Community Affairs Research Conference Opening Remarks
Federal Reserve System's Fourth Community Affairs
Research Conference, Promises and Pitfalls
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On behalf of the Federal Reserve System, it is my pleasure to welcome you to the fourth Community Affairs Research Conference. I believe this year's conference has brought together a set of papers and participants that will make interesting and useful contributions to our knowledge on matters of consumer finance and community development. These are areas in which innovations in lending practices and supporting information technologies have led to a substantial expansion of credit to U.S. households. I think its fair to say that these markets are in a state of flux, making it particularly difficult to assess the costs and benefits of private sector practices and public policies. Against this backdrop, research like that represented at this conference is all the more valuable.

Over the last six years these meetings have provided a valuable venue for presenting and discussing research relevant to improving our understanding of how markets in general, and credit markets in particular actually work, especially for people and households in the lower portion of the income distribution. While many of the headlines we see about the economy and about economic policy deal with the overall level of income and employment, it's clear that market outcomes for individual households can vary widely. I see the community affairs research program as being squarely aimed at understanding this variation in outcomes across households and how it is affected by public policies. Indeed, this purpose is reflected in the title and subtitle for this year's conference – "Promises and Pitfalls: As Consumer Finance Options Multiply, Who is Being Served and at What Cost?" This research program has already taught us some valuable lessons. In particular, we have seen the emergence of a substantial body of research that aims at measuring the effects of community development policy on the behavior of market participants and on economic outcomes in targeted communities.

In the first area, much of the focus has been on the effects of the Community Reinvestment Act on bank lending behavior. While it is always difficult to attribute such changes to a particular policy when there may be many causes, the evidence so far suggests that the CRA has had the expected effect of increasing lending by banks and thrifts to low and moderate income households, especially since the late 1990s and especially for large banks, for whose acquisition strategies can be affected by CRA ratings.

At the same time, many studies have examined the effects of such lending on low and moderate income neighborhoods. They generally find faster growth in average home ownership and average home values in these areas, which may be at least partly attributable to the increased lending encouraged by the CRA and other initiatives. These results suggest that targeted intervention by government or private community development organizations can significantly alter the development path of the target locations.

It appears to me, however, that as valuable as this research has been, much of it has been of only limited usefulness as a guide to public policy. The goal of community development lending is to facilitate the ability of low and moderate income households to make use of financial markets and instruments for their own benefit. In other words, <u>policy is about the well-being of people, not neighborhoods</u>. Research that focuses on neighborhood-wide outcomes – even important outcomes like home ownership or property values – in some sense misses the mark. By focusing on neighborhoods rather than people, they are unable to provide conclusive answers to the most fundamental questions dealing with the economic well-being of households. A measured increase in ownership and home prices in a neighborhood, for example, cannot, by itself, tell us who has or has not gained from these changes. Its unlikely, for instance, that people's location decisions are invariant with respect to the policy intervention under consideration.

Similarly, studies of the behavior of the providers of credit, while important for understanding the impact of regulatory intervention, are limited in their ability to shed light on the impact of such credit on borrowing households. The benefits that households derive from financial market transactions relate to building wealth and smoothing consumption. And people obtain credit from an array of market and non-market sources. Focusing on lenders rather than people, leaves us unable to say much about the evolution of people's well-being.

As a corollary, while the HMDA data reported by lending institutions may be useful in screening for potentially discriminatory lending, further refinements of the HMDA reporting regime are unlikely to yield information that is of much use in making inferences about the well-being of the people we are trying to help. It would be more productive, in my view, to devote resources to collecting longitudinal data, analogous to the PSID. We ought to be building datasets containing detailed and comprehensive records of financial transactions as well as income and spending for a panel of households over the course of many years. So if I were to try to identify the main challenges in community development research, one would be to find ways of improving our understanding of how changes in financial institutions, instruments and regulation have affected the behavior and welfare of <u>individual</u> <u>households</u> in the population of interest. This is not an easy task. One obvious reason for the greater focus on lenders and neighborhoods is data availability. But to the extent to which our research program is driven by <u>policy</u> <u>questions</u>, I would hope that our future research efforts are guided more by a focus on <u>people</u>. And this year's conference program heads in the right direction – a number of papers seek to examine how developments in consumer finance markets, which have been changing rapidly in recent years, are affecting consumers.

Given a focus on people and economic well-being, another challenge for research is to take care in <u>how</u> economic well-being is assessed. One of the primary functions of financial markets is to allocate risk. In consumer finance, borrowing and saving are important tools in households' efforts to prepare for and respond to risks associated with loss of income, illness, or other shocks. The effectiveness of financial market participation as an aid to household risk management can only be fairly assessed on an <u>ex ante</u> basis – that is, from the perspective of before the financial transaction has been initiated. After the fact, a defaulting borrower may not appear to have been made better off by taking out a loan. But for economic research, and economic policy as well, the more relevant question is whether a change in credit market conditions makes the average borrower better off <u>ex ante</u>: "at the time the loan is taken out." That is, how do changes in institutions or government regulation affect the price and terms on which households can obtain credit, and how does that affect their ability to respond to shocks, smooth consumption, and build wealth? This emphasis on an ex ante perspective is not just a good guide for research. It is also, I believe, an important principle for how we think about public policy with regard to consumer finance. And this point relates directly to the "pitfalls" referenced in our conference's title. I think the most significant pitfall is that the broad expansion of credit and proliferation of lending practices that we've seen in the last couple of decades has made evaluation of credit options more difficult, both for the consumer and for the policy analyst.

Popular discussions of lending practices often take a decidedly ex post perspective, revolving around the consequences of particularly bad outcomes. This amounts to policy by anecdote. An ex ante approach would ask instead whether a particular practice expands the menu of borrowing options in a way that is useful to households in pursuing their economic goals. Similarly, it seems to me that both sides of the recent political and media debate about the bankruptcy bill were largely divorced from the essential economics of bankruptcy: namely, the role that it plays in facilitating household risk management. Bringing an ex ante perspective to bear on credit market policy questions is, I think, an area where research can be especially valuable.

By the way, this ex ante perspective underscores the importance of financial literacy. As the array of financial market options available to households continues to expand, their ability to assess those options and make choices that are good for them will increasingly rely on them being well-informed. In other words, the community affairs research program is complementary to the Federal Reserve's interest in building consumer understanding of financial market opportunities and risks.

The future of community affairs research is promising in my view, despite the pitfalls I've noted here. The fact that there remain gaps in our knowledge I see not as a failure of research to date but as a measure of the opportunities for further productive work. The fact that popular policy discussions in this area are so prone to error also points out the social value of good solid research.

As a Federal Reserve economist, a director of research, and now as a Reserve Bank president and chairman of the Committee on Research, Public Information and Community Affairs, I have gained a deep respect for the activities of our Community Affairs offices and for their mission of promoting community development and fair and impartial access to credit. And as an economist, I think that one of the best contributions we can make to this mission is by supporting research into the fundamental forces that determine the well-being of the people who make up the communities in which we have a particular interest. Credit markets clearly play an important role in this process, and as we advance our understanding of this role, we will further our community affairs mission and become better as financial regulators. As a result, I will watch the work discussed at this and future conferences with great interest.