**To:** Senator Chris Van Hollen – Senate Committee on Banking, Housing, and Urban Affairs

**Subject:** Decreasing the racial gap in reserves by mitigating redlining

**Date:** April 21st, 2017

**Executive Summary** The large difference in reserves between whites and minorities contributes to an ever-growing racial wealth gap. Redlining and reverse redlining are two policies that have widened this gap by creating a debt cycle. To tackle the gap, we must address the cycle. Besides the status quo, there are two policies we explored that build on the Community Reinvestment Act (CRA): 1) establishing a low-interest short-term small loan program, and 2) strengthening regulation of predatory lending. The three criteria we used to evaluate these policies are feasibility, effectiveness, and efficiency. After evaluation, I concluded that strengthening regulation of predatory lending is the best policy out of the three. It meets our policy goals by preventing the rolling over of loans, which helps stop the cycle. In addition, feasibility is incredibly important in today’s political climate; while it ranks 2nd in feasibility, it is more effective and efficient than the status quo.

**Problem Description** The increasing racial wealth gap is an alarming problem – a major contributor to this gap is the disparity in reserves. A 2013 federal survey found that “about one quarter of African-American families had less than $5 in reserve,” compared to $375 for low-income white families (Kiel). Redlining and reverse redlining, the denial and overcharging of services to communities based on racial or ethnic composition is a key reason African American families have fewer reserves. For example, until 1968, the Federal Housing Administration denied mortgages to neighborhoods with “inharmonious racial or nationality groups” (Fair Housing Center). Although legislation such as the CRA has attempted to eliminate redlining, the effects are still felt today.

Without enough reserves to fall back on, it is hard for people to climb out of poverty, as any debt will cause them to take on more debt. Mitigating redlining can help generations of Americans take risks and make investments to escape this cycle. These policies designed to mitigate redlining aim to provide a stronger safety net for minority communities by decreasing the discrepancies in economic assets between racial groups.

**Analysis** *Policies* There are three policies, the first of which is the status quo. The CRA gives credits to banks that pass its tests. A bank with a lower evaluation has a harder time getting approval for mergers and similar projects. One problem with the CRA is that it’s subjective; there are no quotas or benchmarks. Thus, while “97% or more of banks received ratings of Satisfactory or Outstanding” (US Senate Congressional Review Service), it’s impossible to tell whether the majority of banks are actually good or if the CRA needs better standards.

The second policy is increasing access to low-interest, short-term loans by creating a small-loan program through the CRA. In this case, a loan would be of any amount less than $1,000 with a capped annual percentage rate (APR) of 50%; this is in contrast to the payday loan average APR of 300% (The State of Lending). This policy will be accomplished by emphasizing the public welfare investment initiative of the CRA that would pressure banks to offer small loans either through local branches or partner community organizations. The ratio of small loans to regular loans will also be evaluated. This expansion of small-loan lending would act as temporary reserves for minority communities, and help them deal with emergency situations.

The third and last policy seeks to modernize the CRA by adding stricter regulations against predatory lending practices such as reverse redlining and payday loans. Gregory Squires, the Chair of the Sociology Department at George Washington University, notes that the CRA may have actually contributed to an increase in reverse redlining because it “increased access to capital, but sometimes by predatory lenders” (Squires). To alleviate this issue, the CRA should consider a banks’ history of predatory lending through the loans’ annualized interest rate. If such lending practices continue, the CRA can take away credits as an incentive to improve.

*Evaluative Criteria* The most important criterion to explore is political feasibility. Is it possible to pass this legislation? Can agencies such as the Federal Reserve Board enforce these policies? The second criterion is effectiveness. Will the assets of low-income African American families increase? Does this then give a sense of a safety net? The last criterion to consider is efficiency. Will communities react positively to this new system? Will banks buy into these policies?

*Analysis* The status quo is the most politically feasible as it is already in place. Out of regulating predatory lending or encouraging a low-interest, short-term loans program, it is hard to evaluate which one is more politically feasible. Banking institutions would be against both, but public opinion is more complicated for regulation. A Gallup survey question asked five times since 2009 found that “around half [of people surveyed] have consistently said there was too much regulation of business and industry” (Bowman). At the same time, people do support regulation in the name of fairness – a Lake Research poll asking how important regulating “financial services and products ‘to make sure they’re fair for consumers’” had 70% answer ‘very important’ (Bowman). The way these regulations are presented to the public can make them politically feasible. A low-interest, short-term small loans program is similarly unpopular among payday loan providers. The Center For Responsible Lending found that “payday loans… cost American families $3.4 billion in fees every year” (The State of Lending), a large chunk of their profits. In terms of enforcement, regulation edges the low-interest small loan program; while the loan program may be encouraged, it cannot be mandated. Not adhering to CRA new regulation policies, on the other hand, will harm banks’ chances of merging and expanding.

In terms of effectiveness, the status quo is the least effective as it does not change the asset gap or provide more of a safety net. Both the low-interest short-term loans program and regulation of predatory lending provide a safety net. Low-interest short-term loans would help people pay off unexpected costs and regulation of predatory lending would prevent loans from rolling over, which is when a consumer cannot pay a loan so they take out another loan to pay the previous one. Similarly, both policies would be able to increase assets; both of them stop debt from perpetuating, and allow the accumulation of capital to happen. In particular, the regulation of predatory lending addresses issues with accessibility to housing. In 2006, “54 percent of African American… mortgage recipients had subprime loans” (Rothstein). With firmer disincentives, banks will disperse fewer subprime loans and be able to repossess fewer houses.

While banks are more than happy to buy into the status quo, communities are not. Since we are trying to help the communities, status quo ranks last in terms of efficiency. As mentioned above in the feasibility section, there is most likely community support for both the regulation of predatory lending and low-interest short-term loans. In addition, a Pew Research Trust report found that 12% of African Americans are 2-3 have taken out payday loans (Urahn 10); there is definitely a big market for a low-interest short-term loan program. Because of loss aversion – the idea that people dislike losing something more than they like gaining the same thing, it seems that banking institutions would be more inclined to follow regulations to avoid losing CRA credits versus adding low-interest loan programs in hopes of gaining credits. Taking this into consideration, regulation is more efficient than establishing a short-term loan program.

*Outcomes/Unintended Consequences* If we keep the status quo, the wealth gap will only grow worse. This is not unexpected, but is very concerning, because it prevents social mobility. If a short-term loan program were to be proposed, payday loan providers would use their economic power to push back through lobbying and campaigns. If this program could weather this, it would provide a strong safety net and allow minority communities to take risks and make investments that would better their future. Regulation would also face opposition, especially from banking institutions; however, if it were to pass, it would decrease the average number of rollover loans people experience.

One of the major arguments against increased regulation is the claim that deregulation will help the economy grow more. While deregulation may help some parts of the economy grow, the “banking deregulation in the 1990s… led to a surge in subprime lending that concentrated in communities of color” (Gamboa). This increase in risky loans is reverse redlining in action, and why currently “barely more than four out of ten black and Latino families [own] homes… compared to seven out of ten white families” (Gamboa). Again, while the economy may improve overall, minority families are hurt.

**Policy Recommendation** The regulation of predatory lending is the final recommendation. The status quo doesn’t actually address the problem, even though it is the most feasible, and thus is not considered. In feasibility and efficiency, regulation of predatory lending is ahead of the short-term loan program, but ranks slightly lower in effectiveness. The reason the short-term loan program ranks highest in effectiveness is because it directly achieves the policy goals by acting as reserves and providing a platform to exit the debt cycle. While increased regulation tries to achieve the policy goals, the safety net it provides may not be enough to prevent people from entering the debt cycle in the first place. However, it provides banking institutions with more incentive to implement it, and is overall more politically feasible, an especially important issue today. Considering all of these tradeoffs, it is more important to work towards legislation that will actually be able to affect these minority communities, which is what regulation will do.

**Citations**

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