# FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY: WHAT ABOUT COMMUNITIES?

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## I. Introduction

The passage and signing of the Gramm-Leach-Bliley Act of 1999 ("GLBA") was hailed as a major overhaul and modernization of the financial services sector of the United States. After laboring for over 20 years in attempts to modify or repeal the Glass-Steagall Act of 1933, the Congress finally passed legislation that the President could sign.

As at least one commentator as pointed out,[1] the Congress could have repealed the Glass-Steagall Act in a few sentences. Instead the GLBA required 380 pages and seven titles. The tortured prose of the GLBA reflected the convoluted history of financial legislation and regulation, as well as the political balancing of a multitude of interests that were required to gain passage. In addition to dealing with the Glass-Steagall Act and related issues,[2] the GLBA also addressed

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[1] *See* David L. Glass, *The Gramm-Leach-Bliley Act: Overview of the Key Provisions; Presentation Before the State of New York Banking Department*, 17 N.Y.L. SCH. J. HUM. RTS. 1 (Symposium 2000).

[2] For example, the Glass-Steagall Act was silent on the issues of insurance and of bank ownership of non-financial enterprises. These were addressed by the Bank Holding Company Acts

consumer privacy issues and made some modifications in the Community Reinvestment Act of 1977 ("CRA").

Like many pieces of legislation, the "revolutionary" aspects of the GLBA were oversold. There had been significant movement toward consolidation and integration within the financial services sector, and especially within banking, even before the passage of the GLBA. These trends surely would have continued even in the absence of the GLBA. But the Act will make some things easier, such as the integration of commercial banking with investment banking and with insurance, and thus may accelerate somewhat the processes of consolidation.

This paper will provide some background and context to the passage of the GLBA and then focus on the likely consequences for local communities, with a special emphasis on banking. Since the GLBA modified the CRA, with potential consequences for communities, the latter part of this paper will discuss those modifications and the wisdom of the CRA itself.

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of 1956 and 1970, which kept banks out of insurance underwriting and out of non-financial businesses generally. But investment banking firms faced no such restrictions. Hence, in order to erase the Glass-Steagall barriers the GLBA had to address those Acts as well.

## II. A "Snapshot" and Some Trends

It is useful to start with a "snapshot" or picture of the financial services sector at the time of the passage of the GLBA. Table 1 provides aggregate data for the assets of important components or sub-sectors of the U.S. financial services sector, as of year-end 1999.[3] As can be seen, the numbers are large.[4] After all, the U.S. has a large economy: as of 1999, GDP was almost $10 trillion. Another important feature of the financial services sector that is highlighted by the table is the reality that commercial banks are not "the only game in town" with respect to lending and investing.[5] Other depositories and other financial institutions are important sources of credit and investable funds;[6] even trade credit -- short-term lending by a supplier to a customer -- is sizable.

The approximate numbers of firms in each sub-sector is provided in Table 2. The table illustrates another important feature of the financial services sector: the large numbers of entities that are present. Despite the wave of mergers and consolidations within the sector, the numbers of banks and other financial institutions remain quite large on a nationwide basis (but, as will be discussed below, local presence is a separate question).

Table 3 provides some recent and longer-term trends, especially for banking. First, the financial services sector is growing as a percentage of U.S. GDP; but banks and other depositories

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[3] At the bottom of the table, the U.S. GDP -- a flow -- for 1999 is also provided, primarily to provide a context or rough basis for comparison.

[4] It should be noted, however, that there are substantial overlaps and "double-counting" possibilities across the sub-sectors. For example, some pension funds may hold some of their assets in the form of mutual fund shares; some insurance companies may hold some of their assets as bank deposits, etc. Accordingly, the net assets held by the financial services sector is smaller than just a simple addition of all of the assets shown in Table 1.

[5] Whether there are some specialties for which banks are still important will be addressed below.

[6] The assets of a financial institution are primarily the loans and investments that it has made.

have been declining in relative importance. Second, the bank merger wave that has been reported in the media is not an illusion: there were over 8,000 mergers between 1985 and 1999. As a consequence, the number of banks fell substantially, and the number of large banks -- those with assets above $10 billion -- almost tripled. However, despite the consolidation (and the ubiquity of automatic teller machines), the number of physical locations (home offices and branches) has continued to expand. Also, there has been a substantial amount of new entry: over 2,500 start-up banks between 1985 and 1999. Third, the banking sub-sector is considerably healthier, as judged by numbers of bank closures and losses from insolvencies, as compared to a decade earlier. Fourth, banking is considerably more global, as judged by the presence of overseas-headquartered banks in the U.S., as compared with the 1970s. Fifth, the "wholesale" side of banking is increasingly electronic; but the "retail" side has persisted with paper; the number of checks written annually has continued to rise, with approximately 65 billion checks written in 1999.[7] This last phenomenon contrasts with the sharp rise in the "retail" use of the Internet for stock trading.

More broadly, the past few decades have been characterized by a dramatic increase in asset securitization, reduced regulation, and more competition among financial services providers.[8] We now turn to a discussion of some of the reasons underlying these trends.

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[7] For a discussion of the persistence of the paper check, *see* David B. Humphrey, Lawrence B. Pulley, & Jukka M. Vesala, *The Check's in the Mail: Why the United States Lags in the Adoption of Cost-Saving Electronic Payments*, 17 J. FIN. SER. RES. 17 (Feb. 2000).

[8] *See, e.g.,* Allen N. Berger, Anil K. Kashyap, & Joseph M. Scalise, *The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been*, 1995 BROOKINGS PAPERS ECON. ACT. 55 (No. 2, 1995); Allen N. Berger, Rebecca S. Demsetz, & Philip E. Strahan, *The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future*, 23 J. BANK. & FIN. 135 (Feb. 1999).

## III. Some Reasons for the Trends

There have been two fundamental, and mutually supportive, forces that have underlay many of the trends described in the previous section. One has been the broad sweep of public policy toward less regulation of financial services; the other has been the rapid technological change in the two "core" technologies of financial services: data processing and telecommunications. We will discuss each of these fundamental forces in turn.

### A. Changes in public policy.

Until the 1930s public policy with respect to the financial services sector -- the laws, regulations, and governmental bodies that influenced financial services -- was largely the domain of the states. This was consistent with the technological limitations of the nineteenth and early twentieth centuries: Finance tended to be a local affair, with a strong tendency for locally based institutions to provide financial services to customers that were geographically adjacent. Reinforcing this basic tendency were state laws -- e.g., for banks -- that uniformly forbade interstate bank branching and that, in many states, restricted or even forbade intra-state branching; somewhat similar laws kept insurance as an in-state business.

There were exceptions: In 1863, Congress authorized nationally chartered banks and a national regulator -- the Office of the Comptroller of the Currency ("OCC") -- for them; but national banks continued to be bound by many state laws and regulations, including those pertaining to branching limitations.[9] The Federal Reserve was created in 1913, but its functions were primarily oriented toward the macroeconomic goals of stabilizing the nation's money supply and the economy more generally. Also, securities markets -- stocks and bonds -- were clearly a

[9] When ambiguities arose in the 1920s as to the applicability of state branching limitations to national banks, the McFadden Act of 1927 resolved the ambiguities in favor of the states.

national phenomenon by the early twentieth century, with a center in New York, and networks of national "wirehouse" brokerage firms that fed orders to the central markets; but the individual states were responsible for securities regulation, primarily through "blue sky laws" that dealt with securities fraud.

Despite the exceptions, pre-1930s finance -- and its regulation -- was decidedly a local affair, and it was compartmentalized by specialty as well.[10] An important consequence was the widespread proliferation of comparatively small financial institutions. For example, at the beginning of the twentieth century the number of separately chartered commercial banks in the U.S. was already over 12,000; by 1910 the number of banks had doubled to over 24,000; and it hit a peak of *30,456* in 1921.

The stock market crash of 1929-1933, the failures of thousands of banks and other depository institutions during those same years, and the descent of the American economy into the Great Depression set the stage for a major structural change. From 1933 onward federal legislation, reflecting policy makers' beliefs that laxity of financial regulation was partly responsible for the debacle, greatly expanded and centralized financial regulation. The Banking Act of 1933 strengthened federal safety-and-soundness bank regulation and placed ceilings on the interest rates that banks could pay to their depositors;[11] the Glass-Steagall Act (which was Sections 16, 20, 21, and 32 of the Banking Act) forced a separation of commercial banking from investment banking and securities activities generally; the Banking Act of 1935 further strengthened federal bank regulation, including restrictions on entry.[12] The Securities Act of 1933, the Securities Exchange

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[10] This locally focused structure partly reflected the technological capabilities of finance at the time but also reflected American populist sentiment, with its distrust of large financial institutions, especially banks, and its desire to keep them small and locally oriented.

[11] The Act also established federal deposit insurance and created the Federal Deposit Insurance Corporation ("FDIC") to administer it.

[12] *See* Sam Peltzman, *Entry in Commercial Banking*, 8 J. L. & ECON. 11 (Oct. 1965); Linda N.

Act of 1934, and the Investment Company Act of 1940 created a federal regulatory regime, based primarily on required information disclosure, for the securities industry, with the newly created (1934) Securities and Exchange Commission ("SEC") as its regulator.[13] Insurance, however, remained a state affair (and remains so today).

Federal regulation of the financial services sector continued to expand through the early 1970s, especially for banks. The Bank Holding Company Acts of 1956 and 1970 (which restricted banks and their holding companies from entering insurance underwriting -- and vice-versa -- and from engaging in non-financial businesses generally), the Interest Rate Control Act of 1966 (which extended interest rate ceiling on deposits to savings and loan institutions), and the Employee Retirement Income Security Act of 1974 (pertaining to employee pensions and creating the Pension Benefit Guarantee Corporation) could probably be considered the high-water marks.

By the early 1970s the financial regulatory tide had peaked and was beginning to recede.[14] The reform and retreat of federal financial regulation in the 1970s was part of a larger public policy trend toward less regulation of prices and of entry for a number of service industries, including air transport, rail freight, trucking, natural gas, and telecommunications.[15] The first such instance

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Edwards & Franklin R. Edwards, *Measuring the Effectiveness of Regulation: The Case of Bank Entry Regulation*, 17 J. L. & ECON. 445 (Oct. 1974).

[13] In addition, the Homeowners' Loan Act of 1933 created a federal charter for savings and loan institutions, with the Federal Home Loan Bank Board (which was created by the Federal Home Loan Bank Act of 1932) to regulate them and provide deposit insurance through the Federal Savings and Loan Insurance Corporation ("FSLIC"), which was created by the National Housing Act of 1934. Also, the Federal Credit Union Act of 1934 created national charters for credit unions (though federal deposit insurance was not provided until 1970, when the National Credit Union Administration was created).

[14] The Community Reinvestment Act of 1977 was an important exception (to be discussed below), as was the Federal Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") and the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").

[15] *See* Clifford Winston, *Economic Deregulation: Days of Reckoning for Microeconomists*, 31

occurred, interestingly, in the securities industry: In the early 1970s the U.S. Department of Justice's Antitrust Division successfully challenged the SEC's endorsement of the New York Stock Exchange's system of fixed brokerage commissions, leading eventually to completely competitive commissions on May 1, 1975.[16]

By the late 1970s, favorable regulatory and court rulings were eroding the Glass-Steagall barriers by widening the scope of banks' securities activities, and serious discussions of outright repeal of the Glass-Steagall Act were beginning.[17] Also, some states were reducing their restrictions on intra-state bank branching, and a few states were forming mutual compacts with respect to interstate bank ownership and branching. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 mandated the phase-out of the 1930s interest rate ceilings on bank deposits (although a ban on the payment of interest on commercial checking accounts remained, and persists today). Also, de novo entry into banking was considerably eased by both federal and state regulators in the early 1980s.

In the late 1980s the Federal Reserve began gingerly easing the Glass-Steagall restrictions on banks' underwriting of corporate securities. In the mid 1990s, after a decade of sputtering efforts, the Congress passed the Riegel-Neal Interstate Banking and Branching Act of 1994, which established a strong federal presumption of interstate branching and bank ownership. And, finally, the 1990s ended with the passage of the GLBA in 1999.

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J. ECON. LIT. 1263 (Sept. 1993).

[16] *See* H. Michael Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, in PROMOTING COMPETITION IN REGULATED MARKETS 301 (Almarin Phillips, ed. 1975; Seha M. Tinic & Richard R. West, *The Securities Industry under Negotiated Brokerage Commissions: Changes in the Structure and Performance of New York Stock Exchange Member Firms*, 11 BELL J. ECON. & MGT. SCI. 29 (Spr. 1980). This system of competitive commissions was ratified by the Securities Act Amendments of 1975.

[17] *See, e.g.,* Lawrence G. Goldberg & Lawrence J. White, eds., THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES (1979).

As this brief history illustrates, although the financial services sector remains heavily regulated -- especially with respect to safety-and-soundness considerations[18] and information disclosure requirements -- the extent of regulation, especially with respect to limitations on prices, entry, locations, and activities, has been considerably reduced.

B. Changes in Technology.

The core technologies of finance are data processing and telecommunications. At first glance, this may seem a strange characterization for an industry that focuses on lending and investing. But the essence of lending or investing is the hope/expectation of having the loan repaid (with interest) or receiving an adequate return on the investment and avoiding losses.[19] In turn, this requires the gathering and assessment of information about the borrower or user of the funds and his/her likelihood of repayment; hence the importance of data processing and telecommunications.

The rapid improvements in data processing and telecommunications of the past three decades, with their concomitant decreases in costs and expansions of capabilities, have had dramatic consequences for financial services. Financial institutions are capable of doing more things and doing them over wider geographic areas; non-financial firms can more readily offer

[18] The FIRREA of 1989 and the FDICIA of 1991 represented a strengthening of safety-and-soundness regulation of depositories, in the wake of the S&L debacle of the late 1980s and a wave of bank failures in the late 1980s and early 1990s; *see, e.g.,* Lawrence J. White, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANKS AND THRIFT REGULATION (1991); George G. Kaufman & Robert E. Litan, eds., ASSESSING BANK REFORM: FDICIA ONE YEAR LATER (1993).

[19] More technically, the lender/investor is at a disadvantage vis-a-vis the borrower in two respects: Before granting a loan, the lender has difficulty determining who (among loan applicants) is more likely to repay; and after granting the loan, the lender has to monitor the borrower to ensure repayment. The former problem is that of "adverse selection"; the latter is that of "moral hazard". Both are specific aspects of the more general problem of "asymmetric information" between lender and borrower.

financial services.

A stylized way of portraying the importance of information processing and transmission for the structure of finance -- who gets finance, from whom, and on what terms -- is provided in Figures 1 and 2. In Figure 1 we illustrate the informational opaqueness or transparency of a potential borrower or user of funds along a one-dimensional line. Individuals (or enterprises) that are informationally opaque -- little is generally known about their repayment capabilities -- are located toward the left side of the line; those who are informationally transparent are located toward the right. Below the line are listed the likely sources of finance that the borrowers with the different degrees of opaqueness/transparency can expect to access.

Those who are informationally transparent -- e.g., the U.S. Government, or the General Motors Corporation -- can access securities markets, since the non-specialist lenders (bond holders) and investors can use the widely available information (and reputation) of these entities to make their judgments as to whether to lend/invest and on what terms. At the other end of the spectrum, those who are informationally opaque -- e.g., a young adult or an entrepreneur with no credit history -- may have to rely on friends and family and on self-finance.[20] In between, individuals and enterprises with intermediate levels of opaqueness/transparency will be able to access financial intermediaries, such as banks and other depositories, finance companies, insurance companies, pension funds, etc., who are specialists in information gathering and assessment.[21]

The diagram includes two wavy lines separating the three categories of borrowers; the

[20] Friends and family are likely to have non-public knowledge about the individual's repayment capabilities and to be in a position to monitor the individual's behavior after the granting of the loan; they may also have special abilities to extract repayment (or be more willing to convert a loan into a "grant"). A limited amount of credit card finance may also be available -- a consequence of the advances in technology discussed in the text.

[21] Supplier companies, who provide trade credit, are in somewhat of a similar position, to be able to assess an enterprise's operations and prospects for repayment.

waviness is meant to convey the absence of precise boundaries. More important, the arrows above these wavy lines point to the left; technological changes are moving both boundaries to the left: On the right-hand side, the processes of asset-backed securitization -- of residential mortgages, credit card loans, auto loans, personal finance loans, commercial real estate loans -- have allowed the securities markets to encroach on areas of finance that 25 years ago were the near-exclusive preserve of banks and other financial intermediaries. The securitization "revolution" is based on vastly improved abilities to gather and analyze information. But, also, on the left-hand side, improved technology has enabled banks and other intermediaries to pierce more effectively the "fog" of asymmetric information and delve more deeply into the realm of opaque borrowers with credit card loans, personal finance loans, small business loans, and other forms of finance.[22]

Figure 2 expands on these notions by providing two important dimensions of the determinants of opacity/transparency for enterprises: age and size. Older enterprises have more of a "track record" that lenders can assess; younger enterprises have less. Larger enterprises are likely to borrow more, which makes the lender's investment in the fixed costs of information assessment more worthwhile. Accordingly, older and larger enterprises are more able to access the securities markets; younger and smaller enterprises will rely on banks and other intermediaries; and very young and small enterprises will have to rely on friends and family and self-finance. And, again, the arrows related to each of the wavy lines point down and to the left (i.e., toward the origin): Technological improvements are allowing younger and smaller firms to access the securities markets, etc.[23]

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[22] Some of the deeper penetration of the previously opaque group has created the new segment of "subprime" lending, where higher-risk borrowers pay higher interest rates but receive finance that previously would have been non-existent; *see, e.g.,* Glenn B. Canner, Wayne Passmore, & Elizabeth Laderman, *The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers*, 85 FED. RES. BULL. 709 (Nov. 1999).

[23] These diagrams also illuminate the importance of financial infrastructure, such as accounting and auditing standards, that encourage greater informational transparency.

C. A summing up.

The changes in public policy and the improvements in technology have been mutually supportive. The technological improvements have permitted financial institutions to do more things and to do them at a greater distance. These expanded capabilities have created profitable opportunities for geographic and product-line expansions, either through internal growth or through mergers.[24] The policy changes have permitted these structural changes, as well as spurring the underlying technological improvements.

The result has been consolidation -- but also more effective competition, as services providers have invaded each other's "turf", either through the establishment of physical branch offices or local agent representation arrangements or through postal, telephone, or Internet-based solicitations from afar.[25] An important element in preserving competition has been antitrust enforcement, which has been aimed at ensuring that important categories of local facilities-based services -- specifically, deposit services and loans to small- and medium-size enterprises -- are not eroded because of mergers. It is typical for the Antitrust Division to require spin-offs of local branches to competitors when a merger of banks with overlapping branch networks would otherwise create anti-competitive levels of bank concentration in local markets.[26] As a consequence, despite the merger wave documented in Table 3, local levels of bank concentration,

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[24] Even where the expanded opportunities may not be profitable, CEOs' desires to manage larger organizations (interacting with weak corporate governance restraints and some CEO hubris) have contributed to the urge to expand and merge; *see., e.g.,* Berger, Demsetz, & Strahan, *supra* note 8.

[25] Ease of entry and expanded competition has also had a darker side: Lenders that have taken advantage of financially unsophisticated borrowers and imposed unduly onerous terms, engaging in "predatory lending".

[26] *See, e.g.,* Margaret E. Guerin-Calvert, *Current Merger Policy: Banking and ATM Network Mergers*, 46 ANTITRUST BULL. 289 (Sum. 1996).

as measured by the average Herfindahl-Hirschman Index (HHI)[27] calculated for metropolitan areas, have scarcely budged over the past two decades.

[27] The HHI is the sum of the squares of the market shares of each seller in a specified market.

## IV. The Effects on Communities

As the discussion of the previous sections has indicated, communities have been affected by the changes in the financial services sector that have occurred over the past two-to-three decades, and they will continue to be affected by the changes that will surely continue to occur. The GLBA may hasten consolidation modestly, at most.

Where the GLBA may make the most difference is in the area of "financial supermarkets", where an institution can offer a wide range of financial services (e.g., depository services, loans, securities investment advice and transactions, insurance, etc.) that it can "cross-sell" to its customers, with links through a common brand name and a common account. The current Citigroup efforts in this regard are the most prominent.

Whether this will ultimately prove to be a successful marketing strategy for financial services is still an open question. Past efforts -- notably Sears and American Express -- were not successful; financial services customers apparently preferred specialist providers. But perhaps new managements and improved technologies will find the key to providing a broad array of services under one roof. In any event, it is highly likely that specialist providers will continue to maintain substantial niches.

In this last respect, financial services are likely to be quite similar to retail services in general, where there appears to be room for a wide variety of different organizational forms: the specialized boutique; the chain of specialty stores; the single location variety store; and the chain of department stores or broad-based retailers (e.g., Wal-Mart). Further, just as the processes of consolidation in financial services have meant the disappearance of many thousands of local financial institutions of all kinds, so too have retail services generally been undergoing a similar process of consolidation and the replacement of locally based entities with branches of regional and national chains.

For the customer who has a special attachment to a particular institution or retailer, this process may involve some loss, as the old relationship disappears and a new one must be established. But, especially for financial services, the vastly improved technologies of data processing and telecommunications have also meant expanded convenience: e.g., ubiquitous automatic teller machines (ATMs) with 24-hour access to cash; widespread credit card availability and merchant acceptance; expanded residential mortgage availability through mortgage bankers and mortgage brokers; Internet-based and telephone-based 24-hour access to bank accounts, brokerage accounts, and mutual fund accounts. Also, as was indicated in Table 3, the number of physical banking locations has continued to expand, despite the proliferation of ATMs and other means of electronic access. And, as was discussed in the previous section, antitrust enforcement has kept average levels of local bank concentration relatively unchanged.

Though there may be some communities whose residents have generally been disadvantaged by the changes in financial services, most communities have surely gained from these changes. The continuing improvements in the underlying technologies should mean continued gains for most communities and their residents.

## V. What about the CRA?

The CRA was passed in 1977,[28] in response to complaints that some banks and savings institutions were "red lining" some low- and moderate-income communities and not lending to creditworthy borrowers in those communities. The Act imposed an obligation on banks and savings institutions[29] "to meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."

A major point of leverage with respect to CRA enforcement has been at the times of bank mergers and acquisitions (or, more rarely, at the times of branch expansions), since community groups could then lobby federal regulators to insist that the bank expand its commitment to its community before the regulators approved the merger "in the public interest". Prior to 1999 the CRA had not been significantly amended since its original passage.

### A. The GLBA and the CRA.

The GLBA addressed the CRA in four ways. First, it reduced the frequency of CRA compliance examinations for "small" (under $250 million in assets) banks whose last examination ratings were deemed "outstanding" or "satisfactory". The smaller institutions' argument was that they were community-focused anyway and that frequent exams for such institutions were a waste of time and money, especially for those who had performed well in the past. The opponents of any laxity feared that even these institutions might stray and that the reduced examination frequency was an initial wedge that might be used eventually to weaken the CRA generally. The small banks won.

[28] The CRA was Title VIII of the Housing and Community Development Act of 1977.

[29] For the remainder of the discussion of CRA, unless otherwise indicated, references to "banks" will also encompass savings institutions.

Second, the GLBA's "sunshine" provision required public disclosure of CRA agreements between financial institutions and non-governmental entities, such as community organizations, along with annual reports. The proponents of this "sunshine" argued that community groups had been extracting "ransom" from merging banks and that such arrangements should be made public. Opponents feared that this was just an effort to harass the community groups. The proponents won.

Third, it required that banks that want to engage in securities and insurance businesses must form a "financial holding company" (FHC) and that the FHC's bank subsidiaries must maintain at least a "satisfactory" CRA rating.[30] Thus, the CRA obligation was directly linked to the new activities authorized by the GLBA.

Finally, the GLBA required reports by the Treasury and by the Federal Reserve on the impacts of the CRA.[31]

B. An assessment.

The GLBA did not make large changes in the CRA. Nevertheless, the CRA provisions were bitterly contested (and disputes over CRA-related provisions prevented passage of an earlier version of the GLBA in 1998), largely because of their feared symbolism. For CRA proponents, the small bank and sunshine provisions represented a potential weakening of the reach of the Act; for CRA opponents the specific connection of CRA ratings with the ability of banks to use the new

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[30] A national bank can also form a "financial subsidiary" for its activities, but cannot engage in insurance underwriting or real estate development in the subsidiary; the bank "parent" of the subsidiary must maintain at least a "satisfactory" CRA rating.

[31] *See* Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky, & Susan White Haag, *The Community Reinvestment Act after Financial Modernization: A Baseline Report*, U.S. Department of the Treasury, April 2000; Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky, Gary Fauth, Maureen Kennedy, & Paul Leonard, *The Community Reinvestment Act after Financial Modernization: A Final Report*, U.S. Department of the Treasury, January 2001; Federal Reserve, *The Performance and Profitability of CRA-Related Lending*, July 2000.

GLBA powers indicated a potential strengthening of the reach of the Act.

Unfortunately, the continued attention devoted to the CRA and its enforcement, despite the good intentions of its proponents, does indicate a continued effort to preserve old structures in the face of a modernizing financial economy. At its 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.[32]

Consider the basic concept:[33] Banks are somehow neglecting loan opportunities in "their" communities -- fundamentally, in low- and moderate-income (LMI) communities -- and must be forced to lend in those communities. Equivalently, if a bank gathers deposits from customers that are located geographically close to that bank's physical location, but then lends the funds to other customers that are not geographically close to that location, then the bank is "draining" deposits out of the former community and must be prevented from doing so.

At its base, this concept rests on the notion that either banks are "lazy" (or ill-intentioned) and are inefficiently passing up profitable opportunities to lend to creditworthy customers in the LMI communities, and so they must be forced to do so; or they are monopolies with market power and excess profits that can be used to cross-subsidize the unprofitable loans that they can be forced to make. Either version has the flavor of the pre-1970s world of locally oriented and protected

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[32] This discussion draws on Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 FORDHAM URB. L. J. 281 (Win. 1993); Lawrence J. White, *Financial Modernization: What's in It for Communities*, 17 N.Y.L. SCH. J. HUM. RTS. 115 (Symposium 2000).

[33] *See, e.g.,* Richard Marsico, *A Guide to Enforcing the Community Reinvestment Act*, 20 FORDHAM URB. L. J. 165 (Win. 1993); Allen J. Fishbein, *The Community Reinvestment Act after Fifteen Years; It Works, But Strengthening Federal Enforcement is Needed*, 20 FORDHAM URB. L. J. 293; Deborah Goldberg, *Remarks of Deborah Goldberg*, 17 N.Y.L. SCH. J. HUM. RTS. 67 (Symposium 2000); Richard D. Marsico, *Enforcing the Community Reinvestment Act: An Advocate's Guide to Making the CRA Work for Communities*, 17 N.Y.L SCH. J. L. HUM. RTS. 129 (Symposium 2000).

banks and banking. Further, the notions that banks have a special obligation toward "their" communities and that the communities need *and deserve* this protection again smack of that pre-1970s world of localized finance. Indeed, these ideas are the late twentieth-century descendants of late nineteenth-century populism and its fears of large financial institutions and its efforts to keep banks small and locally focused (e.g., through that era's branching restrictions -- which, ironically, also created local pockets of protected market power).

Let us instead consider banks in their early twenty-first-century context. There are at least five bases for questioning the wisdom of the CRA. First, and most important, if the loans are profitable, a profit-seeking bank should already be making them. In this case the CRA is redundant at best (but still costly, in terms of regulatory monitoring and compliance costs). Of course, the bank may not be the perfect maximizer that is portrayed in introductory economics textbooks. And in the protected environment of the 1970s and before, there would have been few competitive pressures on an inefficient bank that was forgoing profitable opportunities. But, for all the reasons that were discussed above, the competitive pressures today are substantial. It seems unlikely that banks would consistently and persistently overlook profitable lending opportunities.[34]

There is also the possibility that a single loan in a neighborhood might be unprofitable, but that a group of loans together in a neighborhood might jointly be profitable, because of "externality" or spillover effects. This is, essentially, an argument for aggregated lending -- either by a larger institution (of which there are more today) or by coordination among or a coalition of institutions -- to "internalize" the externality and make the lending profitable. Again, if the loans are profitable, individually or in aggregate, profit-seeking lenders should be seeking ways to make them.

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[34] Also, in the pre-1970s era, the bank may not have had sufficient information about borrowers or adequate information technology to be able to discern creditworthiness adequately and may have used rough-and-ready measures, such as community location, as their indicators. The information and technology revolution of the subsequent decades has allowed far improved assessments of borrowers' information and characteristics.

If the loans are not profitable, then either (a) they require a cross-subsidy from the excess profits of other (super-profitable) activities of the bank; but in an increasingly competitive financial services environment there will be little or no excess profits; or (b) they will involve losses for the bank;[35] 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.[36]

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[35] The language of the CRA does state that a bank's efforts should be "...consistent with safe and sound operation..." But then the conundrum raised in the text still stands. Further, empirical analysis has revealed for small banks an inverse relationship between the tendency for a bank to have a problematic rating resulting from its safety-and-soundness examinations and the tendency for the bank to have a problematic rating resulting from its CRA examinations. *See* Jeffrey W. Gunther, *Between a Rock and a Hard Place: The CRA-Safety and Soundness Pinch*, ECONOMIC AND FINANCIAL REVIEW, Federal Reserve Bank of Dallas 32 (2nd Q. 1999); Jeffrey W. Gunther, *Should CRA Stand for "Community Redundancy Act"?* 23 REGULATION (No. 3, 2000). Further, for large banks, the Federal Reserve study, *supra* note 31, surveyed large banks for 1999 and found that CRA-qualifying loans were rarely more profitable than comparable non-qualifying loans and that, e.g., for residential housing loans (with $56 billion in CRA-related lending), 35% of CRA-qualifying loans were less than fully profitable (with 15% unprofitable) as compared with only 9% of non-qualifying loans being less than fully profitable (and none being unprofitable); for small business lending (with $59 billion in CRA-related lending), however, almost all loans -- CRA-qualifying (95%) and non-qualifying (97%) -- were fully profitable, with the remainder marginally profitable.

[36] There is scant empirical evidence to indicate whether the CRA has caused banks to extend more loans to LMI communities than otherwise would have been the case. Though there are many anecdotal claims that the CRA has caused banks to extend more credit, these claims never satisfy the "than otherwise..." test. To pass this test, one has to establish a counterfactual (baseline) level of LMI lending for banks (in the absence of the CRA) and then show that their actual lending (in the presence of the CRA) is significantly greater than that baseline amount. Even then, the aggregate of lending to LMI communities might not be changed if (a) bank holding companies simply switched LMI community loans from non-CRA-covered subsidiaries (e.g., finance companies) to their CRA-covered banks; or (b) banks acquired and absorbed finance companies that were making LMI community loans; or (c) bank CRA loans displaced independent finance company LMI community loans. The 2001 Treasury Report (Litan et al.), *supra* note 31, offers a least-squares regression result that indicates that, after controlling for other influences, CRA lending in metropolitan areas for 1993-1999 was positively related to CRA agreements and to CRA-covered lenders' shares of lending in those areas; but a reverse causality for this result is plausible, as well; also, the expansion of CRA lending might simply have been at the expense of LMI lending by non-CRA-covered lenders. On the other hand, an analysis of home-purchase mortgage lending to low-income neighborhoods and to low-income borrowers (irrespective of neighborhood) between 1993 and

Second, why should a bank have a special *obligation* to lend to a specific (local) geographic area?[37] What is special about local geographic areas[38] or about the specific placement of physical bank locations? The "draining deposits" notion has the same protectionist flavor as the idea that a local manufacturer "drains" its workers' labor when it sells its goods outside the community or that a local merchant who buys its goods from suppliers that are located outside the community is somehow "draining" its customers' moneys out of the community. Why shouldn't, instead, a bank have the opportunity to take advantage of its managerial skills and informational abilities to establish physical locations, gather funds, and lend wherever it sees fit (so long as it meets regulatory standards concerning the safety and soundness of its practices) -- i.e., to have the roughly comparable geographical flexibility that applies to the bank's manufacturing or retail counterparts? In this sense, the CRA is anachronistic, trying to force banks to focus on specific geographic areas based on specific locations and distrusting competition, when the broad sweep of public policy has been to erase such protectionist measures (such as the restrictions on intra-state and interstate branching, and the forced compartmentalization of financial services) and to place more trust in

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1997 showed that non-CRA-covered lenders increased the proportion of their home-purchase lending that they devoted to these two categories, while CRA-covered lenders' proportion of their home-purchase lending remained flat; but the study did not control for other potential influences on the two categories of lenders, and it did not directly address the question of whether the CRA might nevertheless have made a difference with respect to the latter group's lending efforts; *see* Jeffrey W. Gunther, Kelly Klemme, & Kenneth J. Robinson, *Redlining or Red Herring?*, SOUTHWEST ECONOMY, Federal Reserve Bank of Dallas 8 (May/June 1999). *See also* Douglas D. Evanoff & Lewis M. Segal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, 20 ECON. PERSP., Federal Reserve Bank of Chicago 19 (Nov./Dec. 1996); and Robert B. Avery, Raphael W. Bostic, Paul S. Calem, & Glenn B. Canner, *Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act*, 85 FED. RES. BULL. 82 (Feb. 1999).

[37] Should the bank also have an *obligation* to hire its employees from the locality? To buy its desks from local merchants? Why?

[38] It is important to note that the CRA does not address issues of discrimination based on race, gender, etc. Those issues are addressed through the Equal Credit Opportunity Act of 1975.

competition. The use of the Internet for financial transactions shows the increasing irrelevance of location for financial services.[39]

Further, the "draining deposits" notion ignores the substantial value of a bank that just offers deposit services. It is ironic that LMI community leaders are often concerned about the absence of bank branches for deposit services, and residents' consequent reliance on higher cost alternatives, such as check-cashing services, when the CRA discourages banks from establishing branches where they could provide worthwhile deposit services but would be reluctant to lend.

Third, why place this special obligation on banks (and savings institutions)? Are they special? And if so, in what ways, and are those ways relevant for CRA purposes?

There are at least two aspects of banks that do make them special. Banks (along with savings institutions and credit unions) provide customers with the opportunity to have transactions accounts or to invest their funds in safe, federally insured deposits. These accounts are important for the savings of financially unsophisticated individuals, as well as providing stability to the transactions/payments system of the economy. In addition, commercial banks -- especially small banks -- have been important sources of credit for small and medium-size businesses.[40]

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[39] Similarly, imagine that the CRA were to apply to mutual funds or pension funds, which often gather their funds on a nationwide basis but operate from a single (or a few) locations. Would they have local lending or investing obligations based on their bricks-and-mortar centralized locations? Or on the zip codes of their shareholders or pension holders? Why? And, to push the example to its limit, what about a money market mutual fund that chooses to specialize in investing in Treasury bills?

[40] *See, e.g.,* Allen N. Berger & Gregory F. Udell, *Universal Banking and the Future of Small Business Lending* in FINANCIAL SYSTEM DESIGN: THE CASE FOR UNIVERSAL BANKING 559 (Anthony Saunders & Ingo Walter, eds. 1996); Allen N. Berger & Gregory F. Udell, *The Effects of Bank Mergers and Acquisitions on Small Business Lending*, 50 J. FIN. ECON. 187 (Feb. 1998); Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. BANK. & FIN. 613 (Aug. 1998); Lawrence G. Goldberg & Lawrence J. White, *De Novo Banks and Lending to Small Businesses: An Empirical Analysis*, 22 J. FIN & ECON. 851 (Aug 1998). Whether credit scoring of small business loans has resulted in a widening of the potential sources of credit for these enterprises remains an open question.

The first special aspect of banks provides the fundamental argument for the deposit insurance itself and for safety-and-soundness regulation of depositories. Both special aspects provide the bases for vigorous antitrust enforcement, to ensure that bank mergers do not create non-competitive structures in local markets. But neither provides a basis for the imposition of CRA obligations in addition to these safety-and-soundness and antitrust enforcement efforts.

Fourth, in a dynamic setting, banks will be reluctant to establish new local operations (e.g., branches) in some neighborhoods and communities if CRA obligations are burdensome and if departure (e.g., subsequently closing the branch) is difficult because of the CRA. Barriers to exit are likely also to be barriers to entry. Again, the irony of the "draining deposits" barrier to bank entry providing protection for more costly check-cashing services should not be ignored.

Fifth, the vagueness of the goal -- "...meet the credit needs of the local communities..." -- has encouraged vagueness of enforcement. Initially, regulatory enforcement focused on process: essentially, a bank's *efforts* toward serving its community and the documentation of those efforts (i.e., a focus on inputs).[41] After 1995, enforcement focused more on performance (i.e., outputs), especially lending. But without specific criteria, enforcement remains vague.

The regulatory enforcement of the Act has shied away from specific quotas or targets or local market shares and has thereby avoided an explicit acknowledgement of the CRA as a credit allocation effort.[42] But the concept of "needs' remains a vague and ill-defined notion, and so

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[41] Interestingly, banks' unsatisfactory ratings on CRA examinations in the early 1990s were *not* followed by expanded CRA *lending* by those banks; *see* Drew Dahl, Douglas D. Evanoff, & Michael F. Spivey, *Does the Community Reinvestment Act Influence Lending? An Analysis of Changes in Bank Low-Income Mortgage Activity*, Federal Reserve Bank of Chicago, May 2000 (WP-00-06).

[42] It has been pointed out that explicit targets, if they were tradable, would at least have the side benefit of reducing the cost and improving the efficiency of the aggregate effort to meet the targets. *See* Michael Klausner, *Market Failure and Community Reinvestment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. R. 1561 (1995).

enforcement remains vague and ill-defined, despite the efforts in the 1990s to provide greater certainty of enforcement for the regulated institutions. The presence of such vagueness creates the danger that regulators can use the vagueness as an opportunity to "lean" on banks to "do the right thing". Again, this is not the basis for 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, the CRA may even be contrary to the long-run interests of the communities that it is intended to help.[43]

C. A better way.

There is a better way.

First, to the extent that any lending problems are rooted in racial or other forms of *personal* discrimination, the right tool is more vigorous enforcement of anti-discrimination laws -- notably, the Equal Credit Opportunity Act of 1975.

Second, to the extent that lending problems are rooted in abusive and *predatory* practices of lenders (i.e., lenders' taking undue advantage of unsophisticated borrowers), measures that focus on those problems -- e.g., a "know your customer" requirement for loan originators[44] -- should be used.[45]

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[43] The reports...

[44] *See* Kathleen C. Engel & Patricia A. McCoy, *The Law and Economics of Remedies for Predatory Lending*, Cleveland-Marshall College of Law, April 9, 2001.

[45] Predatory lending should not be confused with subprime lending, and efforts to curb the former should be fine-tuned so as not to discourage the latter.

Third, if neighborhood externality or spillover effects are impediments to worthwhile lending, governments at all levels should encourage neighborhood consortia, including lenders and developers, that can "internalize" the externality.

Fourth, if there are lessons and skills that can be learned from successful lending efforts in low- and moderate-income neighborhoods, regulatory agencies should serve as disseminators of the information.

Fifth, vigorous antitrust enforcement to encourage competition among financial services providers, and the widespread dissemination of services that accompanies competition, should continue.

Sixth, if there are public purposes to be served through the provision of financial services to low- and moderate-income communities that banks and other financial services providers somehow do not find worthwhile, this case should be made directly and publicly, and public moneys -- i.e., direct government subsidies -- should be used to ensure the provision of those services. An open and transparent process for the provision of such services is surely a superior means of achieving public goals than the vague and indirect "leaning on" that occurs through the CRA.

## VI. Conclusion

The long-run importance of the GLBA may well be as much in its symbolism as in the effectiveness of its actual provisions. Symbolically, the Act was a continuation of over two decades of policies designed to reduce protectionism and encourage flexibility, efficiency, and competition in the provision of financial services. These policies were complementary to the dramatic improvements in the technologies of finance -- data processing and telecommunications -- that were occurring during the same time frame. These trends in technology and in complementary policy were well developed well before the passage of GLBA. They surely would have continued in its absence. Communities have generally benefited from these dual trends and will continue to do so.

The CRA, however, stands in sharp contrast to these trends. Though based on good intentions, it continues to push finance in the direction of localism and protectionism -- an unhealthy direction for the American polity to be traveling. The CRA may even undermine the long-run interests of the communities that it attempts to serve by discouraging banks' entry (either de novo or via branching) into those communities. But the CRA's symbolism -- as a modern-day link to the populism of America's past -- is prominent also. Though there are better alternatives for achieving the goals of the CRA, the symbolism may well continue to interfere with sensible reform.

Table 1: Major Components of the Financial Services Sector, and Their Sizes
($billions, assets year-end 1999)

| | | |
|---|---|---|
| Commercial banks | $5,735 | |
| Savings institutions | $1,149 | |
| Credit unions | $425 | |
| Life insurance companies | $3,150 | |
| Other insurance companies (property/casualty) | $891 | |
| Mutual funds | $6,846 | |
| Equity & bond funds | | $5,233 |
| Money market funds | | $1,613 |
| Securities brokers & dealers | $999 | |
| Finance companies | $956 | |
| Pension funds: | | |
| Private | $4,998 | |
| State & local governments | $3,047 | |
| Government sponsored enterprises (GSEs) | $1,720 | |
| Government sponsored mortgage backed securities(MBS) | $2,292 | |
| Trade credit | $1,928 | |
| ----- | | |
| Memo: Market value, equity shares | $18,877 | |
| Memo: U.S. GDP | $9,255 | |

Table 2: Major Components of the Financial Services Sector: Numbers of Firms
(1999, approximate)

| | | |
|---|---|---|
| Commercial banks | 8,580 | |
| Commercial bank organizations | | 6,600 |
| Savings institutions | 1,640 | |
| Credit unions | 11,016 | |
| Insurance companies | 3,600 | |
| Insurance organizations | | 1,600 |
| Mutual funds: | | |
| Number of funds | 7,791 | |
| Equity & bond | | 6,746 |
| Money market | | 1,045 |
| Number of companies | 434 | |
| Finance companies | n.a. | |
| Securities firms | 7,700 | |
| ----- | | |
| Memo: Number of listed (publicly traded) companies (approx) | 10,000 | |
| Memo: Number of enterprises in the U.S. (approx) | 22,000,000 | |

Table 3: Recent Trends, and Some Longer-Term Trends

| | |
|---|---|
| **- Relative growth of financial sector:** | |
| % of GDP, 1970 | 4.0% |
| % of GDP, 1999 | 8.1% |
| **- Decline in the relative importance of banks and other depositories:** | |
| % of financial services sector value added, 1970 | 49.8% |
| % of financial services sector value added, 1999 | 40.3% |
| **- Consolidation of banking (and entry):** | |
| # of commercial bank mergers, 1985-1999 | 8,314 |
| # of commercial banks, 1985 | 14,423 |
| # of commercial banks with assets > $10B, 1985 | 27 |
| % of all bank assets in banks with assets > $10B, 1985 | 34.7% |
| # of bank offices, 1985 | 57,764 |
| # of commercial banks, 1999 | 8,580 |
| # of commercial banks with assets > $10B, 1999 | 76 |
| % of all bank assets in banks with assets > $10B, 1999 | 66.6% |
| # of bank offices, 1999 | 63,359 |
| Entry: # of start-up (de novo) banks, 1985-1999 | 2,543 |
| **- Recent health of banks:** | |
| # of banks closed, 1989 | 207 (loss = $6.2B) |
| # of banks closed, 1999 | 7 (loss = $0.8B) |
| **- Globalization:** | |
| % of U.S. bank assets held by non-U.S. banks, 1973 | 3.8% |
| % of U.S. bank assets held by non-U.S. banks, 1999 | 19.0% |
| **- More electronic banking:** | |
| Daily Fedwire transfers, 1989 | $727B |
| Daily Fedwire transfers, 1999 | $1,363B |
| **- But slow retail growth of electronic banking:** | |
| # of paper checks written (approx), 1994 | 61B |
| # of paper checks written (approx), 1999 | 65B |

- Rapid rise in the use of the Internet for stock trading
- Widespread asset securitization
- Reduced regulation
- More competition

Figure 1: The Spectrum of Informational Opaqueness/Transparency

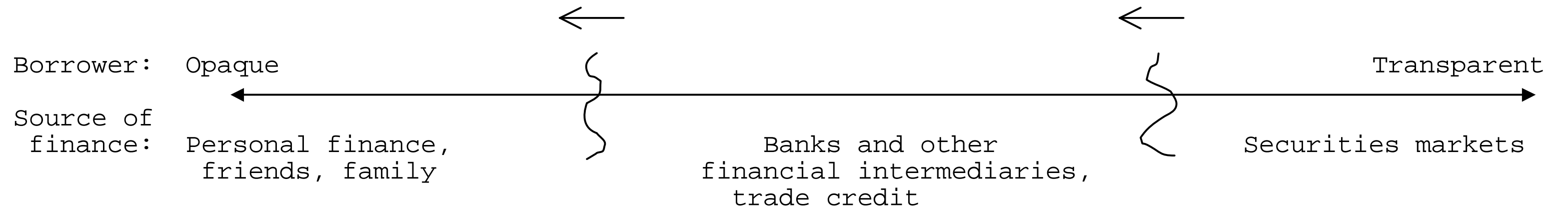

Figure 2: Two Determinants of Opaqueness/Transparency