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More Opportunity Through Deregulation

Remarks by

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It is my pleasure to be here in Detroit to address the 1994 Financial Institution's Joint Housing Conference. It is always refreshing to be among creative people who are actually getting things done and meeting people's needs. Funny, I don't get that feeling in Washington very much.

There are few more important tasks before the country today than the one you will be discussing here at this conference. The need to provide homeownership opportunities to millions of American families who do not now have them and to provide the financial infrastructure to rehabilitate America's depressed areas is great. It is very important that we all work together in this regard, and in particular, that we not get in each other's way. We regulators have a particular responsibility to aid you in your efforts.

Back on July 15, 1993, the President asked the four banking regulatory agencies to revise the Community Reinvestment Act regulations to make them more objective, more focussed on performance and more oriented to extending loans to low and moderate income neighborhoods. As you know, last December we released a proposed rule which represented our first draft of these revised guidelines. More than 2000 individuals and organizations commented on those rules. We very much took those comments to heart and on September 26 issued a new proposal.

I believe that the proposal we have produced meets the

President's objectives. Most important, we have preserved, to a maximum extent, the strength of the current system by allowing examiners flexibility in assessing bank performance in light of local conditions as well as the capacity and constraints of the institutions involved. One size fits all types of solutions have no place in a successful effort to increase credit to America's inner cities. The diversity and variety of conditions in America's credit markets is a fact which we regulators ignore only at our peril. I hope that we have, in general, succeeded in extending maximum flexibility with minimum interference, while still conforming to the President's request for a more objective set of criteria.

In general, we attempted to set a high standard of cost benefit analysis, before imposing either paperwork or capital allocation types of requirements. I think that the standard which we established should be more broadly applied in government. So, the thrust of my comments today is on what government can do to ease the regulatory burden which is holding back home ownership opportunities and inner city development.

I must admit, however, that I am concerned that we may not have, in at least part of the proposed regulation, resisted the standard Washington temptation to write rules which sound good and are well intentioned, but fall short in practice. In particular, as I made clear at the Board table, I have some concerns about the proposed race and gender coding of small business loans at large banking institutions. Under this proposal, whenever a business applies for a loan under $1 million, it will be asked to reveal, by percentage, the racial, ethnic, and gender composition of its owners. Clearly this provision is intended to help promote economic development in underserved minority communities. On the other hand, questions have been raised about the workability and potential unintended consequences of this approach. Given the competing objectives of public policy, we in the banking agencies are now in the process of soliciting the public's views on this proposal, and greatly value your input.

Regardless of the outcome of CRA reform, we in the government have a particular responsibility to evaluate our own behavior in every area. To many people, government problem solving follows an all too predictable pattern. First, a source of a problem <u>other than government</u> is found. Second, that private sector problem source is given a new paperwork burden with severe penalties for non-compliance. Third, the government bureaucracy is enlarged in order to administer the new rule and cope with all the paperwork. We at the Federal Reserve are estimating a compliance staff increase of between 25 percent and 50 percent in order to meet the demands of these and other new rules. While I personally feel that the proposal we have made in the CRA area is worthy of consideration, we should not stop here in looking for ways to help disadvantaged communities.

My experience has shown that the chief obstacle to economic development in distressed neighborhoods is often government itself. In my three years at the Fed, I have toured more than 30 inner cities and talked to countless people who are actively involved in community development about what their biggest problems are. Invariably their answer comes down to government -- federal, state, and local. So, rather than imposing yet another paperwork burden on the private sector, maybe we should try getting government out of the way of the private sector instead.

Government is a source of problems in virtually every aspect of urban redevelopment. Local governments have zoning and tax rules which leave wide expanses of their potentially most valuable real estate vacant. Labor laws such as Davis Bacon at the federal level and similar laws at the state levels drive up housing rehabilitation costs, as do excessively strict local building codes. HUD regulations make it needlessly cumbersome to become a lender under its programs. Let me begin with a list of proposed rules which affect banks, which, as a banking regulator, I think should be on any priority list to help encourage homeownership and inner city development.

Minimum Downpayment Requirements. As part of the FDIC Improvement Act (FDICIA), the agencies were required to impose regulatory requirements for all loans secured by real estate for the purpose of constructing or improving buildings. Originally these involved minimum downpayment requirements of 20 percent in the case of homes and as much as 35 percent for commercial property. Had the homeownership downpayment requirement gone into effect, as everyone in this room can well imagine, it would have literally stopped all low and moderate income homeownership programs in the country. Here was a classic government approach -- rules to solve the immediate political problem without regard to the unintended consequences on problems not currently at center stage.

Instead, we developed a set of general rules that did not contain any specific down payment requirements, but did set guidelines which included a 10 percent downpayment for owner occupied housing with a special "basket" for exceptions. In practice, there are many cases in low income areas where even lower downpayments may still be consistent with prudent lending. Often, a mortgage payment on a rehabilitated property is less than the current monthly rent payment the potential homeowner is now paying. But, because of the high rent, it is virtually impossible for the family to save enough for a downpayment.

The downpayment requirement is particularly onerous for development in low and moderate income areas. The primary capital shortage in the inner city is not debt financing, it is equity capital. This requires accumulated wealth in the form of liquid financial assets or collateral such as property. Downpayment requirements exacerbate this problem by preventing any substitution of debt for equity.

Appraisal Rules. FIRREA required that banks hire certified licensed appraisers to estimate the value of real estate property which is to be used to collateralize any loan. Of course, this drives up the cost of loans for everyone, and marginal loans which are disproportionately in distressed areas are particularly hard hit by this requirement. But, the problem in distressed areas is even more complicated. Appraisals are based on the current condition of properties, not on their ultimate value. Further, property values in distressed areas seem to be systematically undervalued. The net result is to sharply depress the collateral value of inner city properties, thereby cutting them off from access to loanable funds.

The federal banking agencies minimized the potential damage by first establishing a $100,000 appraisal threshold and have since raised the threshold to $250,000. But, getting rid of this requirement entirely could substantially raise the equity capital available in inner cities.

Glass Steagall. Ever since the 1930s banks have been severely limited in taking equity positions in non-bank type enterprises. Yet, "equity kickers" are a natural part of higher-risk loans. These equity positions allow the opportunity for big payoffs in the case of successful endeavors. These potential payoffs in turn allow for more affordable loan rates on the debt portion of the financing. It bears repeating that it is equity capital which is in shortest supply in the inner cities, and Glass Steagall prevents the kind of financing which would most directly help solve this capital problem.

It is true that Bank Holding Companies can have limited equity participation through Community Development Corporation subsidiaries or by petitioning the Federal Reserve for approval of certain investments under Regulation H. But these are both cumbersome and somewhat limiting. Now that the interstate banking legislation is law, consideration of Glass Steagall reform is on the table. Representative Leach, the ranking Republican member on the House Banking Committee, and Representative Gonzalez, the current Chairman, have both announced a willingness to explore this issue next year. This is potentially very good news.

Environmental Liability Rules. Because of their histories, inner cities are far more likely to harbor hidden environmental hazards than are green field properties. These added risks, and the manner which Congress has prescribed for cleaning up these properties, stand as major obstacles to inner city development. Potential owners are naturally wary of taking on a property where they might be liable for pollution caused by someone who owned the property decades before. It is even harder on a bank, which under the deep pocket principles applied, could be stuck paying virtually unlimited damages on a property it didn't even want to own, but on which it needed to foreclose. Ironically, Superfund Reform, which would have eased this problem, was killed in the last Congress partly by efforts to require that Davis Bacon rules be applied to contractors on clean up sites.

Indeed, environmental rules often make rehabilitation of run-down neighborhoods prohibitively expensive for seemingly no benefit. These environmental improvements are not usable as collateral for bank loans. Thus, environmental restrictions drive up the amount of equity financing required for any project without increasing either its likely cash flow or the property's true value. For example, our clean water laws require that ground water be brought up to standards applicable to drinking water. Yet, it is inconceivable that anyone would consider sinking a well in a densely populated area already served by municipal water lines.

Inner city residents and community development organizations often get the job done in innovative ways. For example, in Philadelphia, a neighborhood housing group had redeveloped an entire block of row houses. The problem was at the corner where an old gas station once stood. The risk of having to dig up and dispose of an underground gasoline tank which probably lay beneath the property would have been prohibitively expensive. No one -- including the state and city governments -- would touch the property. So, to avoid an eyesore on their newly rehabilitated block, the neighbors got together, washed the windows, and painted the exterior shell of the building to make it appear occupied.

Restrictions on the Use of Cash. The Treasury has extensive reporting requirements affecting the use of cash. As always, the rules were well-intentioned. They were intended to inhibit money laundering by drug dealers and others. But, many inner city communities have never had easy access to banking services and have residents who may rely on income from informal or casual employment. Restrictions on the use of cash keep these neighborhoods from mobilizing their saving and entering the mainstream of economic activity. Currency exchanges spring up to help meet the payment needs of these areas and charge exorbitant fees.

Probably the most difficult question ever posed to me was by a lady in Denver who had accumulated a large cash downpayment for a house in an area which had not had banking services. When she brought the money in, the bank had enormous trouble accepting it because of these well intentioned laws. She asked me, "You people think we're all drug dealers, don't you?"

I think we should admit that these rules, though well intended, have had some serious unintended consequences. At the very least we should carefully assess the benefit of these rules and reconsider whether they are worth the cost.

Davis Bacon Reform. Present federal law requires that workers at most federally financed or assisted construction sites be paid "prevailing wages". By and large these are the local union wage. An estimated $60 billion in construction falls under Davis Bacon annually. These restrictions impede inner city development in two ways: they drive up the cost of construction and they tend to deprive local residents of job opportunities.

Last week I spoke in Baltimore at a conference very similar to this one. There, the estimate of the so-called Davis-Bacon tax on inner city construction was between 5 and 10 percent. Adding 10 percent to the cost of a housing unit is the equivalent of adding a full percentage point to an 8 percent 30 year mortgage. In short, the Davis-Bacon requirement effectively wipes out much of the good those of you who are bankers do when you lend to such projects at concessionary rates.

<u>Improve the Mechanism for Clearing Title on Abandoned Property.</u> The problems of government are not just federal, however. Local government creates its share of obstacles. Anyone who has been on a tour of an inner city neighborhood can easily see the effects of abandoned properties on living conditions in the neighborhood. Their very presence creates an eyesore and a haven for drug dealers which devalue all of the existing housing in the area. This makes the task of rehabilitating neighborhoods ever more difficult. Government and only government can solve this one. The exorbitant delays nationwide on the rapid transfer of title on abandoned properties in inner city areas is a national disgrace.

What is often missed is the human tragedy that these delays cause. A few weeks ago I was touring the West Humboldt area of Chicago. A real dynamo of a lady, Mrs. Magdalena Martinez, took us down the block where she lives and described the efforts she had made in evicting drug dealers from one property, getting the absentee landowner in another property to fix up his building, etc. Then we came to a vacant lot. She described how two years ago the city of Chicago had promised that her daughter would be able to acquire the property and build her home there. Politicians and press came out for the requisite photo opportunity. Today, the property is still vacant and Mrs. Martinez had tears in her eyes as she asked us when the city would let her daughter acquire the land and build her house.

Property Taxes. One of the greatest challenges facing many blighted urban areas is overcoming long-standing state and city policies regarding the payment of back property taxes. In my view, no place typifies this problem better than Pittsburgh. There, with a spectacular view and within walking distance of downtown, sits the Hill. This depressed area experienced a tremendous amount of abandonment after riots there in 1968. An eyeball estimate would suggest that one third to one half of the land there is vacant. In any normally functioning market, this would be prime real estate. But, any for-profit developer seeking to acquire the land would have to pay back taxes dating back to 1968, with interest. Needless to say, the prospect of paying a quarter century of back taxes makes even the most promising real estate unattractive. So there sits the vacant land on the Hill, not paying any taxes, and dragging down the property values of the entire neighborhood. Where is the cost benefit analysis here?

Or again, consider Chicago. Title clearing and property taxes were the major obstacles confronting a very innovative group on the North Side named People's Housing. They had a project to convert an abandoned property into a cooperative housing unit for low income elderly residents. It took two years to get approval to go Co-op from the city, but no property tax abatement was offered. As a result, the property taxes consume much of the rental cash flow, which is necessarily low because of the income of the tenants. Debt service at anything approaching market rates becomes impossible, thus preventing the duplication of this successful model. What kind of cost benefit analysis produces this kind of policy result?

We are all very familiar with the senselessness of many government regulations. However, it is not generally recognized that residents of our most distressed regions suffer from well-intentioned government even more than do most people. Furthermore, they can least afford the costs government imposes.

Faced with these problems, I believe that we need a new approach to policy making. Rather than just doing something because it sounds good, let's actually think it through to make sure it will do good. I disagree with those who think that government and politicians are evil. They aren't. In fact, they are generally filled with the noblest of intentions. The problem is that they let intentions stand in the way of solutions.

Eliminating Davis-Bacon requirements, or systematically reviewing and modifying the banking regulations I discussed would, in my view, do far more to promote inner city development than would our entire CRA reform effort, as important as it is. I am proud of the effort we have made as regulators in trying to craft workable CRA guidelines. But whenever we consider new policies, we should always remember to ask ourselves: Are we in government really solving anything, or are we just papering over the problem?