

SPRING 2010
Volume 1 Number 2

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



A Proposal: Using the CRA to Fight Vacancy and Abandonment

INSIDE:

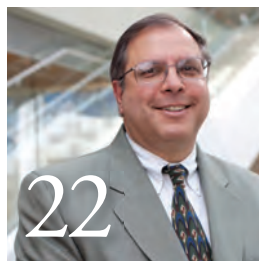
Credit for
Small Businesses

Systemic Risk

Q&A with
Economist
Anil Kashyap

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



The views expressed in Forefront are not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System. Content may be reprinted with the disclaimer above and credited to Forefront. Send copies of reprinted material to the Public Affairs Department of the Cleveland Fed.

Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387
forefront@clev.frb.org
clevelandfed.org/forefront

SPRING 2010

Volume 1 Number 2

CONTENTS

- 1 President's Message
- 2 Upfront
Land Bank Notches First-Year Win
- 4 The Fed's Exit Strategy Explained
- 6 **COVER STORY**
A Proposal:
Using the CRA to Fight Vacancy and Abandonment
- 10 The CRA and the Economics of
Lending in Lower-Income Neighborhoods
- 16 Spotting a Financial Crisis Before It Happens
 - Seeing the Forest *and* the Trees: A Systemic Risk Identification Model
 - Can a Stock Option Predict Financial System Chaos?
- 20 Small Businesses:
Credit Where Credit Is Due?
- 22 Interview with Anil K. Kashyap
- 28 View
Neighborhood Stabilization: Early Reports on Policymaking in Action

President and CEO: Sandra Pianalto

Editor-In-Chief: Mark Sniderman,
Executive Vice President and Chief Policy Officer

Managing Editor: Robin Ratliff

Editor: Doug Campbell

Associate Editors: Amy Koehnen, Michele Lachman

Art Director: Michael Galka

Designer: Natalie Bashkin

Web Managers: Stephen Gracey, David Toth

Contributors:

O. Emre Ergungor

Kyle Fee

Thomas Fitzpatrick

Lou Marich

Todd Morgano

Lisa Nelson

Anne O'Shaughnessy

AnnMarie Wiersch

Editorial Board:

Ruth Clevenger, Vice President, Community Development

Kelly Banks, Vice President, Community Relations

Stephen Ong, Vice President, Supervision and Regulation

James Savage, Vice President, Public Affairs

Mark Schweitzer, Senior Vice President, Research

James Thomson, Vice President, Research

PRESIDENT'S MESSAGE

Sandra Pianalto

President and Chief Executive Officer

Federal Reserve Bank of Cleveland



Some say that major reforms can be enacted only after a major crisis occurs—after conditions become “bad enough.” History and human nature clearly confirm this view. What is less obvious is that hasty reactions following a crisis do not always solve the problem—in fact, they

can often create new problems. If reforms are to be successful and enduring, they should reflect comprehensive assessments and analyses of the factors that contributed to the crises.

I think it's absolutely true that “you cannot reform what you don't understand.” In the wake of the recent financial crisis, there is much more that we *do* understand—lessons built on the front-line experiences we at the Federal Reserve Bank of Cleveland have lived through as banking supervisors.

Through the thick of the crisis in 2008 and early 2009, our direct involvement in the supervision of banking organizations in the Fourth Federal Reserve District, and our knowledge of supervisory activities throughout the country, exposed gaps in the supervision of the financial sector that contributed to the crisis. Since then, we have been able to step back and examine the conditions that existed during those dark days and evaluate the circumstances behind them.

Our experiences during the crisis reinforce the view that the Federal Reserve should continue to supervise banking organizations of *all* sizes and should take on an expanded role in supervising systemically important financial institutions. Retaining our role in the supervision of banks of all sizes is vital.

Our nation's banks serve an extremely diverse range of customers, industries, and geographies. Their health is critically important to the communities and regions they serve. During the peak periods of strains in financial markets, these institutions looked

to their Federal Reserve Banks for liquidity. As banking supervisors, we had a firsthand understanding of the safety and soundness issues facing banking companies. This information was critical to us in our role as lender of last resort, as we understood the particular liquidity circumstances they faced. And as the central bank, we recognized the risks to the economy of credit markets seizing up. Our experience enabled us to respond quickly. We adapted our regular discount lending programs to create an auction facility, and we provided for longer lending terms and more collateral flexibility—not just for the largest and most complex banking organizations, but for *all* banking organizations.

In my Reserve Bank, the economists worked closely with banking supervisors and discount window lenders to pool information, assess situations, and make decisions. And I can tell you that the knowledge, expertise, and direct access to information that come from our supervision and lending responsibilities contributed to our effectiveness in monetary policy. Even today, the intelligence I gather from my banking supervisors is extraordinarily useful to me as a monetary policymaker in helping to identify factors that may pose risks to my economic outlook.

This collaboration extends beyond monetary policy, too. In this issue of *Forefront*, we highlight how our economists are working with bank examiners to tackle access to credit for small businesses. These examples support my view that no other agency has, or could easily develop, the degree and nature of expertise that the Federal Reserve brings to the supervision of banking organizations of all sizes.

Financial reform is not a new idea—we have seen examples of it following crises, and we have seen reform proposals during periods of relative calm. This financial crisis has unfortunately provided us with compelling reasons to press on with the regulatory reform agenda. As we do so, let's act on our best understanding of economic theory and the results of solid research. But let's also act on the basis of what we have learned directly from our firsthand experiences. ■

This article is based on remarks President Pianalto presented at the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies Organized by the Levy Economics Institute of Bard College, April 14, 2010.

Land Bank Notches First-Year Win

In its first year, the Land Bank of Cuyahoga County, Ohio, took strides toward becoming the model approach to the vacancy and abandonment problem that state lawmakers hoped it would be. No,



Thomas J. Fitzpatrick IV

the Land Bank has not magically transformed Cleveland's most blighted neighborhoods into thriving beacons of hope, but small victories in 2009 and early 2010 have formed the beginnings of a long-term solution.

Frank Alexander, a professor at Emory Law School and a leading authority on land banking, describes Ohio's legislation as a "national model" for others to follow. Encouraged by the Cuyahoga County Land Bank's success in just one year, state lawmakers recently expanded to 41 the number of counties that can create land banks.

Ohio's Land Bank legislation seeks to modernize land banking in ways never before attempted. Legal transactional forms had to be created from scratch. Multiple government agencies had to be coordinated, posing additional challenges. The Land Bank's goal is to help acquire and amass vacant and abandoned tax-foreclosed properties, and then demolish, rehabilitate, or repurpose them in keeping with long-term plans for neighborhood stability.

One of the Land Bank's first accomplishments was to help the city of South Euclid, an inner-ring suburb of Cleveland, acquire some vacant property as part of a redevelopment plan. What's the big deal? For years, South Euclid had been trying to acquire a particular vacant house that had been in and out of foreclosure. To complicate matters, the property also had a clouded title because the lender had walked away from the process.

The Land Bank provided technical assistance to South Euclid's leaders, who are now working with the County Treasurer's office to acquire the property, which is in tax foreclosure. The Land Bank has also helped South Euclid acquire several vacant lots that will be turned into community gardens this spring. These small but deliberate steps demonstrate the efficiency the Land Bank brings to the process of acquiring vacant and abandoned property at the municipal level.

Land Bank leaders have also been heavy hitters in raising external funds. For example, the Land Bank took the lead in creating a regional application for the second round of Neighborhood Stabilization Program funds, which were competitively awarded federal grants to use in addressing issues such as vacancy and abandonment. The target area encompassed 2,500 housing units in 20 neighborhoods, touching at least eight different municipalities.

The Neighborhood Stabilization award to the consortium totaled almost \$41 million, by far the largest grant in Ohio.

Another win was the Land Bank's work with the Federal National Mortgage Association, or Fannie Mae, which held a large number of mortgage loans that went into foreclosure. When those houses did not sell to other parties at foreclosure auctions, Fannie Mae ended up owning many of them. Sixty Cuyahoga County municipalities and townships were interested in buying some of them.

The problem? Fannie Mae wanted to sell these properties in large bundles, but the Cuyahoga County municipalities were interested in purchasing only a few houses at a time or a few houses in total. The solution? The Land Bank negotiated collectively for all of Fannie's vacant properties in Cuyahoga County. In the end, Fannie Mae agreed not only to sell the Land Bank its foreclosed properties for \$1 each, but to contribute an additional \$3,500 toward demolition of each property that could not be rehabilitated.

—Thomas J. Fitzpatrick IV, economist

2010 Policy Summit

Housing Policy: Who Pays, Who Plays, Who Wins?

The economic upheaval and damage to U.S. communities resulting from the housing crisis has led not only to calls for significant policy changes, but also to a reexamination of that cornerstone of the American Dream: owning a home.

The 2010 Federal Reserve Bank of Cleveland Policy Summit will examine how national housing policy might be reshaped to help stabilize communities, particularly in weak-market states. The only event of its kind in the Midwest and one of the Federal Reserve System's hallmark conferences, the Policy Summit features both national and regional experts who spur dynamic discourse on relevant, timely research and policy perspectives.

The summit's interactive format encourages participants to increase their knowledge of—and challenge assumptions about—critical issues in community development, including the costs and benefits of housing policy and the role government should play.



June 9–10, 2010 | Cleveland Marriott Downtown at Key Center

Join us for this engaging one-and-a-half-day event that annually draws hundreds of bankers, elected officials, practitioners, academics, and policymakers from the Great Lakes region and beyond.

Agenda highlights include:

- an opening plenary session that takes a thoughtful, critical look at the architecture of U.S. housing policy
- research panels on neighborhood stabilization, government financing of mortgages, and asset accumulation
- a comparative look at reform proposals aimed at government-sponsored enterprises

Please visit www.clevelandfed.org/2010PolicySummit for an updated agenda and registration information.

The Fed's Exit Strategy Explained



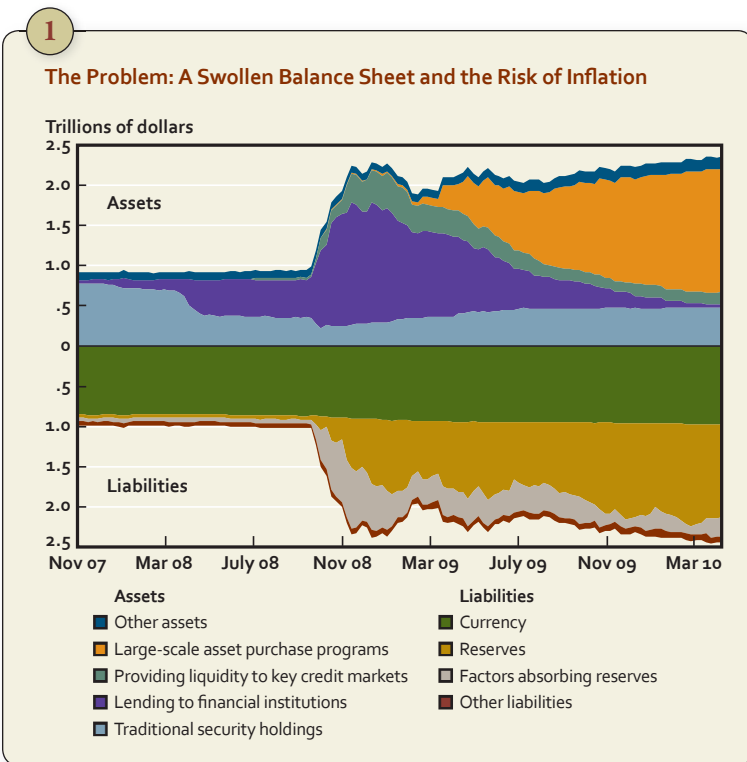
Mark S. Sniderman
Executive Vice President
and Chief Policy Officer

Beginning in 2008, the Federal Reserve purchased \$1.25 trillion worth of mortgage-backed securities, dramatically increasing the asset side of the central bank's balance sheet. The purchases helped drive down interest rates on private market credit, especially home mortgages, and were crucial to the effectiveness of the Federal Reserve's emergency efforts to save the economy.

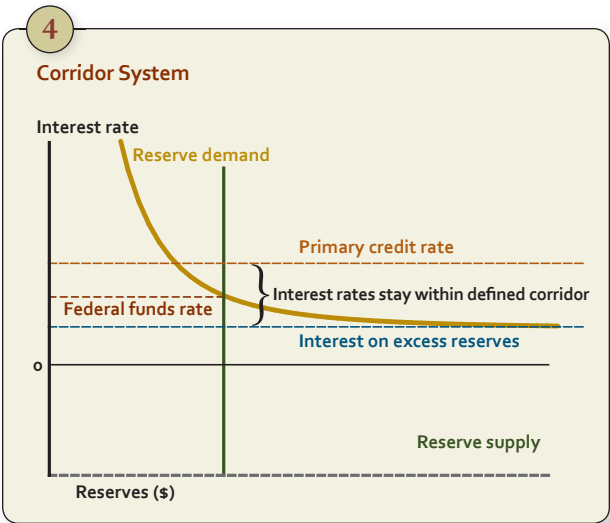
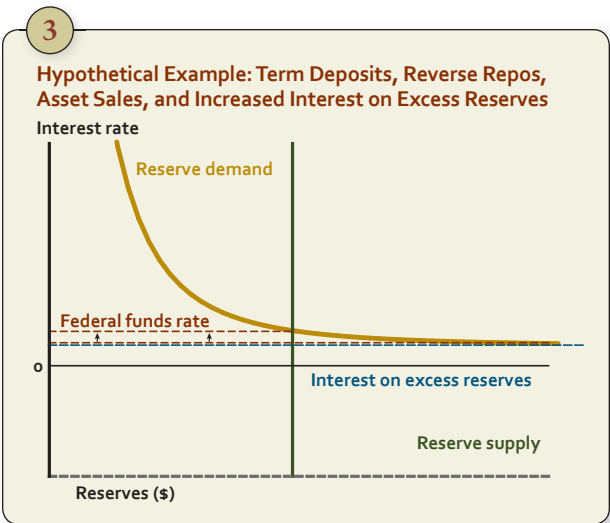
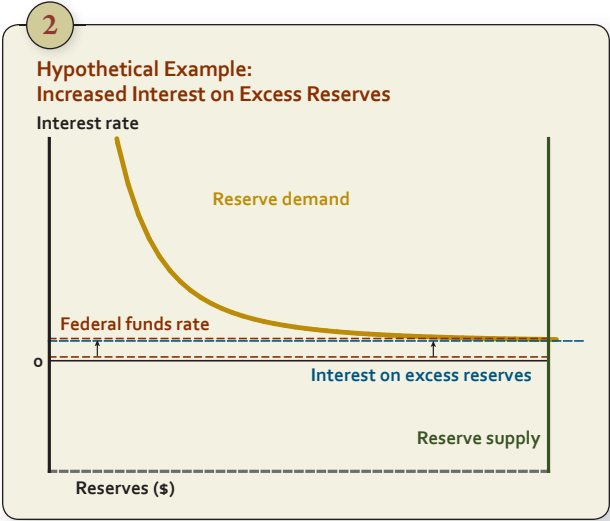
Figure 1. But now there is more than \$1 trillion in excess bank reserves on balance at the Federal Reserve—that is, more reserves than necessary to meet the minimum requirements. Eventually, the time will come to mop up all that cash. The Federal Reserve will have to take steps to keep the bulk of excess reserves from entering the banking system all at once, because the quantity is far too large to keep inflation at bay in a healthy economy.

Figure 2. How can it do this? Congress recently granted the Federal Reserve the power to pay interest on reserves. Now, the Federal Reserve can use that power to immobilize some portion of the excess reserves until it can remove them from the balance sheet through other means.

Here is how it would work: By increasing the interest rate paid on reserves, the Federal Reserve can also raise the federal funds rate while holding the same level of reserve supply as before. That's because the interest rate on excess reserves puts a de facto floor under the demand for reserves in the banking system—banks won't want to trade with one another at the federal funds rate, even as it rises, if they can get a better rate by keeping excess reserves on deposit at the Federal Reserve.



Source: Federal Reserve Board.



Source: Federal Reserve Bank of Cleveland.

Figure 3. As the economy recovers, the Federal Reserve may want to continue increasing the federal funds rate. To do so, the Federal Reserve could first raise the interest paid on excess reserves. Then, to manage the supply of bank reserves, any or all of three other tools could be put to use:

- 1) Term deposits—banks put money on deposit for a specified term, such as three months.
- 2) Reverse repos—the Federal Reserve lends out securities from its portfolio and banks use reserves on deposit as payment, keeping those reserves out of the marketplace.
- 3) Redemption of maturing mortgage-backed securities or their outright sale—with sales, banks pay for the securities by having their reserve balances debited.

The effect is that the federal funds rate moves up, reserve supply drains from the Federal Reserve balance sheet (or to the left, graphically), and inflation stays under control.

Figure 4. As the economy continues to recover, the reserve supply moves farther to the left, much more in line with the level of reserve supply in the banking system before the crisis. Now, smaller movements in the reserve supply will trigger larger movements in the federal funds rate. Under this “corridor system,” the federal funds rate would tend to be bounded at the top by the primary credit rate (or discount rate) and at the bottom by the interest rate paid on excess reserves. ■

Presentation
 To hear and see Mark Sniderman’s full presentation, go to www.clevelandfed.org/forefront

Bernanke Testimony
 Federal Reserve Chairman Ben Bernanke testified before the House of Representatives on the central bank’s exit strategy on Feb. 10, 2010. www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm



A Proposal: Using the CRA to Fight Vacancy and Abandonment

In 2009, banks became the reluctant holders of more than 1,500 foreclosed properties in Cuyahoga County, Ohio. Most of these houses are in Cleveland, worth little to nothing, and in danger of remaining vacant for the foreseeable future—destined to define neighborhood decay.

Cuyahoga County is not alone. In the wake of the housing market crisis, urban communities across the nation are suffering under the crush of vacant homes. At first glance, one solution seems simple enough: Banks should donate these homes—known as real estate owned, or REO—to community groups or land banks that would rehabilitate, demolish, or repurpose them to help stabilize neighborhoods.

But it doesn't often happen that way. Many times, banks would like to hand over foreclosed houses, but community groups don't want them unless they come with clean titles; that is, free from liens. Community groups also want banks

to provide resources needed for restoration, such as loans or charitable donations. Other times, private investors snatch up vacant houses before community groups can acquire them, then make cosmetic changes and put them on the market for resale. Either way, the houses tend to stay empty and neglected for long stretches.

A recent proposal from researchers at the Federal Reserve Bank of Cleveland puts a new spin on decades-old policy: modifying the Community Reinvestment Act (CRA) rules so they increase banks' incentives to provide community groups with loans, services, and investments that support neighborhood recovery efforts.

The Nuts and Bolts of CRA Rules

Under CRA rules, banks are obligated to meet the credit needs of people who live in the areas they serve. Banks can already get some points toward higher CRA ratings by donating properties to community groups and providing loans for rehabbing or demolishing them. But CRA exams put heavy emphasis on lending activities, particularly within banks' so-called assessment areas, the geographic regions where they maintain branch offices.

The proposal would leverage the appeal of high CRA ratings by awarding *outstanding* ratings to banks that focus on rehabilitating and disposing of foreclosed properties in any lower-income census tract nationwide. What's more, banks could earn a rating of *outstanding* based exclusively on their efforts related to foreclosed properties, as long as their other CRA activities remain satisfactory. Banks would still need to fulfill certain lending requirements, but they could amass extra points for lessening the vacancy and abandonment problem.

Emre Ergungor, senior research economist with the Federal Reserve Bank of Cleveland, advocates giving banks new incentives to relieve this problem. For example, banks could do a little less lending in lower-income neighborhoods so they could give community groups more help in dealing with the problem of vacant homes. At the same time, they would improve their chances of earning a CRA designation of *outstanding*.

Banks would still need to fulfill a certain number of lending requirements, but they could amass extra points for lessening the vacancy and abandonment problem.

"You could just change the test so that banks increase their REO activities along with everything else they were doing before," Ergungor says. "But I think we can achieve a path of least resistance if we do not increase the burden on banks."

The Proposal in Detail

The proposal recommends that regulators adopt the following changes until the stock of foreclosed properties in the nation no longer exceeds a predetermined threshold:



- Provide CRA consideration under the **investment** test for REO dispositions (REO donations or sales to qualified community development organizations) *outside* a bank's assessment area as long as the investment needs of the assessment area are satisfactorily met.
- Provide CRA consideration under the **service** test for the provision of technical assistance to qualified community development organizations in developing guidelines and standards for REO acquisition and rehabilitation programs *outside* the assessment area as long as the service needs of the assessment area are satisfactorily met.
- Provide CRA consideration under the **lending** test for community development loans to qualified community development organizations engaged in REO rehabilitation programs *outside* the assessment area as long as the credit needs of the assessment area are satisfactorily met.
- Allow banks to attain an overall rating of *outstanding* based on REO-related activities within or outside their assessment areas as long as their rating for the assessment area is *satisfactory*.
- Put these changes back into effect if the foreclosure threshold is exceeded in the future.
- Redistribute the weight of the lending, investment, and service tests to emphasize investment and service activities. Lending should still be an important component, but an intensified focus on investment and service activities will address the immediate needs for community stabilization and longer-term reinvestment.

(Note: These changes are intended to give banks more flexibility with REO dispositions and would not prevent institutions from obtaining an *outstanding* rating under the existing rules.)

The CRA Test

Depending on their size, banks in good standing undergo CRA compliance exams every two to four years. Regulators evaluate large and medium-sized banks (those with more than \$258 million in assets) on the basis of their lending, investment, and service. Small banks undergo a streamlined test that focuses on lending and receive ratings of *outstanding*, *satisfactory*, *needs to improve*, or *substantial noncompliance*. These ratings are especially important to a bank that wants to expand or merge with another bank, because regulatory approval of these activities may be challenged by community groups if the bank receives a less-than-stellar rating.

As Ergungor puts it, the proposal would allow banks to shift some of the resources they usually devote to local CRA activities to REO dispositions in the weakest housing markets across the nation.

In 2009, 98 percent of America's insured depository institutions were rated *satisfactory* or better on their CRA exams, but only 7 percent were certified *outstanding*. The distinction is important to some banks from a marketing perspective; for others, it demonstrates a community-minded approach to business.

Although there are no exact formulas, lending activities tend to be given the most weight in the rating process. The lending assessment shows whether an institution is making loans to small businesses and, most importantly, to low- and moderate-income borrowers in lower-income census tracts. Loans to community development groups can also be factored in.

As it stands, banks earn a certain number of CRA points for activities related to the disposition of REO properties, which tend to be included in the investment and service tests. Donations of properties count, as do loans to

community development organizations serving lower-income areas (the latter fall under the lending test). Technical assistance, which might include serving on nonprofit boards, writing grants, and advising on financial transactions, also qualifies.

To banks, CRA compliance can seem like trying to solve a puzzle: to obtain a high rating, they must place many different pieces in just the right spots. On top of its complexity, compliance is seen as a burden: Some banks complain that CRA activities are unprofitable, or less profitable than other activities they could be pursuing. Banks are understandably disinclined to pay for liens or property demolition when they have already written off the loans. For that reason, they may see CRA compliance mostly as a regulatory tax.

The Proposal

The Federal Reserve Bank of Cleveland's proposal aims to modernize CRA compliance to recognize the growth of interstate banking since the law was enacted three decades ago.

Under the proposal, banks would be able to earn an overall rating of *outstanding* based on their activities with vacant properties, as long as everything else remains at least satisfactory inside their assessment areas. For example, as long as levels of mortgage and small-business lending were satisfactory inside a bank's assessment area, activities involving REO/vacant properties anywhere in the country would be sufficient to be considered for an *outstanding* rating. Examples might include credit lines to community groups that are engaged in rehabilitating and disposing of vacant properties or donating them to land banks.

The opportunity for banks to get CRA credit outside their assessment areas may be particularly important for community groups that are working with the largest banks.

These banks may not have any local branches, but they nonetheless were very active in underwriting mortgages during the housing boom. These institutions may have to work with national community groups to identify local players who have the experience and credibility to deal with these properties once they are off the bank's balance sheet.

Another virtue of the Cleveland Fed's proposal is that it works around the profitability issue by modifying the cost structure of CRA compliance to place increased attention on foreclosed properties. Under the proposal, banks can make a positive dent in the vacancy and abandonment problem but are no worse off in CRA compliance.

In this way, banks can take a straight route to an *outstanding* rating by focusing squarely on activities that reduce the number of vacant houses. At the same time, communities can win big. The hardest-hit housing markets can get the extra help they need, regardless of whether they happen to be in a given bank's main region of service.

The proposal doesn't prevent institutions from obtaining the highest rating under the existing rules—it just adds flexibility to help banks put their swollen portfolios of vacant houses to positive community use. What's unique in the proposal is that it identifies a single factor as the determinant for an *outstanding* CRA rating. As Ergungor puts it, the proposal would allow banks to shift some of the resources they usually devote to local CRA activities to REO dispositions in the weakest housing markets across the nation.

Granted, this means fewer resources for other CRA activities, but the tradeoff may be worthwhile, given the magnitude of the foreclosure crisis. As long as the housing decay persists, other loans and investments will struggle to make a positive difference. Either the area lacks the population density that a small business needs in order to succeed, or it is deemed too risky to insure, an outcome that hurts homeowners and businesses alike.

It is important to recognize that a significant percentage of the nation's vacant properties are held by securitization trusts, which are not subject to CRA rules and thus unaffected by the proposal. But there are still plenty of foreclosed homes on bank balance sheets—more than enough for community groups to acquire on the road to neighborhood stabilization.

The hope for the future is that the need to focus on vacant and abandoned properties will wane along with the housing crisis. For that reason, the proposal would apply only until the nation's stock of foreclosed properties no longer exceeds a predetermined level.

Next Steps

The Cleveland Fed has been talking with bankers and community groups to get their preliminary reaction. Researchers are using the feedback to refine the proposal and then seek more views.

“While we don't expect our proposal to singlehandedly solve the vacancy and abandonment problem, we do think it could have a material impact,” Ergungor says. “We look forward to comments and suggestions.” ■

What do you think?



Tell us what you think about the proposal. Will it work? Under what conditions? Send comments to forefront@clev.frb.org and put “CRA Proposal” in the subject line. We will publish a selection of comments in the next issue of *Forefront*.



Podcast with Emre Ergungor and Ruth Clevenger

Cleveland Fed researchers discuss the Bank's proposal for recasting the CRA to address the vacancy and abandonment problem. www.clevelandfed.org/forefront

The CRA and the Economics of Lending in Lower-Income Neighborhoods



O. Emre Ergungor
Senior Research Economist

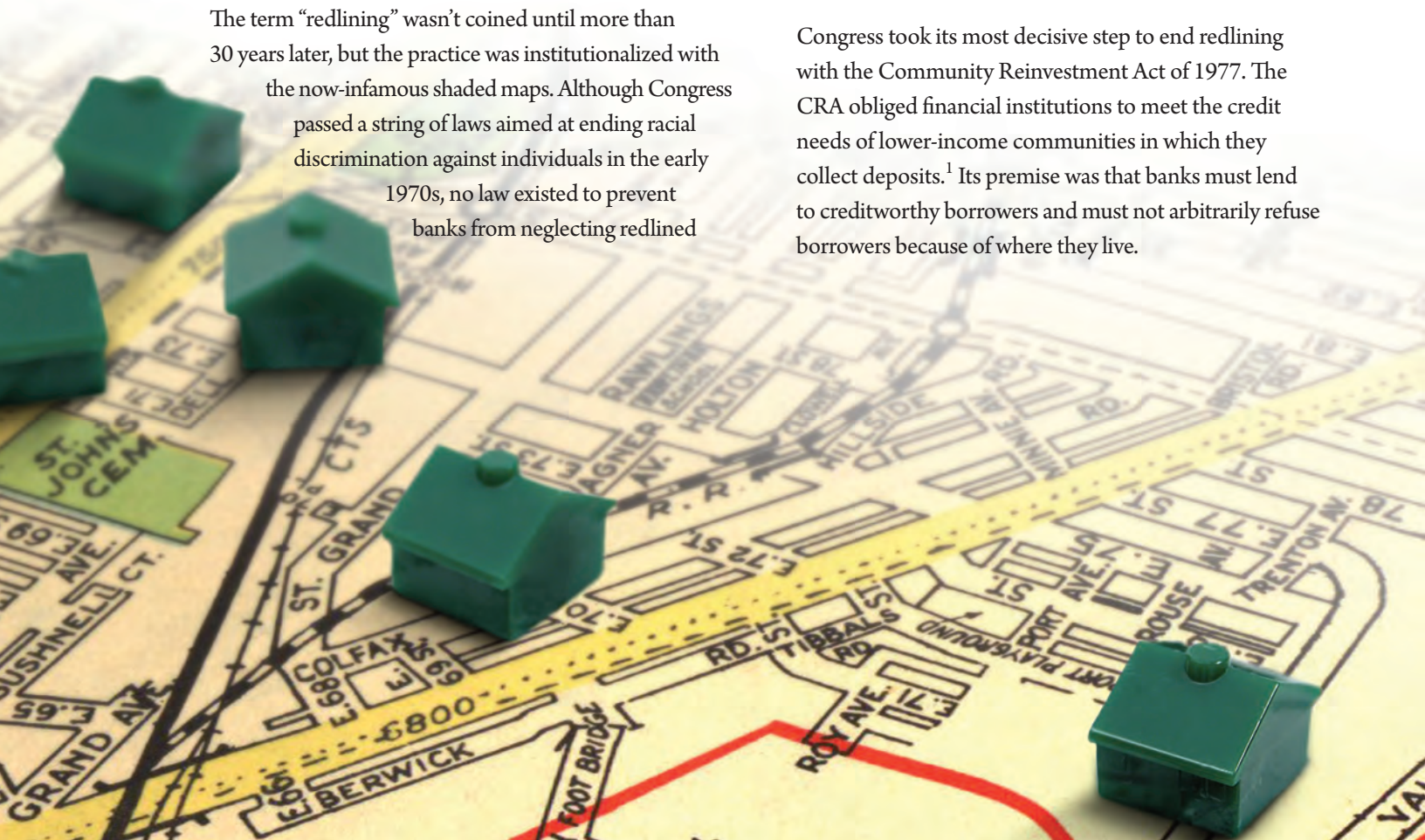
In 1935, a team inside the Home Owners Loan Corporation embarked on an ambitious project. Staffers of the federal agency, whose mission was to help Depression-slammed families avert foreclosure, began to color-code neighborhoods in 239 cities by real-estate risk level. The resulting maps classified residential areas on a scale of one (lowest risk) to four (highest risk). The riskiest neighborhoods were populated by low-income people, who were more often than not African-Americans. These were assigned the color red.

The term “redlining” wasn’t coined until more than 30 years later, but the practice was institutionalized with the now-infamous shaded maps. Although Congress passed a string of laws aimed at ending racial discrimination against individuals in the early 1970s, no law existed to prevent banks from neglecting redlined

neighborhoods in their entirety. Over time, these primarily minority and lower-income communities were caught in a vicious spiral of decline with rising crime and waning economic prospects.

The way many saw it, banks were contributing to these communities’ decline by stifling the flow of credit. They were collecting residents’ savings as deposits and investing them outside the community, even though there were creditworthy borrowers and profitable investment opportunities inside it.

Congress took its most decisive step to end redlining with the Community Reinvestment Act of 1977. The CRA obliged financial institutions to meet the credit needs of lower-income communities in which they collect deposits.¹ Its premise was that banks must lend to creditworthy borrowers and must not arbitrarily refuse borrowers because of where they live.



Thirty-three years later, there is a new financial order, and it may be time to reconsider whether the CRA needs a twenty-first-century overhaul.

The Economics of Lending in Lower-Income Areas

The very existence of redlining implies that financial institutions refuse loans to people who deserve credit; that is, profitable lending opportunities are left on the table. Why would that happen? At least three plausible explanations exist: prejudice, imperfect information, and unprofitability.

Prejudice against certain groups of people is an obvious though unfortunate reality. But unless every lender in the country is prejudiced, some should theoretically be willing to move in and cherry-pick profitable loans in underserved neighborhoods.

However, in the 1970s, banks were hamstrung in their ability to move around in search of good customers because branching across state lines (and often within states) was prohibited. In 1977, there were about 18,000 insured thrifts and commercial banks, and 54 percent of them had just one office. There were also caps on how much interest lenders could charge on loans, effectively preventing them from competing for high-risk borrowers.

These restrictions significantly reduced competition and turned banks into sheltered institutions, which had no incentive to try new products or business models to compete for low- and moderate-income customers.

In the intervening years, there was a revolution in financial services. Banks were given the ability to branch across state lines, making it possible for anyone to do business in lower-income communities. This weakened the case for institutionalized prejudice as a culprit in disinvestment. As a result, in 2010, the reasons why credit wouldn't be available in lower-income communities may have changed. Disinvestment can result from prejudice only if unprejudiced lenders are prevented from doing business in these neighborhoods.

1. This article uses "lower-income" instead of the more technical term "low- and moderate-income," which is used to define borrowers and their neighborhoods under the Community Reinvestment Act. Under current federal rules, a low-income household has income of less than 50 percent of the median family income for the area, and a moderate-income household has income of less than 80 percent, with both adjusted for household size by the Department of Housing and Urban Development.

Imperfect information is a second possible hindrance to banks in evaluating borrowers' creditworthiness. Especially in lower-income communities, where employment histories can be spotty and credit histories nonexistent, it might be prohibitively expensive or practically impossible for a loan officer to determine whether an applicant is a good risk. Such information problems are often at the root of malfunctioning credit markets and contraction of credit.

The CRA has brought credit and investment to lower-income communities. For example, the number and dollar amount of mortgage loans to lower-income borrowers have grown dramatically since the CRA passed, and research shows that this growth did not come in the form of poorly underwritten subprime loans.

Why is information so important? Consider a hypothetical and highly simplified world with only two kinds of mortgage applicants. One kind will do everything in their power to make timely loan payments. The other would rather not make any payments; they want to live rent-free for up to a year, until the bank forecloses and the sheriff serves them with an eviction notice. In this world, neither sort of applicant makes a down payment, and the lender cannot determine who is creditworthy by looking at the limited financial information they can provide.

In a world of perfect information, diligent applicants would get loans, and the others would be denied. But in the absence of information, if the lender charges a low interest rate on mortgages to make them affordable to creditworthy applicants, it loses money because other applicants will get the same rate and default. On the other hand, if the interest rate is high enough to compensate the lender for a possible loss, the loan becomes unaffordable to the creditworthy applicants, and only the opportunistic applicants benefit. Thus, the lender is in a bind: Whatever the interest rate, creditworthy borrowers cannot get credit. Economists refer to this problem as *adverse selection*.

Unprofitability is a third factor in making business decisions in lower-income areas. Even in the absence of adverse selection, there may be so few creditworthy customers in such areas that setting up a branch or marketing products there does not make business sense.

In a survey of bankers in 2000, 64 percent of respondents reported that their CRA special mortgage programs were at least marginally profitable, though less profitable than their other business lines. Among large banks (those with more than \$30 billion in assets), about 60 percent said such programs were not profitable. (Also, a “marginally profitable” loan could still mean a loss for the bank if that loan takes resources away from more profitable investments.)

Profitability of CRA Programs



Source: Avery, Bostic, and Canner.

What did CRA accomplish?

The CRA has brought credit and investment to lower-income communities. For example, the number and dollar amount of mortgage loans to lower-income borrowers have grown dramatically since the CRA passed, and research shows that this growth did not come in the form of poorly underwritten subprime loans. Institutions covered by CRA were more likely than non-CRA lenders to originate prime loans to lower-income individuals. Recipients of CRA prime loans, in turn, were less likely to default and be foreclosed upon. Evidence also suggests that CRA contributed to increased homeownership and fewer vacancies in lower-income areas. [See related article, “Little Evidence that CRA Caused the Financial Crisis.”]

This is a remarkable success for a blunt tool like CRA. After all, CRA does not try to make markets more competitive (that problem was addressed in later years through other legislation) or to deal with the adverse selection problem. It only directs financial institutions to find a way to attain certain lending goals without compromising safe and sound banking practices.

To their credit, depository institutions have shown the creativity necessary to make CRA work. They compensated for their lack of information by building partnerships with local governments and nonprofits to sort out loan applicants’ creditworthiness. Using the same connections, banks also became better at identifying the need for various financial services and developing the products to meet those needs. Individual development accounts, a type of savings account, and low-cost alternatives to payday loans are two examples of such products.

Federal and local governments provide a multitude of incentives to promote investment and growth in lower-income neighborhoods. Because a single incentive is rarely enough to make investments feasible, banks had to learn how to pool their tax credits and subsidized funding sources. CRA seems to have helped banks overcome their inertia by making community investment a routine activity.

What are CRA’s shortcomings?

Despite its many successes, the CRA has some inherent weaknesses. For example, many large financial institutions view complying with CRA as akin to paying a regulatory tax. Such a tax may be justified only if the regulation’s social benefits (more stable neighborhoods, lower crime, and so forth) exceed the private cost to the lenders.

But taxes also have unintended consequences. To maintain their good standing, financial institutions sign agreements, usually with local governments in their assessment areas, committing themselves to specified lending and investment quotas. But research suggests that some of those institutions try to meet their perceived quotas even if there are not enough profitable lending or investment opportunities; that is, they may view any loss associated with such activity as the cost of maintaining their good standing. For them, the benefits of being in good standing may outweigh a small loss from a loan.²

So what’s the problem? Trying to meet perceived quotas may hurt small local lenders that cannot compete with larger lenders, which may be pricing their loans at less-than-profitable levels. Researchers found that small banks reduce their lending activities if a large bank is implementing a

(continues on page 14)

2. Banks do not face lending or investment quotas in CRA exams.



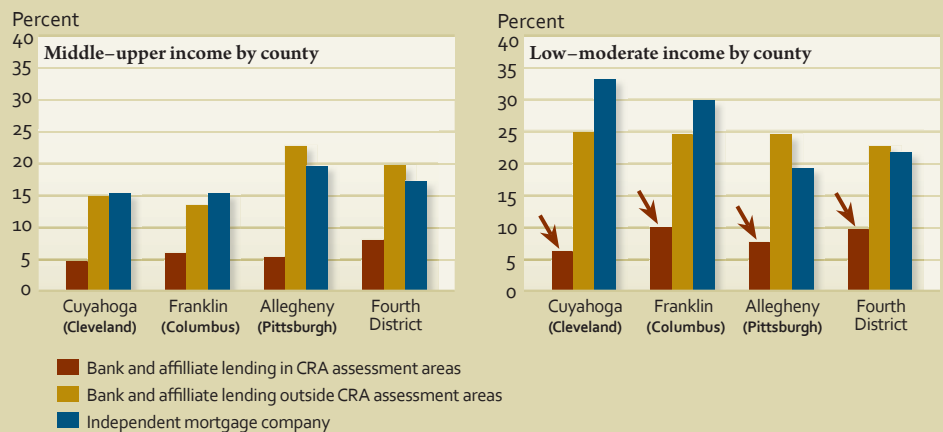
Lisa Nelson
Senior Policy Analyst

Little Evidence that CRA Caused the Financial Crisis

The CRA has come under scrutiny as a suspected contributor to the financial crisis. Under the CRA, insured depository institutions are evaluated on the lending they do in low- and moderate-income (LMI) neighborhoods and to LMI borrowers within the banks' assessment areas. Critics of the CRA suggest that banks were forced by the legislation's requirements to lower lending standards and provide loans to LMI borrowers, regardless of creditworthiness.

Our analysis of CRA lending in the Fourth Federal Reserve District, like analyses at the national level, found little evidence to support this claim.¹ CRA-regulated institutions provided a relatively small share of all loans within the District, and an even smaller percentage of the riskier high-cost loans. The figure shows the distribution of high-cost lending by lender type and borrowers' income group.

High-cost lending by income and lender type, 2006



What immediately stands out is the large percentage of high-cost loans being originated by independent mortgage companies in LMI areas and to LMI borrowers, particularly in Cuyahoga County, Ohio. More than 33 percent of all high-cost loans in Cuyahoga County were originated by independent mortgage companies to LMI borrowers or areas.

Our analysis also reveals that the small percentage of high-cost loans were originated by CRA-regulated banks in LMI areas or to LMI borrowers in their assessment areas. This is true across the three counties and in the Fourth District overall. (See arrows in figure).

Even in the middle- and upper-income areas, CRA-regulated institutions are doing very little of the high-cost lending in their assessment areas. In both Allegheny County, Pennsylvania, and in the Fourth District as a whole, a larger share of the high-cost lending is done by banks and affiliates outside their assessment areas compared to Cuyahoga and Franklin counties, where independent mortgage companies are more dominant.

1. Analysis prepared by Neil Bhutta and Glenn Canner at the Board of Governors of the Federal Reserve System: http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf

CRA agreement in their market. However, large banks do not maintain their level of CRA activities after their agreements expire. The small banks that scaled down their lending when the larger ones moved into their market may have lost their relationships with the community. So when the larger lenders cut back on their activities after their CRA agreement expires, there may not be enough providers to fill the gap.

Of course, any legislation may have unintended consequences, but there are strong signs that CRA has not kept up with changing times.

But if profitable business opportunities exist, why don't lenders move in to fill the gap after a CRA agreement expires? First, new entrants lack the community relationships that old lenders had. At the outset, this lack of connection could exacerbate the adverse selection problem. Second, as CRA's opponents argue, lenders may avoid opening new branches in lower-income communities, where they would come under the purview of CRA and incur the associated regulatory obligations. Thus, the argument goes, a policy to bring banking services to lower-income communities may actually discourage new banks from entering these communities.³

Of course, any legislation may have unintended consequences, but there are strong signs that CRA has not kept up with changing times. For example, assessment areas are now defined around banks' branches, a practice that fails to capture the realities of the current banking market. If a group of banks from across the nation form a partnership to fund low-income housing projects using housing tax credits, they will get CRA consideration only if the project is built in their assessment area. A bank that participates in a housing development will not get CRA credit unless it has a branch nearby. The CRA fails to motivate such interstate collaborations because it was designed at a time when banking was strictly local and banks were constructions of bricks and mortar. And it was designed at a time when banks provided almost all of people's important financial services, from checking and savings accounts to mortgage loans, because banks were the only show in town.

3. See Macey and Miller.

A further problem with assessment areas is the scrutiny they receive during a compliance exam. A bank is expected to provide more products and services in the areas where it collects most of its deposits. However, over the past 30 years, it has become increasingly difficult to track a deposit's location. For example, a large, multistate bank may take a deposit in Ohio but report it at its New York headquarters. As a result, the assessment area in New York must provide more CRA-related products to its community because that is where the deposits are counted for regulatory purposes.

Questions for the future

The goals set in CRA are worth pursuing. However, three big issues need to be addressed.

First, how can we know a community is being served if we cannot measure its needs? As noted in the earlier discussion of CRA agreements, banks may have an incentive to overinvest in some neighborhoods if they do not discover a community's needs and regulators' expectations during the compliance exam. In fact, many banks complain that the statute is vague and that they don't know exactly what level of lending and investment would satisfy the community and the regulators.

This concern is a sign that lenders are not necessarily driven by the profitability of their CRA activities but by their desire to meet some undefined quota in each assessment area. This brings us to the second question: **How profitable are CRA products?** Hard evidence is scarce. CRA loans and investments are treated no differently than a lender's non-CRA activities. These loans do not carry a CRA "flag" that would help researchers identify and evaluate them. The cost of these loans is practically impossible to calculate, because many of these products are cross-subsidized. For example, when the bank advertises its checking account product, a lower-income customer who opens an account may also take out a loan. So it is not all that clear how a lender should allocate advertising costs among product lines. Still, some bank surveys have indicated that CRA business is profitable, though not always as profitable as non-CRA activities. Tying up the bank's capital in less profitable endeavors is admittedly a loss to bank shareholders. More work remains to be done in this area.

The third issue concerns the very premise of CRA. **If there is a social benefit in bringing loans and investments to lower-income neighborhoods, why should the bank's shareholders bear the entire cost?**

In 1977, CRA's champions justified it with the argument that banks received some unique benefits from taxpayers. For example, bank deposits are insured by the Federal Deposit Insurance Corporation, and banks have access to the Federal Reserve's discount window, which provides emergency funds if they cannot raise funds in the market. If banks receive these benefits from taxpayers, the argument goes, they should pay for services to lower-income communities. This line of reasoning made sense at the time because competition in banking markets was limited and any benefits provided to banks accrued to shareholders. However, in today's competitive banking markets, where financial institutions cut their rates and fees to the bone to stay competitive, benefits provided to banks actually accrue to the end users of their products, that is, consumers and businesses. As a result, banks may not have the surplus they need to cushion potential losses from CRA activities.

If the quid pro quo argument is no longer valid, who should pick up the tab? Of all the questions surrounding CRA, this is the most urgent. ■

References

- Avery, Robert B., Raphael W. Bostic, and Glenn B. Canner. 2000. "CRA Special Lending Programs." *Federal Reserve Bulletin* 86: 711–31.
- Macey, Jonathan R., and Geoffrey P. Miller. 1993. "The Community Reinvestment Act: An Economic Analysis." *Virginia Law Review* 79: 291–348.

Recommended Readings



Find more academic resources about the Community Reinvestment Act.
www.clevelandfed.org/forefront



Profitability of CRA Programs

Learn more about the economics of lending in low- to moderate-income communities.
www.clevelandfed.org/forefront

Spotting a Financial Crisis Before It Happens

In the fall of 2008, as big-name financial institutions toppled, policymakers focused their efforts on saving the global economy from collapse. Now that the recovery is well under way, the nation is moving closer to establishing a new regime for monitoring systemic risk to make sure we don't repeat past mistakes. It is high time, then, to discuss how we intend to do that. What could we have done differently to spot—and then stop—the impending financial crisis of 2008?

Researchers are making headway in answering that question. Last fall, the Federal Reserve Bank of Cleveland and the National Bureau of Economic Research sponsored a research conference on Quantifying Systemic Risk. Viral Acharya, a research associate with the Reserve Bank, presented a paper at the conference that helped inform the New York University Stern School of Business's recently unveiled Systemic Risk Rankings service.

Cleveland Fed researchers are also studying a number of approaches to the systemic risk problem. Here are two of them. As always, we'd like to hear what you think. Contact us at forefront@clev.frb.org.

Seeing the Forest *and* the Trees: A Systemic Risk Identification Model



Stephen Ong,
Vice President,
Supervision and Regulation

Let's begin with the well-supported premise that financial crises happen when shocks to the financial system meet structural weaknesses within that system. If we have a strong shock but an equally strong financial system, the danger of a crisis is low. But if the system is fragile, even a moderate shock can wreak havoc.

To prevent a financial crisis, regulators must see both the big picture (the financial system as a whole) and the little picture (individual institutions). Only recently, however, have researchers looked at ways to combine "macroprudential" supervision of the entire financial system with "microprudential" supervision of individual institutions. By monitoring and analyzing both types of information, researchers can identify signs that potential shocks are building and compare them to potential structural weaknesses in the market.

Toward that end, Federal Reserve Bank of Cleveland researchers have been working on a systemic-risk identification model called SAFE, for Systemic Assessment of the Financial Environment. SAFE is being designed to identify early signs of emerging shocks and structural weaknesses—a highly useful feature that enables policymakers to prevent those conditions from becoming reality. (If policymakers had only a few days' notice of a financial system collapse, it would be far more difficult to develop an effective response.) This model's key innovation is its use of confidential supervisory information, gleaned from regular bank examinations, and data from supervisory tools to identify weaknesses in the institutions that make up the financial infrastructure.



Identifying the Shocks

Identifying a financial shock before it happens is difficult at best. Cleveland Reserve Bank researchers have approached this problem by thinking of a shock as a sudden change in investors' expectations. In the SAFE model, these expectations are based on three factors:

- **Return:** how much an investor may expect to make on a particular asset
- **Risk:** the chance that an asset may lose some or all of its value
- **Liquidity:** the ease with which an investor may sell or trade an asset

The model's central assumption is that investors are constantly making judgments about the return, risk, and liquidity of the assets they hold—the measures that determine the price of the assets. These measures are continuously compared to the historical norms for their assets. History shows that when significant, sustained gaps emerge between current measures and their norms, the likelihood of shocks increases.

Structural Weaknesses

The health of the financial market's infrastructure strongly determines the potential for systemic risk. It directly affects financial firms' ability to absorb shocks, which originate in gaps in investor expectations. To gauge the financial market's condition, the SAFE model uses information on the nation's largest financial institutions to assess three aspects of systemic structural fragility: connectivity, concentration, and contagion.

Connectivity indicators measure the volatility of each financial institution's balance sheet compared to the volatility of the wider financial system. When the balance sheets of several large institutions move in concert with the entire system, institutions and the system are considered highly correlated. In this case, an emerging financial-market shock will likely ripple through the country's largest financial institutions as well as its financial markets.

Concentration indicators measure the intensity of asset holdings and market making—the ability to dictate prices—within the financial system. In general, the more concentrated the financial system's asset holdings and the more narrow its market making, the more fragile the system. More specifically, when an institution or a small subset of institutions holds a large share of a market's assets, its trades increasingly “make” the market, that is, move prices. Thus, if an asset price shock occurs and these institutions sell concentrated assets, their disproportionately large holdings overwhelm buy orders, so that the market cannot function or does so only at very low prices. Likewise, if a single bank or a small group of institutions serves as the sole market maker, its failure would eliminate a liquid market for those assets.

Contagion indicators measure the relative ability of individual financial institutions to withstand a financial shock and remain solvent. If individual institutions can “internalize” the effects of a shock, it will not spill over into the larger financial system. On the other hand, if individual institutions cannot absorb the shock and remain solvent, the losses they sustain will probably affect other institutions' health and spill over into the larger financial system.

The Cleveland Approach

To derive these three indicators, Bank researchers are using confidential supervisory information, including details about loans and liabilities that aren't publicly available. Researchers are also tapping outputs from proprietary supervisory tools that are accessible to the Federal Reserve in its role of banking supervisor. It is this unique feature — the incorporation of supervisory information — that distinguishes SAFE from other models developed to identify systemic risk. Just as a weather forecaster uses radar tools to predict a coming storm, the SAFE model is being designed to help spot episodes of financial stress so as to head off a full-blown crisis.

Of course, policy actions don't exist in a vacuum, and it would be useful to know how they might affect the financial climate. The short-lag variant of the SAFE model

incorporates policy actions' effects on emerging conditions to see if they are working as intended or if different policy actions are required. Taken together, the long- and short-lag versions of the SAFE model are being developed to identify the advent of systemic risk and provide valuable feedback on policy actions that address those risks.

To validate the model's effectiveness, researchers are building a financial stress index to chart previous episodes of stress in the U.S. financial system. Think of the index as a thermometer that tells regulators how hot or cold stress in the economy is running.

The work continues. Bank researchers are circulating the SAFE model among economists and bank supervision professionals in the U.S. and abroad for comment. ■

Can a Stock Option Predict Financial System Chaos?



James B. Thomson,
Vice President
and Financial Economist

Calls for the establishment of a systemic risk supervisor presuppose several conditions: that systemic risk can be quantified; that it can be measured and tracked on a real-time basis; and that its changes can be reliably predicted. At present, none of these conditions exist.

Fortunately, a number of promising efforts to construct such a metric are under way. They draw on several academic areas, including risk management, economic forecasting, banking and finance, and what's known as contingent claims. Ultimately, identifying and predicting systemic risk is likely to rely on a combination of approaches.

Martin Zambrana, a visiting scholar at the Federal Reserve Bank of Cleveland, takes the contingent claims approach in his proposal for a forward-looking systemic risk indicator. Simply put, a contingent claim gives the holder the right to something, depending on what happens in the future. An option to buy a share of AIG at a certain price during a certain time period is a type of contingent claim. A credit default swap, in which the buyer collects a sum of money if an outcome such as default occurs, is another example. Contingent claim analysis can run all the way from defining the valuation of claims to backing out information from the price movements of a specific set of contingent claims.

These analyses can yield useful information. For example, UCLA economist Richard Roll developed weather forecasts for Orange County, Florida, using information gleaned from futures contracts for frozen orange juice (the very contracts that play a central role in John Landis's 1983 movie, *Trading Places*). Roll's forecasts outperformed those of the National Weather Service. In a similar vein, economist John Carlson at the Federal Reserve Bank of Cleveland has backed out market forecasts of Federal Open Market Committee policy actions using the prices of options on federal funds futures contracts.

Zambrana uses the option-based "distance-to-default" measure developed by Moody's KMV, a credit analysis firm. Distance to default is a measure of the probability that a firm will default, so this article uses the term "probability of default." This measure is based on estimates of the market value of a firm's assets, the volatility of the assets' value, and the bankruptcy threshold (that is, the point at which the firm will become insolvent). These estimates are typically backed out of observed accounting data and the price of the firm's traded equity using an option-pricing model.

Although it may sound skull-cracking (indeed, it typically involves sophisticated mathematics and analytic tools), it is a fairly straightforward procedure. The probability-of-default measure can be constructed for any firm if the minimum information requirements are met. Moreover, under certain assumptions, this measure can be constructed frequently, even daily, which makes it a promising tool for identifying systemic risk, where timeliness is paramount.

Zambrana computes probability of default both for a traded index of European bank stocks (DJ STOXX) and for each bank in the index. He then constructs an index using individual banks' probability-of-default measures. So, he now has two probability-of-default numbers that cover essentially the European banking system: one constructed from DJ STOXX and one from the aggregation of the probability-of-default numbers for individual bank stocks.

Zambrana's innovation is to use a well-known fact in finance: An option to buy or sell an entire portfolio of stocks is not worth the same amount as a portfolio of options on the individual stocks in the portfolio. (That's

simply because the option to buy or sell an entire portfolio of stocks does not come with the same inherent flexibility as having an entire portfolio of options to buy or sell stocks.) This means that his two probability-of-default measures for the European banking system will be different, except when there is perfect correlation between the stocks in the portfolios. So if returns on individual bank stocks in the DJ STOXX become more highly correlated, that is, their prices increasingly move in lockstep, their probability-of-default measures will converge.

Why is this important? One of the lessons learned from the demise of the Long-Term Capital Management hedge fund and from research by Andy Lo at MIT is that during periods of financial stress, asset returns in the financial system become more highly correlated. That makes increased correlation in financial markets a handy indicator of increased systemic risk. So tracking the differences between Zambrana's two probability-of-default measures for the European banking system provides a measure of increased systemic risk.

Of course, identifying and tracking changes in systemic risk is just the first step. The indicator must also be forward-looking, that is, it must reliably lead changes in market stress. A plot of each index, as well as the difference between the European banking system's two probability-of-default series, leads movements in the DJ STOXX index of European bank stocks. Hence, Zambrana's approach to measuring changes in systemic risk in the financial market holds promise. A similar measure could become an important part of the macro-prudential supervisor's regulatory toolkit. ■

Putting Systemic Risk on the Radar Screen



The Federal Reserve Bank of Cleveland's 2009 *Annual Report* essay tackles the problem of systemic risk. Economist Joseph Haubrich argues that the first step is a program to define and measure systemic risk.
www.clevelandfed.org/about_us/Annual_Report/2009/

Measuring Systemic Risk



A Federal Reserve Bank of Cleveland Working Paper.
www.clevelandfed.org/research/workpaper/2010/wp1002.pdf

Papers and Presentations



Systemic Risk Analysis Using Forward-Looking Distance-to-Default Series. A Federal Reserve Bank of Cleveland Working Paper by Martín Saldías Zambrana.
www.clevelandfed.org/research/workpaper/2010/wp1005.pdf

Small Businesses: Credit Where Credit Is Due?



Across the country, small-business owners are telling the same story:

First, they need more customers for their products and services.

And second, they need banks to lend them money.

The story of Torbeck Industries, a Harrison, Ohio, manufacturer of safety equipment, has grown all too familiar. During the recession, business at the 35-employee firm has fallen about 50 percent, close to the industry average. In 2009, owner Rich Torbeck approached several banks about obtaining a new loan guaranteed by the Small Business Administration, or SBA. His company had used SBA programs in the past and always made good on its payments.

Only one bank stepped up. But after doing its due diligence analysis, that bank downgraded the firm's collateral by half, which killed the deal. Meanwhile, Torbeck Industries could not pass working-capital tests when it bid on new contracts. In March, the company was forced to turn down a large order because it couldn't finance its cash flow.

"This is a vicious cycle," Torbeck said. "I don't know where it's going to end."

The Federal Reserve has paid a lot of attention to the problem of low demand for products and services. Near-zero interest rates and several emergency programs have been aimed at reviving the overall economy. But the nagging issue of access to credit—especially for small businesses—persists. Why are banks still reluctant to lend?

To find an answer, Federal Reserve Banks across the country recently hosted forums with small-business executives and bankers, asking for their views and hearing from many of them. Helped by that information, researchers are now developing proposals for unblocking the small-business credit channel.

Credit Tightens

The problems facing small businesses are a big deal for the whole nation. Small businesses have created almost two of every three new jobs over the past 15 years. During that time, they have employed more than half of all workers and created half of GDP. But in the recession, they have suffered intensely, accounting for half of U.S. jobs lost versus 10 percent in the 2001 recession.

Although it is impossible to lump all small businesses in the same bucket, it is fair to say that they share characteristics that make them vulnerable during harsh economic times. They generally cannot tap the public markets for capital, so they turn to commercial banks or personal credit cards, often putting up their own property as collateral.

These factors make small businesses far more vulnerable than others to problems in the real estate markets, which of course have taken their own hit with the recession. As collateral values are written down, many small firms suddenly find themselves in technical violation of loan covenants.

Two major sources of credit for small businesses contracted sharply in 2009: Commercial and industrial loans fell by 20 percent, and commercial real estate loans by 4 percent. In all, bank lending declined by 7.4 percent in 2009—the most since 1942. These declines occurred even though banks' reserves had more than doubled since 2007, aided by the Federal Reserve's response to the financial crisis.

The View from the Bankers' Side

Bankers see the situation as far more complicated than a mere credit crunch. For starters, they report that loan demand is off, and many companies aren't fully drawing on existing lines of credit. And many of the small firms that are seeking credit seem like risky bets, given their financial condition. They are either losing money, over-extended, or don't have adequate collateral.

With their own capital positions weakened, some bankers admit having to "button down" on lending standards. In sum, they see more risk than reward out there. This mindset is reflected in results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which recently found that banks have significantly tightened credit standards on many loans to small firms over the past few years.

"In 2009, it seemed as if banks pretty much stopped lending," says Marsha Powers, principal of Powers Financial Group, a Pepper Pike, Ohio, firm that helps businesses obtain financing. "I do see some positive activity in this [first] quarter, but they still are being extremely careful in their underwriting. And rightly so."

The Central Bank's Response

Although poor sales loom as small businesses' biggest problem, there is strong anecdotal evidence that tight credit is also holding back the recovery. The Federal Reserve has tackled the problem from several angles. Besides its efforts to buoy the economy with low interest rates and emergency lending programs, the central bank has joined the nation's other bank regulatory agencies in issuing new guidance for small-business and commercial real estate lending. This guidance encourages bankers to work with their customers during periods of stress. Its goal is to prevent overzealous supervision from creating additional problems for bankers and their customers. At the Federal Reserve Bank of Cleveland, discussions have begun about how banks' perception of regulators' increased stringency may affect access to credit for small businesses.

Another new focus at the Federal Reserve Bank of Cleveland, largely motivated by conversations with small business owners and bankers, is the potential for expanding other government and public programs. For some time, SBA-guaranteed loans have served as a backstop option for small firms in need of credit. In normal times, those loans account for only about 5 percent of outstanding credit to small business. But in times of crisis, that's not

enough to meet the needs of creditworthy small businesses in this country, especially when banks need a taller backstop to safeguard against risk.

SBA programs provide good options for some borrowers in some circumstances, but there can be impediments. A persistent story among businesspeople is that SBA loans are attractive in theory but difficult to secure in practice. Often, the problem is just a matter of paperwork; at other times, it is a matter of borrowers' inability to find a banking partner to underwrite the loan.

Federal Reserve research suggests that as currently structured, SBA lending is too narrowly focused on start-ups, and the scale of lending is too limited to deal with the shortfalls in credit that small businesses are reporting.

The Administration, for its part, has taken steps to address this issue by proposing legislation to allow higher caps on certain kinds of SBA loans and to allow refinancing of certain kinds of owner-occupied commercial real estate. The Administration has also proposed allotting \$30 billion of Troubled Asset Relief Program funds that community banks can use for loans to small businesses. Meanwhile, the SBA has embarked on its own effort to examine product enhancements and streamline the application process.

Even so, it would be a mistake to rely on the SBA as a cure-all for the problem. Researchers at the Cleveland Federal Reserve have met with SBA officials this spring to discuss wider opportunities to further unblock channels for small-business credit. ■

What do you think?



Researchers at the Cleveland Fed are collecting public comments as they develop proposals to widen access to credit for small businesses. Future meetings with small-business owners, community development groups, and bankers will be aimed at identifying promising solutions.

We also want to hear from you. What are your ideas for solving the small-business credit crunch? What changes would give bankers more confidence about lending to small businesses? Send your comments to forefront@clev.frb.org.

President's Speech



Cleveland Fed President Sandra Pianalto described the importance of small businesses and efforts to open up access to credit in her February 25, 2010, speech, "When the Small Stuff is Anything But Small." www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2010/Pianalto_20100225.cfm



CHRIS STRONG PHOTOGRAPHY

Interview with Anil K. Kashyap

Some say that the financial crisis has launched a thousand Ph.D. dissertations and perhaps just as many books. Anil Kashyap was on the case from the very beginning. In September 2008, as troubles in the financial markets spun into a full-blown crisis, he dashed off one of the earliest and most coherent explanations of what was happening. “Everything You Need to Know about the Financial Crisis”—which Kashyap wrote with fellow University of Chicago economist Douglas Diamond—became the most circulated post ever on the *New York Times’s* “Freakonomics” blog. Later, Kashyap joined the Squam Lake Working Group on Financial Regulation, a veritable who’s who of top thinkers in financial economics, and he helped prepare several of the group’s policy briefs.

Kashyap is the Edward Eagle Brown Professor of Economics and Finance at the University of Chicago’s Booth School of Business. Before joining the Chicago faculty in 1991, he worked as a staff economist with the Federal Reserve Board of Governors. His research on financial markets has earned him several awards, including a Sloan Research Fellowship and the Nikkei Prize for Excellent Books in Economic Science. Among his other activities, Kashyap co-founded the annual U.S. Monetary Policy Forum and co-organizes the National Bureau of Economic Research’s Working Group on the Japanese Economy.

Mark Sniderman, executive vice president and chief policy officer at the Federal Reserve Bank of Cleveland, interviewed Kashyap on February 15, 2010, at the Booth School. An edited transcript follows.

Sniderman: *Everybody has a version of what caused the financial crisis. Every newspaper story, every magazine article, has its own take on it. I’d like you to share your views on this with us.*

Kashyap: Ken French [Dartmouth economist], a good friend of mine, has a good analogy: If you investigate an airplane crash, you usually find 10 things that failed. Seven of them could have happened and there would have been no problem. It would probably take nine or 10 to happen simultaneously to take the plane down. That’s the way I think of the financial crisis. I don’t think there was just one thing or even two things. It was a combination of problems.

There were a lot of bad incentives all through the financial system: The ratings agencies, the regulators, the politicians, and the traders inside a lot of the financial institutions—they all had bad incentives. It was a combination of actions by many different actors and failures of many different parts of the system.

Sniderman: *A lot of people look at the housing sector and say it’s the epicenter of everything. But if I understand the way you describe it, perhaps six months to a year later, some other sector might have shown the stresses and strains.*

Kashyap: The financial institutions were so highly leveraged—it was like a Ferrari that hits a pebble and crashes. The system was so fragile that, yes, it turned out to be housing, an initial set of losses related to subprime mortgages. But, as we saw, the damage was much broader.

And then you say, where did that leverage come from? People could tell that there were some problems with financial institutions, so they were not interested in putting in equity financing, and were only willing to fund the banks with debt. Then funding became increasingly short-term because people knew that they might want to get out, and keeping terms short is a good way to keep financial institutions on a leash. But then, of course, when trouble comes, it’s all the worse.

Sniderman: *Now that we have some insights into these half-dozen or more weak spots in the system, most of the attention is focused on how we fix them. Here again, there are many versions of what needs to be done. I know you are a member of a group of economists and finance professionals who are taking a very comprehensive look at this—the Squam Lake Working Group on Financial Regulation. I wonder if you might tell us how this group was formed and the directions you are headed in.*

Kashyap: Right after Lehman Brothers failed, a number of finance faculty were talking to each other about what this would mean. Many people were worried that there would be an over-reaction, an immediate jump for scapegoats, and not a lot of well-thought-out regulatory responses. So Ken French started calling around and saying, we have to get together and come up with something much more technical and focused on the real set of problems. We wanted to make recommendations that would consider the possibility of unintended consequences from the reforms. This group was formed with the idea of being very nonpartisan, not to ascribe blame to any one cause but to come up with a much more academically grounded set of recommendations about what might be done.

Sniderman: *Before we get into particulars, let's broaden the scope a bit. This financial crisis was actually global. Does it turn out that some of the regulatory reform proposals that make sense for the United States also make sense internationally? Or is there something different about the way you are looking at the U.S. situation?*

Kashyap: The Squam Lake proposal, along with most of my thinking, carries across borders. The legal and political problems vary from country to country, so to get the same package passed in each country, the political deals needed might vary. But I don't think the international dimension was so unusual that you would get a different diagnosis for us than for Europe.

Sniderman: *Let's get into particulars. What are the top three to five places to focus for financial reform that you and your colleagues are recommending?*

Kashyap: I would say the single biggest thing would be a resolution authority. Let's suppose Greece, which just had all this trouble, had somehow spectacularly failed and then we discovered that a financial institution connected to it had a lot of exposure, and now had its solvency threatened. We'd have all the same bad choices that we had with Lehman, and I think that's terrible.

Most of the response to the crisis post-Lehman amounted to giving guarantees to different actors to get them to go along. We provided access to different types of support, loosened the rules here and there, and there was basically no way to say credibly that we were going to fail an institution. That's a huge problem. That's by far the single biggest priority.



CHRIS STRONG PHOTOGRAPHY

I think the single biggest issue is just getting the rules in place so you could actually take an institution over without having to sell it in one shot.

And then there are a bunch of complementary ideas that make failure less likely. Everybody is talking about changing capital standards, liquidity standards. Living wills are an idea that would allow firms approaching bankruptcy to get a bit better informed before something happens. But to me, the central thing has got to be if a large organization gets in trouble, there has to be a way to actually shut it down.

Anil K. Kashyap

Position:

Edward Eagle Brown Professor of Economics and Finance, University of Chicago Booth School of Business

Books:

Corporate Financing and Governance in Japan: The Road to the Future, with Takeo Hoshi (Cambridge, Mass: MIT Press, 2001).

Structural Impediments to Growth in Japan, jointly edited with Magnus Blomström, Jennifer Corbett, and Fumio Hayashi (Chicago: NBER and University of Chicago Press, 2003).

Monetary Policy Transmission in the Euro Area, jointly edited with Ignazio Angeloni and Benoît Mojon (Cambridge, England: Cambridge University Press, 2003).

Japan's Bubble, Deflation, and Long-term Stagnation, jointly edited with Koichi Hamada and David E. Weinstein (Cambridge, Mass.: MIT Press, forthcoming).

Selected Papers:

"Banks as Liquidity Providers: An Explanation for the Co-Existence of Lending and Deposit-Taking" with Raghuram Rajan and Jeremy Stein, 2002, *Journal of Finance*, 57 (1), pp. 33–74. (2002 Brattle Prize Distinguished Paper.)

"Leveraged Losses: Lessons from the Mortgage Market Meltdown" with David Greenlaw, Jan Hatzius, and Hyun Shin, 2008, *U.S. Monetary Policy Forum Report No. 2*, Rosenberg Institute, Brandeis International Business School; and Initiative on Global Markets, University of Chicago Graduate School of Business.

"Will the U.S. Bank Recapitalization Succeed? Eight Lessons from Japan," with Takeo Hoshi, *Journal of Financial Economics*, forthcoming.

Education:

Massachusetts Institute of Technology, Ph.D., 1989
University of California at Davis, B.A., 1982

Sniderman: *Is this largely a matter of legally creating an entity to do it, or a matter of figuring out how the financing would take place?*

Kashyap: I think the single biggest issue is just getting the rules in place so you could actually take an institution over without having to sell it in one shot. The FDIC rules we have in the United States make it possible to walk into an institution on Friday and have it running in some form on Monday that leaves people largely able to function. You just couldn't do that with the 20 biggest financial institutions in the world. We need an intermediate thing that's not going to create panic that then spreads to the next one.

The week Lehman failed, Merrill had to be sold, and Morgan Stanley and Goldman were in trouble because their funding was at risk. We need a way to stop that, where you can say, "OK, this organization is in trouble. We are going to carve it up and sell off some parts of it and operate some parts for awhile." And that process must be understood well enough so there won't be complete panic that shuts down the entire sector. That's where I think the attention needs to be focused.

Sniderman: *Sometimes I hear two schools of thought about these financial crises. Some people say we should turn the clock back to Glass-Steagall restrictions, when commercial banks were just commercial banks, and we had more lines of demarcation. Other people say that if you go back hundreds of years across countries, you will always see financial crises. There's no hope, basically, of preventing these things in the future. Where do you place yourself?*

Kashyap: I'm closer to the latter view. The number of systemic banking crises in just the last 25 years is huge. Most of them didn't involve activities that were so different than those that would have been permitted under Glass-Steagall. So I'm pretty skeptical that just by containing things for awhile we could avoid all this instability.

It's important to realize that a lot of the trouble in the current crisis came through price contagion, where there were fire sales and we saw markets drying up, prices becoming uninformative, and illiquidity making it difficult for people to transact. The collapse, say, of asset-backed commercial paper and lots of other securitized forms of financing transmitted this shock from the financial sector into the real economy. So I worry that even if you did go in the direction of Glass-Steagall, you would just crowd out a lot of activities from the formal, better-regulated, and better-managed sector into parts of the system you can't see. And then when it blows up, you have all of the same problems but many fewer tools.

Sniderman: *A lot of books about the financial crisis have raised the question about the nature of the market system, and whether we really will have to rely more on government intervention and regulation. It's the very problem that we worried about when Squam Lake was getting started—that there would be too much regulation as an overreaction. Yet a number of people have said, "Well, the free market school (including Chicago Booth) has led us down a primrose path by suggesting that markets can do more than they really can." I want to ask you about that because I know you are teaching a new class about the analytics of the financial crisis.*

Kashyap: That's a hard question. I think markets work reasonably well. But markets require regulation, rules of the game. Many aspects of the crisis involved fraud that nobody condones. In the U.S., our regulatory system was so fragmented. It was really ripe for having these problems emerge. Two days before Bear Stearns fails, its primary regulator—the SEC—says there's no problem. That's just unbelievable. You saw the Fed, which was late on subprime concerns, eventually put out guidance, but it took a long time. And what happens is the banks that are most worried about changing their charter go where they can't be supervised by the Fed. The regulators that were supposed to be on top of AIG had no clue.

There were so many loopholes in our regulatory system that I think made things worse. Some of these things were widely discussed for years and years. Others were problems we didn't appreciate adequately. On the other side, the United Kingdom tried to consolidate supervision and that didn't work so well either. Its Financial Services Authority ended up not covering itself in glory.

So I don't think there's some best practice that we all mindlessly adopt that's going to work very well. But we need to design regulations that would cover both the formal banking system and the so-called shadow banking system so we avoid big discontinuities in the rules you have to follow (or the capital you have to hold) if you restructure transactions and move them out of the formal system. I think that has been the least researched and discussed aspect of the crisis. My current fear is that we are going to do something that might be somewhat draconian and punitive to the banks and push a lot of stuff that has been inside the banking system to outside the banking system, where we won't have the regulatory apparatus in place to follow things very well.

Sniderman: *How comfortable (or uncomfortable) are you about the idea of having a macroprudential supervisor that would be able to spot all of these things happening in the broader financial marketplace?*

Kashyap: I think we need to try to do that. People talk about capital standards as an important part of that, and many people talk about liquidity as a second thing. I want to focus more on leverage as a third consideration, because deleveraging was very costly. Everybody decided to shrink their balance sheets at once, and the economy suffered. That doesn't have to happen in the banking system. If the shadow system stops securitizing, it has all the same pernicious effects. I want to make sure if we are going the route of macroprudential supervision, it involves some tool that gets all three legs—liquidity, capital, and leverage.

Sniderman: *So is it fair to say some of your research and current thinking is on these issues?*

Kashyap: I have been trying to think about this. I don't know if we'll ever succeed, but Dick Berner at Morgan Stanley, Charles Goodhart [former member of the Bank of England's monetary policy committee], and I are trying to write up a macro-prudential toolkit. I am also working with some people at the Chicago Fed on trying to write a living will for Lehman and to explain how that would have mattered. Jeremy Stein [Harvard economist] and I have been working on several projects.

Sniderman: *You have been a student of Japan and the Japanese banking system and a student of monetary transmission mechanisms more generally. Has this crisis gone by the playbook, or have aspects of it turned out to be surprising even for people who have studied these things?*

Kashyap: I think the hardest thing for academics and a lot of central banks is the workhorse way of thinking about the financial system—it's very loose. Three years ago, most macroeconomic models didn't have a financial system. So if we went back and read central bankers' speeches or even if we just went to conferences where academics were talking, there was no uniform way of discussing if your financial system gets sick, what it's going to mean and how it's going to matter. I think that's been a real handicap for people who have studied financial crises.

In the U.S., the amount of reliance on the informal shadow system wasn't so well understood at first. Just seeing how fast the market evaporated and how that tightened credit conditions was something different. But it looks a lot like the other big financial crises we had and a lot of recent emerging market problems.

Sniderman: *What about lessons from the Great Depression for central bankers?*

Kashyap: Here's something funny. Three years ago, as I mentioned, the workhorse model didn't include the

financial system. What are the two biggest macroeconomic catastrophes over the past 75 years? The Depression, and you'd probably say Japan. Both were cases where the collapse of the banking system was absolutely central, yet even the models that did describe how financial conditions matter tended to rely on borrower-side frictions.

[Federal Reserve Chairman Ben] Bernanke, [New York University economist Mark] Gertler, and [Boston University economist Simon] Gilchrist proposed a starting point for addressing these phenomena. They say the fundamental friction in the economy is that borrowers can disappear with funds and lenders are concerned with that. I take a different view. The fundamental thing that can go wrong in the financial system is that the supply of credit contracts because of funding problems for banks. This credit supply channel is understudied. It was really important in the Depression and in Japan. I think it's been really important in this crisis, and I bet that when it's over, most macroeconomic models will have a financial system, and the credit supply will be the primary way it will matter.

Sniderman: *And that will come in through frictions in supply?*

Kashyap: I think it will have something to do with the funding that's available to the banks to intermediate. If the banks can't get their own funding, then they pull that from the borrowers. So many creditworthy borrowers still want funding, but changes in the lenders' condition make them unable to give it.

Sniderman: *It sounds like it's not strictly either/or. These external finance premiums are what we are seeing a lot, particularly with small and medium-sized businesses that have a lot of problems in finding access to credit.*

Kashyap: In many cases, they are suffering because their lenders have problems. There's a nice paper by [Harvard economists] David Scharfstein and Victoria Ivashina,

which I think is the best study of the current crisis. The final draft [to appear in the *Journal of Financial Economics*], which most people won't have read because an earlier draft got a lot of attention a year and a half ago when it was first circulated, includes a neat experiment where they look at which



My current fear is that we are going to do something that might be somewhat draconian and punitive to the banks and push a lot of stuff that has been inside the banking system to outside the banking system, where we won't have the regulatory apparatus in place to follow things very well.

banks tended to be part of loan syndicates with Lehman. Once Lehman went away, not surprisingly a lot of people who were borrowing from those syndicates immediately said, boy, we're not going to be able to get credit, so they took down a lot of that credit. What Scharfstein and Ivashina show is that those banks saw a disproportionate drawdown of credit that cut their new lending. This is almost a natural experiment, because people who were syndicating with Lehman were not selecting very different kinds of borrowers. The people who got cut off were really exposed to the contagion and second-round effects of the Lehman failure.

Sniderman: *One topic we haven't talked about is consumers in the marketplace. In this particular episode—you mentioned fraud earlier—there has been a lot of concern about consumers not being able to compete on an equal footing in the financial services marketplace. And there are a number of recommendations on how to deal with that. Have you thought much about the consumer side of this and where there may be opportunities?*

Kashyap: That's probably the part I've studied the least and that's because costs during the really acute phase of the crisis—say from September 2008 to April or May of 2009—didn't change much on the consumer side. People were comfortable taking out these mortgages that they must have known they didn't understand. Many of them probably thought this deal was too good to be true, and it was. But we didn't have as many breakdowns on consumer protection across all countries, and yet the crisis was still very, very bad when the financial institutions themselves got into trouble and that spread. I think we could try to do more on consumer protection.



A lot of the regulatory proposals put too little weight on the liquidity provision. There's a limit to how much immediately demandable funds the market can produce.

That's a place where I'd be very careful because we know from past experience that something can start out well-intentioned but have really strange consequences once it gets enacted. You could easily end up restricting the supply of credit to groups because you think, well, they're not sophisticated so we need to protect them, but that could get them redlined out of the financial system. The details matter in a lot of these proposals.

Sniderman: *You mentioned the commercial banking system and the shadow banking system and how we need to be careful about not driving business from one to the other if we over-regulate. Banks have been considered special for quite a while in the literature. Some people say banks are inherently special; other people say banks are only special because we regulate them that way and choose to make them special. Has the time now come to stop thinking about the commercial banking system and the shadow banking system as two separate systems? Should we be thinking about this in a much more integrated way? Or are the banks in fact special?*

Kashyap: There are two theories of banking. At the 30,000-foot level, some people think the banks monitor firms or customers that are difficult to evaluate and for whom getting market credit would be hard without the monitoring. Others emphasize the fact that banks do liquidity provision. A lot of the regulatory proposals put too little weight on the liquidity provision. There's a limit to how much immediately demandable funds the market can produce. Part of the reason why the shadow system collapsed is that way at the end of many of these chains of market transactions was a liquidity guarantee from a bank. Those became in doubt, and the whole chain imploded. I don't think you'll ever be able to set up the market system to necessarily do a lot of liquidity creation. You might be able to do a certain amount of the monitoring, but I think the liquidity creation fundamentally resides in banks.

You ask why. Again, two theories. One is that anyone who has access to the discount window in the end can get central bank funding, and that's what allows them to give funding. But I also think there's a reason why there's a natural amount of liquidity creation because banks are in the business of giving people checking accounts, which is something people want. Then managing that kind of risk of liabilities

going away is very similar to measuring the kind of risk you need to appreciate if you are going to give somebody a loan agreement. A checking account and a loan commitment are really almost the same thing from the organization that's providing them. Either way, you wake up one day and all of a sudden more money has gone out the door. So if you have the infrastructure in place to manage the checking accounts, it's natural that you are going to go in the loan commitment business. But now, of course, we're into liquidity creation.

In the end, you might say the access to the discount window is what allows you to get into this franchise. But I don't think that's quite true because you see in lots of other countries in other time periods that there is always somebody that provides checking accounts, and this was before we had central banks. And almost invariably, the people doing that and allowing what was called overdraft protection were in the business of giving loan commitments. So I think that synergy is real. It's not just because of the central bank guarantee. The central bank guarantee must help it, but I think that's the sense I would say that banks are special. This perspective delivers a bunch of propositions about regulations, including whether they will be effective and whether they will be costly.

Sniderman: *Systemic risk has become a very, dare I say, popular topic these days. When we get into macroprudential supervision and look at systemic risk, we need some definitions of systemic risk so that we don't just say yes, we're going to do this. That may require some additional theory, then some measurements and tools, and maybe some new data. How, as a practical matter, might we do this?*

Kashyap: It's unbelievably challenging because we don't measure well so many things that we know are important.

An active area of research is to try to come up with ways to summarize networks and linkages. I think you're right; it's going to require all three things you mention. Some new theory, some new data probably, and

then some changes in regulations. I'm hoping the Fed can do its bit by publishing some of the statistics that you are probably collecting. I keep pushing on this deleveraging idea, but haircuts and margins are something the Fed, by virtue of acting in the marketplace, is already seeing in those prices.

I'd love to see the Fed publish, once a week, a set of statistics about indicative margins that indicates something about the ability to get leverage. That's the type of thing I suspect we're going to need, because those types of factors matter a lot for the securitized markets. And the condition of the repurchase markets is something we need to learn more about. Measuring that isn't so easy but it's an important task.

Sniderman: *Do you mean that having more information in the public domain will help markets discipline behavior?*

Kashyap: I was thinking even more selfishly. It will help academics write papers that will teach the regulators. The Squam Lake group wrote a memo pointing out that if you just disclose more stuff to the regulators on all kinds of dimensions, that's probably not going to be enough. We need to think about ways to put information into the regulatory system but also so that it can come out and others in the system can learn more. I think you're right, the chance of getting market discipline going depends on people believing that they understand what's happening in the system as well as having confidence that regulators can do the right thing.

Sniderman: *One element of financial reform that seems to be getting rave reviews is the idea of creating some exchanges, clearing houses, and new ways for derivative markets and other markets to clear and settle. Why do people view that as such a promising direction, and are there pitfalls we need to watch out for?*

Kashyap: On exchanges, I think one thing we learned from Lehman's case was that unwinding all the positions that were open at the time of the liquidation or failure was incredibly complicated. And there was no obvious reason why all these transactions had to be over the counter and why many couldn't be standardized. You mentioned the pitfalls of exchanges—especially what happens if the exchange itself fails. Hopefully, that is not going to be a problem. Exchanges have proven to be very robust in the past. It's probably going to be a good idea to say, look, things don't absolutely have to be traded over an exchange. But if you do trade over an exchange, you don't have to hold as much capital, and you're subject to extra supervision and regulation on over-the-counter transactions.

The fear with exchanges, besides failure, is that you might stifle innovation. Not all of the structured products we saw were serving a great purpose, but many of them were designed for good reasons. And if we go toward a world where we have more specialized derivative contracts, they invariably have to start out highly customized. Only after you learn about them can you get them standardized enough to trade them over an exchange.

So I think it would be a big mistake to say everything has to be traded over an exchange. There's not enough discussion about the differences between centralized clearing and exchange trading. You can get a lot of advantages just by clearing trades differently, even if you don't trade them over an exchange. So I'm usually in favor of centralized clearing as a minimum condition. And if stuff migrates to an exchange, that's fine. But you really need a lot of infrastructure supporting the centralized counterparty.

Sniderman: *In the area of supervision, for understandable reasons, conditions at individual institutions are not revealed, but are there other opportunities to benefit the financial system by improving information flow?*

Kashyap: You're right in saying that it would be desirable to do more to get the markets to appreciate the intent of the regulation and to reinforce some of the actions that would come out of supervision. There are huge discussions as to whether anyone actually believed Lehman could fail. Some organizations didn't think there was any chance it could happen, which made it all the messier when it did. If there had been some way to disclose policy rules and discuss them ahead of time, it might have made a difference.

More generally, if macroprudential supervision is doing its job, it is going to include writing some reports on market conditions and warning about stuff. That's why I think it's really important that the macroprudential supervisor has some tools to follow up. One thing we learned about this process is that having many officials talk about something for a really long time doesn't matter. Fannie and Freddie were slow-moving train wrecks. Every single official in the Treasury and the Fed had been talking about the problem for years, but they didn't have a way to do anything about it. And the result was that it was allowed to fester. So disclosing information to the market can help, but there's got to be some scope for following up if the actions you want to be taken aren't taken and if the untoward or reckless behavior continues, so that there are consequences. Information is good, but you've got to be able to follow through. ■



Watch video clips of this interview

www.clevelandfed.org/forefront



Related link

Visit the Squam Lake Working Group's website to learn more about its views on regulatory reform.

www.squamlakeworkinggroup.org

View: Neighborhood Stabilization: Early Reports on Policymaking in Action



Anne O'Shaughnessy,
Community Development
Project Manager

Many neighborhoods bear visible scars of the housing crisis in the form of vacant and abandoned homes. These properties attract crime, drag down the values of neighboring properties, and erode a neighborhood's sense of community. On a larger scale, widespread vacancies threaten the stability of regional and national housing markets. Help for the hardest-hit areas has come through the federal Neighborhood Stabilization Program, or NSP, one of the largest infusions of federal housing dollars in the past decade. The program is three-fourths of the way through the first phase. Is it working? And how can the NSP1 experience help inform NSP2?

The main goal of the Neighborhood Stabilization Program is precisely what its name suggests. Enacted in July 2008, NSP funneled close to \$4 billion in grants to neighborhoods severely battered by the foreclosure crisis. Money is targeted to areas that have the highest concentrations of vacant and foreclosed properties. The housing crisis is still a virulent force, and unemployment now fuels many new foreclosure starts. So while a community works to return some vacant properties to productive reuse, many more homes may emerge from foreclosure, then quickly deteriorate and be abandoned.

This is the challenge faced by weak-market states like Ohio, where Cuyahoga County alone has seen more than 13,000 new foreclosure starts annually *for the past four years*.¹ Can a program like NSP effect meaningful change in such communities? Will NSP2, in which grant money will be awarded to consortia of local governments and nonprofits working together, yield better outcomes than NSP1?

1. From Policy Matters Ohio and NEO CANDO (Northeast Ohio Community and Neighborhood Data for Organizing).

At the Federal Reserve Bank of Cleveland, we've been assessing NSP as a tool for improving neighborhood stability here in the Fourth District. Focusing on 10 communities, we documented how each plans to use its allocation of NSP1 dollars and, through outreach visits, investigated the barriers and challenges administrators grapple with in spending those funds.

We've learned two key things to date. One is that communities define "neighborhood stabilization" in different ways. Thus some flexibility in how grant money can be spent is critical. The second is that partnerships—particularly long-established ones—have been a vital element of communities' NSP successes.

We first shared these findings as a learning tool with communities receiving NSP funds. We have also used them to help inform policy. In early 2010 we, along with several other Reserve Banks, state NSP administrators, the National Vacant Properties Campaign, and the Federal Reserve Board of Governors, met with Housing and Urban Development (HUD) officials in Washington to share our collective findings on NSP1. While it is too early for a definitive answer on the program's overall success, our assessment suggests that the first phase is yielding mixed results.

Critics have called the program too rigorous and inflexible. Complaints range from the heavy administrative burden on communities, especially smaller ones, to the narrow time frame allowed for spending the dollars. NSP rules also severely limit the uses to which officials may direct these dollars. And some feel that NSP1 allocations are simply too little.



Money aside, implementation challenges abound. Some officials are finding that although areas targeted in their original plans as “most needy” are still worthy of stabilization efforts, other areas in their communities are now worse off. Grant money, however, must be spent in the areas targeted by the original plans.

Another challenge lies in purchasing the properties specified in a community’s plans. Program administrators tell us that private investors often scoop up these properties before public entities can. The reasons vary: a cumbersome administrative process for securing legal approval to buy the house with NSP funds; a seller unwilling to accept less than fair market value for the house; or an able and willing investor—able to move quickly and willing to pay fair market value—who beats the community to it. While competition from private investors can certainly indicate a market is working, it has nevertheless been problematic for some communities. Moreover, private investors often do nothing with their purchases but wait, leaving the properties to fall into further disrepair.

To its credit, HUD is addressing these complaints. In its most recent move, the agency announced on April 2 that it is relaxing some of its NSP rules to smooth communities’ path to redeveloping some of their vacant properties using the grant monies. These changes are the direct result of feedback HUD received from sources across the country, including the Federal Reserve Bank of Cleveland. But not every problem can be resolved. Final deadlines loom. Some money will undoubtedly have to be returned because a community, despite its great need, could not fulfill all the program requirements and commit its funds within the prescribed 18 months.

Despite the challenges, there have been positives to report. In Lima, Ohio, where manufacturing has declined and population has dwindled in recent years, the plan is to demolish 210 properties in less than three years; previously, the city averaged between five and 10 demolitions a year. Cooperation among several departments, including public works, economic development, and legal, was the critical element in the city’s success with NSP.

Greater flexibility would allow communities to adapt plans to shifting market conditions.

In Montgomery County, Ohio, rehabbing homes has been an essential part of the NSP plan. But to make it work, administrators needed to develop a pool of potential home buyers. Tapping local realtors, they set up a website, posted video clips of homes for sale, and generated neighborhood support through online transformation stories of local properties. Neighbors then told others about rehabbed houses available on their streets. County administrators cite this buy-in and word-of-mouth marketing as crucial to helping them sell properties enhanced with NSP1 dollars.

Key lessons so far: Greater flexibility would allow communities to adapt plans to shifting market conditions. Not every community has the same needs, and rural areas seem to have had a tougher time with NSP program requirements. Extending the time frame might enable communities, especially those with fewer resources, to take fuller advantage of programs like NSP. Technical assistance before the program launches could help get the right players and partnerships in place to succeed. And ongoing process improvements are a must.

HUD’s responsiveness to feedback about NSP1 demonstrates adaptive policymaking in action. A community’s circumstances can and do change over time. Every community has its own definition of neighborhood stabilization. Weak markets face different challenges than do stronger ones. In considering the government’s neighborhood stabilization goal on a national level, then, the policy message from our study of NSP thus far is clear: Flexibility supports sustainability. ■

A Look at the NSP



Find profiles of how some Fourth District communities are spending their NSP dollars.

www.clevelandfed.org/Community_Development/topics/nsp/

HUD Ideas in Action



The agency lays out its five-year strategic plan and invites public feedback via online forums. <http://hudideasinaction.uservoice.com>

FEDERAL RESERVE BANK *of* CLEVELAND
PO Box 6387
Cleveland, OH 44101

PRSRT STD
U.S. POSTAGE PAID
CLEVELAND, OH
PERMIT NO. 385

Return Service Requested:

Please send corrected mailing label
to the above address.

Next in *Forefront*:

Wider Watchdog

Everything you ever wanted to know about
macroprudential supervision but were afraid to ask

Education

Which policies make a difference?

Interview

Laurence Meyer

New Feature:

Forefront in the Classroom

Study questions for high school students available online

To subscribe, request copies, or sign up for web feeds of *Forefront*, visit www.clevelandfed.org/forefront.
