DEREGULATION, SEGMENTATION, AND EXCLUSION IN THE FINANCIAL SERVICES SECTOR: THE EFFECTS ON THE LOW-INCOME SIDE OF THE ECONOMY (LESSONS FROM THE USA)

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The last twenty years has been a period of major structural change for the financial services sector in the United States. Some of this restructuring has been prompted by technological change, but public policy has also helped to facilitate the increased mobility of capital to places where it brings the highest short-term private return but not necessarily the greatest long-term social return. While deregulation and technology have combined to provide a wider choice of services and increased price pressure in the lucrative segments of different financial markets, the pursuit of affluent customers has left lower-income consumers and very small firms at a disadvantage. The supply of capital to lower-income populations and communities has been volatile and susceptible to changes in international and national investment opportunities.

Financial services in the U.S. and in Europe are undergoing a simultaneous process of concentration and convergence. Since 1985, the number of commercial banks has declined precipitously in the U.S. from more than 14,000 to about 9,000 in 1997. The top 50 banking organizations in the U.S. now comprise over two-thirds of added value of all U.S. banks, up from less than half in 1985, and the assets of the top ten banks has increased by 70% in real dollars. After decades of European and Japanese dominance, two U.S. banking organizations, Citigroup and BankAmerica, rank among the top six banks in the world as of March of this year. In Europe, the largest bank is expected to have exceeded $1 trillion in assets by the time of this publication.

Consolidation is also occurring in securities and insurance industries, though at a somewhat slower pace than in banking. At the same time, the former independence of financial service industries has been eroded, with cross-industry mergers and acquisitions becoming commonplace. Beginning in the Great Depression of the 1930s, the U.S. had maintained a financial structure that separated lending (banks), investing (securities firms), and insurance activities. But in the last decade, these boundaries have begun to break down, with government deregulation accommodating the desire of financial service giants to build their economies of scale and scope.

Believing that the country is "overbanked," regulators, led by the Federal Reserve System, have encouraged mergers of banks in the U.S. Federal Reserve researchers have begun to argue for new techniques for analyzing the competitiveness of local banking markets, arguing that traditional techniques overstate levels of concentration.[1] Since controversy about very large mergers increased following the "megamergers" of 1998, members of the Board of Governors of the Federal Reserve have spoken repeatedly of the advantages of banking consolidation.[2] In fact, only minimal scrutiny of bank mergers occurs in the U.S., despite regulations – such as the Community Reinvestment Act (CRA) -- that call for evaluation of impacts on markets and communities.[3] No bank merger has been blocked due to CRA concerns since 1995, and even that merger was later approved. Of almost 60,000 CRA-covered applications to regulators from 1989 to 1996, only 24 were denied.[4] Even when mergers began resulting in institutions of a size rivaling the largest European banks, little change in the regulatory process occurred. Public hearings were held on the 1998 megamergers only after elected officials from areas being threatened with job losses called for them. In the end these mergers were approved without significant conditions.

In the case of cross-industry mergers and affiliations among banks, securities firms, and insurance companies, regulatory accommodation has occurred somewhat incrementally, with federal banking regulators allowing banks to operate further and further from their traditional core mission of taking deposits and making loans, primarily through affiliates owned by bank holding companies. Full-fledged convergence or integration, which would be facilitated by legislative changes, has been slowed primarily by the different industry players competing to influence the ground rules under which industry combinations would occur, with each industry preferring rules which gives its largest firms a competitive advantage.[5] This intrasectoral infighting has worked to the advantage of those wishing to slow the amalgamation and concentration of financial resources, although no end to such trends seems in sight.

One result of financial sector restructuring has been a concentration of financial power in a much smaller number of firms, without any real safety net or universality provisions to ensure that lower-income communities have access to the same types (and prices) of financial products that more affluent customers are routinely offered. True, the United States does have the CRA and fair lending laws, which in recent years have improved access to home purchase loans in underserved markets.[6] But financial capital has migrated out of the commercial bank sector into affiliated and unaffiliated firms, neither of which are covered by the CRA. The law has been more vigorously applied, but to a smaller segment of overall financial capital. In 1998, bank deposits accounted for 25% of household assets in the U.S., down from 55% in 1975. Similarly, banks and thrifts made just over 40% of mortgage loans in the U.S. in 1996, with relatively unregulated mortgage companies making the remaining portion. In 1977, banks and thrifts accounted for 80% of mortgage activity. Many of these mortgage lenders are in fact owned by bank holding companies (another result of convergence), but this portion of the parents' activity is not subject to CRA. Similarly, many of the deposits that were lost by banks during the 1980s' rise of money market mutual funds are now held by firms that are affiliated with large banks.

Market Segmentation and Exclusion

The convergence across industries, and not merely the consolidation of banks themselves, has fed the concentration of financial resources. Now, as financial service firms concentrate and converge, a third trend is occurring in the provision of financial services: escalating market segmentation. The financial powerhouses, which have begun to rival the largest European banks in size, actually contain a number of discrete business units which serve customer segments differentiated in ways that are highly correlated with class, race and neighborhood. The size of these corporations allows them to invest in and construct highly sophisticated data warehouses which provide them with a wealth of information to segment the market among their various product lines and units. Higher-income customers are targeted by large regional and increasingly national banks for a full range of services, including money management and investment services, low-cost home-equity lines of credit, and other products. Meanwhile, these banks shun lower-income customers by avoiding physical presences in low-income areas and by offering lower-priced services to higher-income customers. Moreover, internet banking, which some analysts expect to capture 10 % of the mortgage market by the year 2000, serves disproportionately affluent borrowers. Large institutions utilize computerization to score and segment the population into profitability sectors. This intensifies competition for the most lucrative customers, those with large cash management and investment needs, and reduces it for lower-income consumers and smaller firms, especially those not owned by affluent individuals.

Until the late 1980s, banking in the U.S. was essentially a local or statewide activity, with restrictions on interstate banking. Some states had maintained what were called unit banking laws, which prohibited even in-state branching. In 1994, with the Riegle-Neal Interstate Banking and Branching Efficiency Act, the last of the major mobility restrictions -- the prohibition on interstate branching of single banking enterprises -- fell. These mobility regulations maintained a banking system in which financial institutions were somewhat dependent on local economic conditions for their own success. As interstate banking restrictions fell, banks were no longer locally dependent and could provide financing throughout the country. This may have improved the competitive environment for borrowers where few local banks existed, but it also meant that banks could search nationally for more lucrative transactions. Thus, interstate mobility increased competition and reduced price for lucrative customers, but may have actually aggravated poorer service in less attractive market segments. Of course, some very large banks had already developed extensive international businesses, which were not subject to interstate restrictions, and so it was natural for them to replicate their capital mobility schemes within the U.S. once permitted to do so.

The continuing push by banks to focus more and more on middle- and higher-income market segments has left lower-income segments with relatively few providers offering a weaker selection of less attractive financial products. The growth of secondary markets in the 1980s provided an instant source of financing for nonbank mortgage companies, which often operate through independent mortgage brokers and do not rely on relatively costly physical branch presences.[7] These brokers tend to segment markets based on race and class, and tend to deliver products tailored to their segment of the market. Higher-income borrowers are courted by brokers offering access to a wide variety of conventional bank and mortgage company financing. Lower-income and especially minority communities are targeted by smaller numbers of brokers and mortgage companies. Many such lenders specialize in loans guaranteed by the Federal Housing Administration (FHA), which provides 100% guarantees that can lead to excessively risky lending. Some of these lenders concentrate their activity in lower-income and, especially, minority communities and experience relatively high foreclosure rates. This, combined with the program's poor performance at putting foreclosed properties back on the market, has contributed to pockets of property abandonment and blight in many lower-income urban neighborhoods.[8]

In addition to the mortgage lenders specializing in FHA loans, a set of providers has emerged in recent years that focus on "subprime" loan products, designed to serve those not meeting conventional "A" credit standards. Subprime lenders may specialize in "B," "C" or some lower grade of loan, signifying higher risk. But market segmentation and the lack of competition in certain markets by prime lenders, especially large banks, allows some subprime firms to exploit less sophisticated loan applicants by offering them products that are priced higher than what they could qualify for from another lender. Frequently loans are "packed" with extraneous fees and charges that are not based on cost and are not subject to well functioning competitive markets.[9] Repeated refinancing of debt and the rolling in of charges into the loans can put homeowners into very heavy debt situations.

Because prime lenders, especially banks, have recently been encouraged by CRA regulation to make home purchase loans to lower-income and minority borrowers, subprime lenders have had less success in the home purchase loan arena. But subprime lenders are often the dominant refinance and home improvement lenders in low-income markets.[10]

While lending units targeting lower-income segments of the market are often clearly differentiated firms from prime-lending depository institutions, the current trend of convergence and concentration has meant that, more and more, parent corporations own institutions serving these different markets. For example, First Union, the sixth largest commercial bank in the U.S. recently purchased The Money Store, one of the largest subprime lenders in the country. Conversely, Conseco, the parent company of GreenTree Financial, a major subprime lender, has recently applied to regulators to open a thrift, or savings bank. Many of the largest subprime lenders in the U.S. are affiliated with a major commercial bank (including Bank America, First Union, and Bank One) through a bank holding company structure. But again, the subprime units tend to be organized as mortgage companies, which are less scrutinized than CRA-regulated banks and thrifts.

In addition to the segmentation of residential credit, low-income communities are also the object of segmentation and exclusion in the market for basic financial services, including deposit accounts. Recent estimates are that one in eight U.S. families do not have a banking account. Low-income consumers tend to rely more heavily than others on storefront check-cashing outlets, which charge relatively high per-transaction fees for cashing checks and other services. Typical monthly costs for using these providers can be more than four times that of using a conventional depository institution. Banks and thrifts have generally avoided seeking out low-income retail account customers. This is evidenced by a decline in branches in low-income areas. Federal Reserve researchers found that, from

1985 to 1995, low- and moderate-income neighborhoods accounted for almost two thirds of the total decline in branches over this period, despite only accounting for only one-fifth of all branches in 1985. Over roughly the same period, the number of check-cashing outlets has tripled according to industry estimates.[11]

Segmentation and Exclusion in Financing Small Enterprises

In the small business arena, the lack of substantial secondary markets has meant that the role of nonbank lenders has been constrained. Banks continue to dominate small business lending, although larger firms have become less reliant on banks through issuing their own corporate debt. Finance companies are significant providers of small business loans, especially for retail firms, and may be increasing their role in specialty niches, but still comprise a significant minority of the market for small business loans. Segmentation, then, has occurred primarily within the banking industry itself. Large banks, until recently, were relatively inactive small business lenders, especially for very small firms needing relatively small loans (especially under $100,000). Smaller banks, especially those with assets of less than $5 billion made the bulk of small business loans. Their reliance on physical branches located in commercial areas, their willingness to invest in relationships with small firms, and their inability to compete with larger banks and mortgage companies on high-volume transaction businesses like mortgages and deposit services (especially automated tellers) all resulted in small banks doing a disproportionate share of small business loans.

In recent years, however, the advent of automated underwriting and data warehouse-based marketing has enabled large banks to penetrate small loan markets. Large banks have utilized computerization to identify likely loan candidates based on databases of firm information, including credit report data. They have also utilized automated underwriting to reduce the average transaction costs of small loans. After adjusting for mergers, small business loans of less than $100,000 at large banks (those with more than $5 billion in assets) grew by 19% from 1996 to 1997, compared to just 9% for all banks.

While the small business loan market had been segmented by loan size, with large banks making the larger loans and smaller banks making smaller loans, the segmentation is now shifting toward risk, geography, and race. Large banks, whose comparative advantage is in high-volume, low-cost automated processes and mass marketing, will increasingly target small firms with impeccable credit, especially those firms owned by individuals with high net worth. Meanwhile, smaller banks are seeing many of their "best" customers flee to lower-cost commoditized credit from the large banks and are left making more traditional, relationship-based loans to firms that exhibit higher average credit risks. This segmentation will work to raise the price of credit for the small firm whose owner lacks high net worth or impeccable credit.

Another manifestation of segmentation of small business lending is geographical. Despite the growth of some mass marketed small business loans, small business lending remains highly correlated with branch location. Banks with branch networks tend to lend to firms quite near their branches. My analysis of Federal Reserve data for small business loans shows that, of the four very large bank holding companies in the Chicago metropolitan area (each with assets of $15 billion or more), only the one with a significant branch presence in lower-income neighborhoods made more than 12% of its small business loans in such areas. (The industry as a whole made 15% of all loans in such neighborhoods). The other three large bank holding companies have built up branch networks in relatively affluent, predominantly suburban areas. Together, less than 10% of their loans are made to firms in lower-income areas. Meanwhile the 5 small banks making the highest percentage (between 32% and 52%) of their loans to lower-income neighborhoods all had substantial branch presences in such areas.[12]

The segmentation of small business loan markets contributes to poor credit access by firms in those market segments not prized by mainstream, larger banks. Lower-income and minority neighborhoods receive fewer small business loans after controlling for the number and types of firms in the area.[13] Moreover, black-owned businesses are rejected for bank loans at two and one-half times the rate as white-owned firms. This differential only drops to 2-to-1 when business characteristics are controlled for.[14] Minority-owned firms are forced to rely more on trade credit or personal resources to initiate and expand their operations.

Segmentation and CDFIs: Opportunities and Threats

The direct avoidance of lower-income market segments by banks can provide market opportunities for socially responsible community development financial institutions (CDFIs). CDFIs include community development banks (like South Shore Bank in Chicago), community development loan funds, community development credit unions, microenterprise loan funds, and community development venture capital funds. These alternative financial institutions utilize private, public and philanthropic capital to develop financial markets in communities that conventional banks and lenders have shunned. While estimates of the total size of the CDFI sector vary, true CDFIs control a very small portion of financial assets in the U.S., certainly only a fraction of a percent. Many are very small and will require a good deal of time and capital to grow to an appreciable scale.

Since CDFIs obtain much of their capital from private-sector financial institutions, particularly through the encouragement of CRA, their ability to expand will ultimately depend on an expansion of CRA requirements for nonbank financial institutions, including mortgage and finance companies, as well as securities and insurance firms.

While segmentation can provide opportunities for CDFIs to serve markets exploited by high-priced providers, it can also threaten their growth. In some cases, subprime lenders can dampen potential markets by leaving behind households whose finances are beyond the aid of a CDFI. When excessive fees and charges are built into financing packages or when loans are repeatedly refinanced with increased costs rolled in, borrowers can find themselves with such high levels of debt that even CDFIs, which generally can take greater risks than banks, cannot provide them with assistance. Thus, CDFIs may find it in their interest for such segmentation to be limited, and for "predatory" practices to be curtailed.

Notes

1 Anthony W. Cyrnak, "Merger Policy and the New CRA Data," Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, September, 1998, 703-715..

2 See, for example, "Remarks by Chairman Alan Greenspan: Changes in Small Business Finance," at the Federal Reserve System Research Conference on Business Access to Capital and Credit, Arlington, VA, March 9, 1999.

3 The federal Community Reinvestment Act, which has been in place since 1977, requires banks and thrifts in the U.S. to serve the credit needs of their communities. Banks are examined every two years for compliance with the law and are given a "CRA rating." A bank's CRA performance is considered when it applies to regulators for permission for a variety of activities, including merging with another depository. The law is implemented through a set of regulations which were significantly modified in 1995 after several years of preparation.

4 These include all CRA-covered applications, not just for mergers and acquisitions. See Ken Thomas, The CRA Handbook, McGraw Hill, 1998.

5 The federal legislation which seeks to reduce barriers between banking and nonbanking financial activities has been called "financial services modernization." Most proposals to reduce barriers between banking and nonbank financial activities would allow for increased shifting of activities and assets from Community Reinvestment Act-regulated banks into unregulated entities. Amendments to expand the CRA to such nonbank affiliates have generally not been successful.

6 Increased enforcement of CRA and fair lending laws began in the early 1990s. From 1992 to 1995, home purchase loans to African-American borrowers in the U.S. increased by more than 125%, with loans to lower-income borrowers growing by 75%. Both of these groups saw lending increase faster than the overall rise of 54%.

7 In the U.S., the growth of large secondary markets, in which loans are purchased and sold after being originated, has increased the liquidity of lenders without direct access to deposits for funding loans. The two dominant players in mortgage secondary markets in the U.S. are the government-sponsored enterprises, Fannie Mae and Freddie Mac.

8 Calvin Bradford, *The Two Faces of FHA*, Chicago Fair Housing Alliance, 1998.

9 Norma Paz Garcia, *The Hard Sell: Combating*

Home Equity Lending Fraud in California, Consumers Union, San Francisco, CA, 1998. Also see U.S. Senate Special Committee on Aging Hearings: "Equity Predators: Stripping, Flipping, and Packing Their Way to Profits," March 16, 1998.

10 Randall Scheesele, "1997 HMDA Highlights," U.S. Department of Housing and Urban Development, November 1998. This analysis shows that subprime lending for refinancing in the U.S. grew from 45,000 transactions in 1993 to 461,000 in 1997, and increase of over 930%, while conventional refinancings declined by 52% over the same period. Subprime lenders accounted for at least 30 % of refinances of low-income homes but only 9 % of high-income ones. Researchers at the Kansas City Star found that fifteen of the top 20 lenders in Kansas City's minority neighborhoods are subprime lenders. See Ted Sickinger, "Paying the Price for a Loan," *Kansas City Star*, March 1, 1999.

11 The branch analysis is in Robert Avery, Raphael Bostic, Paul Calem, and Glenn Canner, "Changes in the Distribution of Banking Offices," *Federal Reserve Bulletin*, September, 1997. The check cashing outlet estimate is from Richard Oppel, Jr., "The Stepchildren of Banking: Efforts to Serve Low-Income Areas Appear to Sputter," *New York Times*, March 26, 1999.

12 Daniel Immergluck and Erin Mullen, *Getting Down to Business: Assessing Chicago Banks' Small Business Lending in Lower-Income Neighborhoods*, Woodstock Institute, 1998.

13 Daniel Immergluck "Intrametropolitan Patterns of Small Business Lending: What Do the New CRA Data Reveal?" *Urban Affairs Review*, July, 1999. Also see Gregory Squires and Sally O'Connor , "Access to Capital: Milwaukee's Small Business Lending Gaps," presented at the Federal Reserve System Access to Business Capital and Credit Conference, May 9, 1999.

14 David Blanchflower, Phillip Levine, and David Zimmerman, "Discrimination in the Small Business Credit Market," National Bureau of Economic Research, November 1998.