A Call to Action

Rediscovering a Public Purpose in Financial Services

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Overview

This policy brief argues that the present financial crisis creates an opportunity for community development financial institutions and consumer protection advocates to exert a more powerful voice in the debates around regulatory changes in American finance. To do so we must more aggressively market our own substantial practice and research during the past several decades. That experience and knowledge challenged the extension of irresponsible forms of debt to American households and demonstrated that low-income and low-wealth communities can thrive on high quality development and consumer finance. We must be the voice that advocates for a regulatory framework that simultaneously contributes to safety and soundness, community investment, and consumer protection.

A World Turned Upside Down

Americans have watched with bewilderment and anxiety as the financial landscape has turned upside down, seemingly overnight. One-time industry leaders such as Merrill Lynch, Bear Stearns, and Lehman Brothers have crumbled. The largest mortgage lenders in the country such as Countrywide and Washington Mutual have imploded. Government Sponsored Enterprises—Fannie Mae and Freddie Mac—that helped finance the American dream of homeownership for millions, are in national receivership to avoid full insolvency. And some of the largest banking establishments in the world are being held together only by government investments and guarantees.

What began as a decline in housing values became a crisis of institutional solvency that revealed flaws in the architecture of the financial system: our methods of off-loading risk and regulating financial instruments; how we incentivize everyone from brokers to executives; and the prevalence of balance sheets with too much debt, too little transparency, and inadequate risk management capacity.

Financial services are built first and foremost on human trust and public norms. In the absence of trust and common values regarding exchange, property, and security, there is no functioning market place for goods and capital. To compensate for the opaque nature of financial instruments, the complexity of financial transactions, and the anonymity of exchange, government regulatory and legal systems are designed to maintain that trust and predictability, thereby ensuring the flow of commerce. Trillions of public dollars have been placed as subsidy, equity investments, and guarantee funds to keep the financial system going, millions of families have lost their homes and retirement wealth and other savings have plummeted. The present regulatory debate must go beyond technical issues: in our view, we must have a debate about the public purpose of financial services and the role of ordinary citizens in gaining a fair shake in the market place.

Asserting the Voice of Consumers and Community Development Finance

The financial architecture of the US, including its regulatory system, is now at the center of media and political commentary. Consumer advocates and community development finance practitioners ought to play a significant role in this public debate; in part because our understanding of the downside risk of the subprime mortgage industry was correct, and in part because we are on the front lines of managing household and community decline.

The fact that the electorate responded to the economic situation by electing a forceful and thoughtful President whose work experience was based in low-income communities gives us the chance to capture that attention and become more constructive policy participants. To succeed we need to be strategic and thoughtful. We have to start by claiming the knowledge and insights of our own sector and practice.

First, we have to tell the real story of our sector during the past fifteen years. Contrary to the images projected by the anti-Community Reinvestment Act (CRA) voices who view us as the perpetrators of irresponsible demands for more credit for low income homeowners while enormous levels of unsustainable debt were being driven into our communities, we were sounding the alarm on inappropriate lending. And in our own activities we demonstrated the difference between predatory practices and high-quality lending and development transactions. We have the studies, portfolios, and legislative testimony to document this.

Second, we have to tell the story of why righting the lending practices that went on in our communities and across the country is so essential to the nation's economic and political health and security, and about the role that quality investments play in sustaining and building quality neighborhoods at all income levels. Unlike any other period in recent memory, this financial crisis has demonstrated the dramatic link between consumer protection and broad systems risk. Our perspectives on community investment and consumer protection regulations are critical to the overall safety and soundness of the financial system.

We have to develop more fully the fact base to support those narratives. Moreover we have to learn to use the media more effectively to convey our perspective, including new media that is able to reach broadly and to generate loud voices where needed to counter an increasingly irrational, but largely unchallenged, anti-CRA phenomenon. The written and electronic narratives ultimately have to be based on hard data, historical fact, and a store of community-based stories that make the narrative real.

Critical Elements of Effective Regulation of Banking and Financial Services

Even the most anti-regulatory perspectives acknowledge today that the public sector functions as a default guarantor of the market system. In normal times, the government establishes the market structure and the rules of the game (hopefully fair ones that encourage good behavior), supervises at least some of the players, and enforces the rules for all. This provides industry participants and those who use their services with the confidence that the market is fair, the products safe, and the producers likely to be around to make good on any promises they have made. It also enables industry participants to operate with far more financial leverage than they could in the absence of government oversight.

There are certain elements that we believe are inherent in a public regulatory system for financial services. The majority of those elements focus on safety and soundness, but several of them speak to issues of consumer protection and community investment. The general tendency has been to separate (in terms of importance and attention) the two sides of regulation: financial and consumer. The present crisis demonstrates the limitations of that approach. An effective financial services regulatory regime should include the following: 1) Capital adequacy; 2) Consistency of regulation; 3) Effective enforcement; 4) Requirements that all parties have a financial stake in transactions; 5) Transparency; 6) Product regulation to support best practices; and 7) Community investment.

Capital adequacy is critically important. Capital serves as a cushion for unexpected losses. Financial services are a risky business in which trust between counterparties is critical. The system works more effectively if participants believe the government is watching over the system. However, as the recent crisis has so clearly demonstrated, assumptions of trustworthiness and effective government supervision are not necessarily correct. Therefore it is essential that institutions have a sufficient financial cushion on which to operate safely. This requires greater ability and will to assess and understand risk, across entities and across countries. Moreover, capital standards should be counter-cyclical, rather than pro-cyclical, so that banks and other financial institutions build up capital in good times and have it as a cushion when things get bad, so they are not constrained from doing business when we most need them.

Because business practice will flow downhill to the practices of the least regulated, **consistency of regulation** across the same type of transaction, no matter what the corporate form of the entity doing the transaction, is critical. At the same time, we also need to pay some attention to the size and complexity of the entity being regulated, recognizing that smaller institutions, with more limited product and geographic reach, are far less likely to pose a substantial risk to the financial system than are large, diverse institutions. For instance, while we recognize that Community Development Financial Institutions (CDFIs) that are not banks or credit unions may need greater regulatory oversight than is currently the case, this must be seen in the context of a system in which all financial institutions—and especially those that directly serve consumers—are supervised effectively and the role of CDFIs in taking "unbankable" risk is recognized.

A third important element is effective enforcement. Without **effective enforcement,** capital regulations encourage overleveraging, and consumer protection regulations give false comfort. Banks and credit unions are subject to on-site examinations at close intervals; the largest have examinations virtually continually. In contrast, other types of financial institutions are, in general, regulated by exception and complaint, generally by agencies (such as the Federal Trade Commission, the Securities and Exchange Commission, and state consumer protection agencies) that are consistently underfunded. Enhancing the funding for and quality of enforcement is critical. But enforcement can also be more effective if leveraged by other structures, including public awareness, media activity and, if necessary, litigation.

Aligning the desired outcomes of regulation with the incentives of the regulated will also encourage better outcomes. Everyone involved in a financial company or a financial transaction—companies, boards, employees, agents and customers—must have **a financial stake** in the long-term performance of both financial institutions and financial transactions. This is critical in part because the public has a big financial stake in an honest and well-run financial system. Applying this principle to re-thinking new forms of securitization could not be timelier. If we learned anything from this crisis it is that all parties to transactions where risk is transferred must retain some of the risk of the transaction. Moreover, this principle needs to be reflected in compensation reform, so that compensation is based on long-term performance, both at the corporate level, and with respect to the compensation of any person involved in a transaction whose performance is removed in time from its initiation, such as a loan or investment.

This leads to the concept of **transparency**, which goes beyond making sure that the terms and risks of complex financial transactions and the identities of counter-parties are clear. Transparency also means making public a far greater amount of information about how institutions are behaving when that behavior impacts the public, and making sure the information is timely, and in a format that can be used fairly easily by those who are interested. This kind of transparency enables limited regulatory resources to be leveraged by the public (and their representatives, including the state attorneys general), the media, by community based organizations, and even by competitors.

In banking, this is exemplified by both financial Call Reports, and the Home Mortgage Disclosure Act (or HMDA) reports, which annually reveal, with some but not excessive aggregation, who banks have made mortgages to, where, at what price—and who they have turned down. HMDA needs to be expanded to small business lending (where there is ineffective disclosure); other essential consumer financial services (where there is none); and corporate investments in community and the environment (as is required to some extent in the European Union, but not in the United States).

Strong and effective product regulation is as important as any of the other regulatory elements. This includes both product transparency and disclosure and substantive product regulation. Possible strategies for this include standard contracts for products; "default" products that must be provided first, with substantial liability exposure for ineffective disclosure of the risk of alternatives; and creation of a Financial Product Safety Commission modeled on the Consumer Product Safety Commission. In addition, the concept of "suitability," well established in the securities industry, should be applied more broadly, especially to credit products. The absence of product suitability regulations in the mortgage industry was a significant impediment to slowing down the distribution of loans that were all but designed to fail for many consumers.

Finally, we believe that it is time for explicit recognition that government regulation and oversight are what enable private financial services companies to operate profitably at high levels of leverage. In return, those companies must be held to an affirmative mandate to fairly and equitably serve all communities, sectors, and constituencies. This goes beyond non-discrimination to an affirmative obligation. For banks, this requirement is presently located in the Community Reinvestment Act, as well as the service goals that have, until now, applied to Fannie Mae and Freddie Mac. The case for doing so revolves around four observations:

- Mainstream financial institutions have a long history of neglecting lower income and minority communities
- Such neglect degrades the impact of significant government expenditures at the federal, state, and local levels
- The dislocation of financial institutions from local communities limits the capacity of those communities to marshal civic resources
- Regulated industries and their regulators are inherently conservative (notwithstanding recent excesses) and thus overestimate the risks involved in serving these communities

Adding community to the regulatory obligation means recognizing that fair and equitable service to all communities and consumers is a condition for being permitted to gain the benefits of participating in the financial services marketplace. It should not be an afterthought or a "nice to have." In this respect, financial services companies should be treated as that kind of foundational infrastructure that they are—unlike any other commodity. Recognizing that community is important also requires that the regulatory system stop favoring bigness, both by requiring compensation for protection of that status (rather than subsidy), and by providing support for an effective network of smaller institutions.

A New Public Bargain

It is easy to see from these principles how our present system—constructed largely in the 1930's with uneven add-ons designed to catch up to product and institutional innovation (as well as the civil rights movement in the case of CRA)—has failed. Basic regulation has been uneven with respect to banking institutions of various size and product specialization; between banks and non-bank financial institutions, and with respect to largely unregulated securities whose impact on banks and consumers is profound. The system of securitization, which allows originators of loans to sever all connection to asset performance after sale and investors to rely on ratings generated by a compensation system that rewarded laxity, has turned out to be unsustainable. The inadequacy of capital within the major investment banking firms has been a significant accomplice to the present unraveling. The general lack of balance sheet transparency among major banking, insurance, and non-bank (especially hedge funds) financial institutions has contributed to the present market lock-up. And CRA is applied unevenly among financial institutions without a clear sense of what kind of standards ought to be applied where financial institutions are national and global and may have limited retail footprints.

There is wide agreement—across political parties—that the present system of regulation is inadequate. There will be debates over what kind of regulations should be adopted, where regulations constrain innovation and enterprise, how to respond to past failures, and where exceptions ought to be made. Moreover, there will be a need to reappraise the institutional armature of regulation. We have too many regulators, with too little enforcement capacity, leading in many cases to competition among regulators over who will be most accommodating. And finally, we have inadequate flows of centrally analyzed data (information) necessary to manage global, systemic risk.

The present situation demands more than tinkering around the technical edges. The product and institutional innovations of the past decades surpassed the ability of public or private regulators (rating agencies, insurers) to understand and manage risk. And the enormous concentration of banking assets has created a situation that few Americans fully appreciate. Today, four bank holding companies (Bank of America, JP Morgan Chase, Citigroup, and Wells Fargo) control half the nation's bank assets, in a system that has more than 8,000 banks. Finally, the vast asymmetry of information and knowledge about credit and loan terms established by a 'shadow' banking system with limited public accountability caused untold problems.

A new public purpose bargain would have to work toward establishing the kind of information infrastructure that makes product safety and suitability standards possible. Moreover, it would have to be able to monitor excessive wealth stripping from particular places and sectors; with an eye toward intervention. The prejudice towards bigness in financial institutions would have to be countered by establishing specific forms of support for smaller banks and community development financial institutions that specialize in community lending and development. This is all possible with the experience, data, and political will that exist within our industry and our country. It is high time we acted on our capabilities for the benefit of all.