics, New York University Law Review, vol. 75, p. 513, 2005.

A tradable obligation approach to CRA could avoid this problem by broadly defining the region, or assessment area, for which a bank has CRA obligations. That region could extend beyond the areas in which the bank is physically located. Because a bank would not be required to perform all CRA services itself and because trading would be permitted within assessment areas, a larger assessment area would provide for a more liquid market for CRA obligations.

B. *Mortgage Lending by Nonbanks*

Another change that has occurred since 1977 is the dramatic expansion of the mortgage lending market to include institutions other than banks. CRA applies only to banks, which at the time of enactment were the primary providers of home loans. Today, however, mortgage brokers and mortgage bankers originate more loans than banks originate. Thus CRA applies to a relatively small and shrinking fraction of the home loan market.

CRA in its current form could be expanded to nonbank mortgage lenders. But to the extent that some of these lenders are not well suited to serve low- and moderate-income communities, it would be less costly from a societal point of view to allow these institutions to transfer their CRA obligations to institutions that can fulfill them more efficiently.

C. *The Growth of Community Development Financial Institutions*

Another development that could make a tradable CRA obligation regime attractive is the growth of Community Development Financial Institutions (CDFIs) across the country.[18] CDFIs provide a wide range of financial services in lower income communities, including services that banks provide under CRA. CDFIs provide some services directly and some in collaboration with banks. CRA has helped fuel the growth of CDFIs by inducing banks to finance them and to collaborate with them in serving CRA-qualified communities.

A tradable obligation regime could potentially enhance collaboration with CDFIs and enhance the delivery of financial services to the communities in which they operate. First, CDFIs could enter the market for tradable obligations and take on banks' CRA obligations. This could be an ideal case of a specialized bank taking over the CRA obligations of other banks and providing better service to the community. Most CDFIs are not banks, which raises the question whether nonbanks should be able to enter the market for taking on banks' CRA obligations. One concern would be a lack of regulatory follow up to ensure that the obligations are fulfilled. If a transferee of CRA obligations is a bank, its examiner could ensure that it has fulfilled all obligations that it takes on. There may be reason, therefore, to limit the market for CRA obligations to banks. But once this market exists, more CDFIs might well become banks in order to go into the business of taking on CRA obligations and thereby expanding their services.[19]

---

[18] See Providing Capital Building Communities Creating Impact, a publication of the CDFI Data Project (2006).

[19] Alternatively, nonbanks that perform CRA services could be brought into the CRA regulatory process. Beyond having nonbank CDFIs perform CRA services, one could imagine other nonbanks—Wal-Mart, for example—doing so.

A CDFI would need additional capital to fund expanded services. Some of that capital would come from amounts paid by banks that transfer their CRA obligations to the CDFI. But more would be needed. That additional capital could come from collaboration with banks. For example, a CDFI might enter into an arrangement with a bank in which the CDFI takes on some of the bank's obligations and in addition assists the bank in making loans that would allow the bank to fulfill some of its own CRA obligations. Alternatively, the bank could make a large equity investment in a CDFI, fulfilling its own investment obligation under CRA and perhaps those of transferor banks as well. Collaboration with CDFIs can count toward a bank's CRA rating under the current system, but by allowing banks to focus on particular neighborhoods rather than spreading their CRA activities throughout their assessment area, a tradable obligation approach would allow a CDFI to work with fewer banks with higher volume from each. The transaction costs of this arrangement may be less than the transaction cost of working with many banks each of which devote fewer resources to the relationship. With a CDFI as the hub of a financial service network in a community, the problems of information asymmetry, information externalities, and neighborhood externalities could be addressed in much the same way that South Shore Banks addressed those problems when working alone in Chicago's South Side in the 1980s.[20]

IV. Caveats and Questions

[20] See Ronald Grzywinski, The NEW Old-Fashioned Banking, Harvard Business Review, May-June 1991, p. 87.

Although a tradable obligation approach to CRA has the theoretical potential to enhance the delivery of financial services to low- and moderate-income communities, legitimate questions can be raised regarding the success with which the program could be implemented in practice. This section briefly raises some of those questions.

A. *Objective Description and Quantification of CRA Obligations*

A tradable obligation regime would require objectively specified CRA obligations. One question that should be investigated is the extent to which this can be accomplished. As described above, each bank's CRA obligations need not be fully defined by regulation. Instead, bank examiners could specify a bank's obligations at the time of examination, much as they do today in evaluating a bank's past performance. Nonetheless, even if individually specified, each bank's obligations would have to be specified objectively. For a trading regime to succeed, clarity in three respects would be necessary. First, a bank that has transferred a CRA obligation would need clarity with respect to how much of its entire set of CRA obligations it has transferred and what obligations remain. (This would be true as well when a bank performs a CRA obligation itself.) Second, a transferee bank would need clarity regarding what it must do *at the margin* beyond performing its own CRA obligations in order to fulfill the obligations transferred. Third, the CRA examiner would need clarity with respect to what has occurred in order to verify that the trade resulted in the transferee bank actually fulfilling the transferor bank's CRA obligation. For a quantifiable obligation, such as an obligation to make loans, these conditions may be relatively easy to meet. But for a less

quantifiable CRA service, it may be more difficult to ensure that a trade is adding services at the margin.

Ideally, all types of CRA obligations would be objectively specified in order to allow them to be traded. But if this is not possible, a tradable obligation regime that extends to only some types of CRA obligations, such as lending or investment obligations, could be an improvement over the current regime.

B. *Liquidity*

In theory, CRA trading would occur on an active market, with prices of certain types of obligations—loans in a particular community, for example—readily discoverable. Intermediaries could well emerge to facilitate these trades, as they have in the acid rain and carbon emission contexts. But there surely will be frictions, and it is unclear how liquid this market would be. If many banks choose not to trade, the market would be illiquid, which of course would further impede trading, and the potential benefit would be lost. There is no way to know how much trading would occur until one tries to implement the system, but some valuable information could be obtained by simply polling potential buyers and sellers of CRA obligations regarding how they would expect to respond to a trading regime.

C. *Geographic Coverage*

CRA in its current form reflects an ambition that all low- and moderate-income communities be served. A bank's performance under CRA is evaluated with respect to geographic distribution of the bank's service to CRA-qualified communities throughout its assessment area. As discussed above, this requirement is counterproductive in certain respects. Nonetheless, it does address a concern that communities not be left out.

It is unclear how effectively this concern would be met under a tradable obligation regime. In the extreme, if banks' CRA obligations had no geographic ties, there would be a danger that less attractive CRA-qualified communities across the country would not be served. To the extent the profit motive drives the market, banks would emerge to serve the low- and moderate-income communities that offer the greatest profit potential (or lowest loss potential), and the supply of such services would expand to less profitable communities (or those where the greatest losses are feared) up to the point at which the nationwide stock of CRA obligations is exhausted. The aggregate quantity of CRA obligations could be increased in order to fill in geographic gaps in coverage. But this would be a blunt policy instrument. Instead, the danger of geographic gaps could be addressed by imposing a geographic constraint within a trading regime. For example, the country could be divided into regional trading markets, and banks that operate within a region could be required to trade only within that region. The imposition of geographic limits would reduce the liquidity of the market, but trading regions could still be large. It is impossible to know in advance the tradeoff between geographic distribution of CRA services and the liquidity of the CRA market. This would have to be determined and adjusted with experience.

D. *Antitrust*

A theme repeated throughout this proposal is that a tradable obligation approach to CRA would promote concentration of lending markets within CRA-qualified neighborhoods. Concentration would promote internalization of externalities and achievement of economies of scale. But concentration could also lead to antitrust concerns. With CRA examiners periodically present and community groups organized to scrutinize banks' performance, this may not turn out to be a problem, but it is a potential danger of this proposal.

E. *A Pilot*

Some of the questions raised here and others that surely could be raised might be answered in the abstract. Others, however, can only be answered with experience. A pilot program, perhaps limited to a single region, might be a reasonable step toward determining whether a tradable obligation approach might enhance the delivery of services to low- and moderate-income communities.

V. Conclusion

A tradable obligation approach to CRA has some promise of responding to market failures in CRA-qualified communities better than does the current command-and-control approach. It also may be a more efficient means of accomplishing CRA's redistributive goals. The growth of mortgage lending by nonbanks and by banks operating outside the areas in which they have physical facilities also militates in favor of a tradable obligation approach. Nonbanks mortgage lenders are not currently covered by CRA, and extending CRA in its current form to these institutions may be infeasible. But imposing on them CRA obligations that they can transfer to others would have fewer obstacles. Finally, a tradable obligation approach to CRA may complement the growth of CDFIs over the past decade. Some CDFIs could become transferees of CRA obligations and increase their impact on communities. Others could facilitate transfers among banks and work with transferee banks on a larger scale than they do under the current CRA regime.

On the other hand, this would be a radical reform. I have raised several issues that would have to be addressed before one could be sanguine about its success. On balance, the approach seems attractive enough to warrant consideration of those issues as well as others that surely would arise if it were adopted, in order to assess the viability of this approach to CRA.