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State of the Market 36: CRA goes global

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During the next two years, the Community Reinvestment Act will be reinvented, first by regulation, then by statutory amendment. It's overdue for a reboot—during the third of a century CRA has operated, finance has gone global, and the concept of corporate social responsibility has risen from abstraction to reality in dozens of nations around the world.

Meanwhile, some form of CRA or inclusive banking is inevitable internationally. Populist ire that arose from the credit crunch is being directed at banks from all corners of the globe, triggering a series of new laws and schemas, whose combined effect will be to impose on banks greater government control over their economics (more regulation on safety and soundness) and greater government interest in their social outcomes (inclusive banking).

When economies are suffering, banks cannot retreat behind their credit policies, pull up the drawbridge, and wait out the global recession. US banks should not follow but lead impending change and influence the global financial ecosystem as it forms. Banks should ask, *How do we shape the world that is to come, using US experience to improve a global CRA?*

Why globalizing inclusive banking is sound public policy

Governments have a legitimate public-policy interest in furthering inclusive banking. Banks make their money because governments devise the laws that protect capital and property rights.

Furthermore, banks cannot survive without government; it creates the enabling or disabling environment, and—as we have just seen all around the world—in times of systemic failure or disruption, government is the ultimate liquidity backstop.

Let's export what we've learned

> Material in this State of the Market is adapted from an article I published in the Federal Reserve Board of San Francisco's periodical *Community Development Investment Review*, entitled *CRA Goes Global* (link in .pdf)—or email me directly for a pdf copy.

Globalization is also driving forces that create a need for inclusive banking initiatives:

- **Urbanization and expanding cities.** This huge demographic force of the twenty-first century puts tremendous pressure on cities to accommodate its immigrants. Global-northern cities (e.g. New Orleans, Los Angeles, or Liverpool) face challenges of integrated urban renewal, while expanding slums challenge global-south metropolitan areas (e.g. São Paulo, Mumbai, Cairo, or Istanbul). The economics of urban land markets dictate that the bottom quartile can never afford market-quality housing, so governments need a mixture of subsidies, inclusionary zoning/ land use, and effective community reinvestment of private capital.
- **Public-private partnership as the vehicle of choice.** When first confronted with the challenge of housing affordability, virtually every

government chooses direct public intervention as its initial option. Governments everywhere initially love to build new units (e.g., Turkey's TOKI, the UK's social housing, and US public housing), and often to rent or sell them to civil servants (e.g., Egypt's Ministry of Housing). Moving to public-private partnership involves a fundamental shift in government's awareness of its natural role.

- **Addressing a heritage of spatial exclusion**. America's CRA was born in part from frustration over housing as a segregationist holdover: although expunged judicially, discrimination nevertheless persisted spatially and as a matter of habitual banking inertia. Even vigorous enforcement of Fair Housing laws could not make buildings suddenly move or neighborhoods change overnight—poor investment leads to poor conditions that are then used to justify poor investment. For that, we need continuous reinvestment in communities, and that requires incentivization.

Examples from around the world

As you might expect, the nations most adoptive of inclusive banking rules also have national legacies of spatial exclusion.

South Africa. In 2003, under political pressure, the banking sector volunteered, a unilateral industry-wide pledge. Under the Financial Sector Charter, banks voluntarily negotiated lending and investment goals with quantitative targets, agreed to report their performance publicly and transparently, and subjected themselves to consequences: prohibitions from government contracting for subpar performance, preferred access to government contracts for superior performance).

United Kingdom. The UK is eminently suitable for a CRA, with many decades of 'blue-lining' areas 'not to be lent to' by UK building societies (akin to U.S. savings and loans). Despite this, the United Kingdom has nothing of the kind (and the concept is greeted with horror by bankers, which perhaps suggests the need for CRA is urgent). Meanwhile, for a quarter-century the UK has had an inclusionary-zoning ordinance known as Section 106, that is zero-sum (no density bonus and no additional resources), hence contentious. It would be significantly more effective if coupled with a UK CRA.

India. Despite *Slumdog Millionaire*, India has a formal down-market banking requirement, Priority Sector Lending, which directs banks to deliver a portion of their net bank credit into 14 priority sectors, including affordable housing—and the state of Maharashtra (home to Mumbai) also has a 35% affordable housing inclusionary zoning requirement, as well as a truly nifty density bonus, the Transferable Development Right (TDR).

Brazil. Land of the burgeoning and dangerous favelas, Brazil has a 2003 law (*Resolução 3109 Conselho Monetario Nacional*) whereby banks must earmark 2% of deposits for micro-credit loans, but they are unenthusiastic participants and use of the resource is low.

Principles emerging from global experience

1. *Banks do business with the public via an asymmetric power relationship.* When the customer is poor, power dynamics tilt in the bank's favor—a bank can take money from poor people by allowing them to deposit, can make money off poor people by processing their credit cards or checks, and yet can exclude poor people from credit, doing nothing to alleviate their poverty, and indeed even contributing to it.

2. *What to a bank may look like "careful credit" could be bigotry in disguise.* Credit bigotry is unacceptable, yet credit prudence is also desirable, and in today's more complex world, it is difficult to distinguish one from the other.

3. ***The public interest conveys a public authority to ensure inclusionary banking.*** To operate, banks need government's security resources (e.g., charters, deposit insurance). Post-crunch governments have not merely rescued many banks from their past excesses, they are actively replenishing their equity capitalization, with central bankers holding macro interest rates at infinitesimal levels while banks then lend the capital at spreads much wider than they enjoyed prior to the crisis. This inescapable implicit reliance on governmental bailout for their business model gives the 'pay to play' element of CRA an ethical foundation.

4. ***Banks should fulfill their community service through <u>banking</u>.*** Government should establish priorities, provide resources, and incentivize banks to do *banking business*: flow capital down-market as lending, investing, and inclusionary access to banking services.

5. ***The right credit-access boundary is between commercial and noncommercial risks.*** It is not bigotry to withhold credit when one fears government will meddle to capital's detriment after the fact—and there is no way for private parties to eliminate their risk of government as unreliable counterparty. Government cannot chide banks for refusing to extend credit unless it relieves them of the noncommercial components of risk (e.g. enforceability of foreclosure rights and sanctity of contracts) in a judicially or financially enforceable way.

6. ***Keep score on results, with rewards and penalties associated with the scoring.*** Banks with high scores may gain preferential advantages (e.g., opportunities to do business with the government), while those with low scores may be denied access or disadvantaged vis-à-vis growth and consolidation (e.g., bank mergers).

Globalizing CRA 2.0—principles from international experience

Although the US may have invented the judicial CRA, other nations' inclusive banking approaches represent an interesting thought experiment of principles for CRA 2.0. They include:

- ***Recognize more capital forms***. Because capital is protean and complex, rather than a simplistic division into debt and equity, think in terms of spending and risks accepted. Every fragmented capital slice should be eligible for inclusion as a qualifying capital deployment.
- ***Encompass more institutions***. Within banking today so much more than passbooks and local home loans, a community reinvestment obligation should rest upon any major entity that has explicit or systemically implicit ('too big to fail') government backing—insurance companies, investment banks, and commercial banks, to name the obvious.
- ***Align more with economic distress, less with geography***. Instead of a geographically bounded definition of assessment area, develop one aimed at socioeconomic need. (India is GPS mapping every slum in the country, over 6,500 of them, and will conduct detailed on-the-ground censuses, including a national unique biometric record system.)
- ***Reward origination and innovation***. Providing liquidity is overhyped and overvalued; what changes society are successful first-time credit extensions, particularly programmatic innovations. (Admittedly, asking bureaucrats to score innovation is no small challenge.)
- ***Eliminate the churning incentive***. To hold a loan is economically equivalent to selling it and buying it again, yet CRA gives credit to new loans, not ones continuing to be held.

- ***Examine uniformly***. For curious historical reasons, the CRA is regulated by four independent entities, a structure that invites inconsistency. There should be one examining body.
- ***Use good rulemaking and scoring***. Bad rules make bad games. Many of today's CRA inefficiencies result from inconsistent and opaque examinations based on fuzzy, outdated definitions and procedures. By contrast, the LIHTC QAP process works well: prospective publication, open public commentary, quantitative scoring, transparent results reporting.

Conclusion: distilling the essence of CRA

Community reinvestment is a legitimate imperative. Banks exist under and make profits under a regulatory umbrella that derives its legitimacy from all levels of society. Because legitimacy and depository capital comes from all levels of society, banks should recycle some capital into communities, on a commercially reasonable basis; otherwise capital flows will be used as a tool of disinvestment in disfavored neighborhoods.

Over three decades, banks have found that community lending is good business, if given an enabling environment and time to flourish. In fact, CRA has generated important system-wide benefits, including:

- Knowledge transfer between banks and community development entities.
- Financial product innovation by banks into new business spaces (e.g., lending for affordable rental, investment in Low Income Housing Tax Credits or New Markets Tax Credits).
- New business activities and profit centers (e.g., community development banks).

All of these innovative byproducts have permanently and positively influenced affordable housing lending and investment. They have also helped government make subsidies smarter, not just bigger.

If banks do not extend their thinking to help government, government will eventually compel their performance, and not always gracefully: in its zeal to stamp out prejudice, government can unwittingly do much more harm than good. Banks should and can forthrightly acknowledge a social responsibility to bank expansively (reaching out to those as yet underbanked) but sensibly, and to work with government to craft programs that make government responsible for noncommercial risk, and for permanent subsidy.

For the banks, the devil one designs for oneself is far better than the one a frustrated government can impose. For their own survival and self-preservation, they must help evolve the regulatory ecosystem. Global inclusive banking is part and parcel of what banking is supposed to do.