

**To:** University of Michigan: Center on Finance, Law & Policy

**From:** Matthew J. Razzano

**Date:** October 20, 2020

**Re:** Central Bank of the Future 2020 (Policy Proposal Submission)  
The Fed and Community Development

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## POLICY MEMORANDUM

Widely seen as a purely macro-focused institution, the Federal Reserve (Fed) has historically played a small role in community development. But it should expand this once passive remit to proactively foster growth in cities and neighborhoods. The Community Reinvestment Act (CRA) specifically mandated that the Fed regulate member financial institutions to ensure fairness in local lending practices. Rather than continuing to exercise only oversight powers, however, the Fed should promote financial inclusion and directly stimulate low-income communities through targeted bond buying.<sup>1</sup>

### I. Background

The CRA was passed in 1977 because for years, banks issued loans in a discriminatory fashion, with poor and minority communities receiving unfair rates or no loans at all.<sup>2</sup> The purpose of the CRA was to extend credit in low-income communities and establish an oversight framework to promote fair banking practices.<sup>3</sup> The Fed was tasked with regulating CRA compliance of its member banks. In addition, it shared metrics and research with these banks to promote further development. As a result, the Fed held a passive oversight role in regulating community development,<sup>4</sup> but it was never directly involved.

When the Fed engages in bond buying, the Federal Reserve Act and subsequent amendments limit which securities it can purchase. Federal Reserve banks may buy “in the open market, under the direction and regulations of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.”<sup>5</sup> The banks can also purchase bonds “having maturities from date of purchase of not exceeding six months, . . . issued in anticipation of the collection of taxes or in anticipation of the receipt of

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<sup>1</sup> The Fed introduced a corporate bond buying program to support the economy at the outset of the COVID-19 pandemic. *See Policy Tools: Secondary Market Corporate Credit Facility*, FED. RES., <https://www.federalreserve.gov/monetarypolicy/smccf.htm> (Oct. 15, 2020).

<sup>2</sup> *See* Community Reinvestment Act, Pub. L. 95-128, 91 Stat. 1111 (1977).

<sup>3</sup> *See id.* § 803.

<sup>4</sup> *See Community Development at the Federal Reserve*, FED. RES. BANK OF ATL., <https://www.frbatlanta.org/community-development/about-us/federal-reserve-community-development.aspx> (last visited Mar. 5, 2020).

<sup>5</sup> 12 U.S.C. § 355(2).

assured revenues by any State, county, district, political subdivision, or municipality in the continental United States.”<sup>6</sup> Yet at the start of the COVID-19 pandemic, the Fed expanded these actions to include corporate bonds and other credit facilities to promote market liquidity, .<sup>7</sup>

Other central banks, however, may purchase a broader array of securities through their open market operations. For instance, the European Central Bank (ECB) and the Bank of England are considering a program of green quantitative easing.<sup>8</sup> This involves buying government-backed green bonds, as well as climate-based corporate securities.<sup>9</sup> The ECB has also started its own corporate bond-buying program.<sup>10</sup> The Fed’s authority to replicate these initiatives on an ongoing basis is still somewhat unclear, but purchasing more diverse securities would grant the Fed greater flexibility to address discrete economic problems.

Given all this, the Fed should consider expanding the types of securities it can purchase and engage in community development bond buying, allowing the central bank to inject capital directly into low- and middle-income communities.

## II. Analysis

Quantitative easing involves large purchases of government obligations and other securities to generate liquidity during times of economic difficulty.<sup>11</sup> This process became widespread after the 2008 Financial Crisis. The result is an increase in household deposits, which translates into more consumer spending.<sup>12</sup> At the outset of the COVID-19 pandemic, the Fed created the municipal liquidity facility to promote liquidity in cities and states.<sup>13</sup> While this program expanded the Fed’s municipal bond buying, it sought to promote general stability, rather than targeted community development efforts. Given this expansion of scope, the Fed could buy local or municipal bonds with a community reinvestment focus, allowing it to directly inject capital into low- and middle-income neighborhoods. Each of the regional banks already assess and collect data for community development purposes under the CRA; this program would merely leverage that data for an ulterior and more direct purpose.<sup>14</sup>

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<sup>6</sup> 12 U.S.C. § 355(1).

<sup>7</sup> See *Secondary Market Corporate Credit Facility*, *supra* note 1.

<sup>8</sup> Tommy Stubbington & Martin Arnold, *Pushback and Practicalities Limit Hopes for ‘Green QE’ from ECB*, FIN. TIMES (Nov. 4, 2019), <https://www.ft.com/content/d3f52ba6-fef2-11e9-b7bc-f3fa4e77dd47>.

<sup>9</sup> See Yannis Dafermos et al., *Climate Change, Financial Stability and Monetary Policy* (BOE Working Paper, Oct. 2016).

<sup>10</sup> *Corporate Sector Purchase Program—Questions & Answers*, EURO. CENTRAL BANK, <https://www.ecb.europa.eu/mopo/implement/omt/html/cspp-qa.en.html> (last visited Mar. 9, 2020).

<sup>11</sup> See Alan S. Blinder, *Quantitative Easing: Entrance and Exit Strategies* (CEPS Working Paper No. 204, Mar. 2010).

<sup>12</sup> Wei Cui & Vincent Sterk, *The Powers and Pitfalls of Quantitative Easing*, CEPR POLICY PORTAL (Jan. 9, 2019), <https://voxeu.org/article/powers-and-pitfalls-quantitative-easing>.

<sup>13</sup> *Policy Tools: Municipal Liquidity Facility*, FED. RES., <https://www.federalreserve.gov/monetarypolicy/muni.htm> (last visited Oct. 15, 2020).

<sup>14</sup> See, e.g., *Community Development: Data and Measurement*, Fed. Res. Bank of S.F., <https://www.frbsf.org/community-development/initiatives/data-measurement/> (last visited Mar. 10, 2020); *Special*

This is uncharted territory for the Fed, but banks and other institutions have implemented similar programs on a smaller scale. For instance, community development banks were designed as front-line institutions to serve underbanked populations, offering loans and financing options for direct community investment.<sup>15</sup> Additionally, some financial institutions created departments to address similar goals—funding more extensive, long-term community development projects. The impact investment group at Goldman Sachs for instance has financed \$7 billion of investment in cities across the country—from affordable housing in New York, to Detroit’s riverfront project.<sup>16</sup>

Unlike these institutions, the Fed’s resources and flexibility could address larger, longer-term community development needs that might not yield a quick return on investment. For instance, community development banks focus on smaller loans, typically aimed at funding local businesses.<sup>17</sup> And while Goldman Sachs targets larger housing and commercial revitalization projects, its efforts are scattered and unsystematic. As such, the Fed should aim to purchase bonds for projects beyond what these institutions support. Specifically, the Fed should target affordable housing, commercial space for local businesses, education infrastructure, and green investment.<sup>18</sup>

- **Affordable Housing:** The Fed should look at purchasing bonds issued to finance affordable housing projects both in major cities rural communities. During the financial crisis the Fed started purchasing mortgage bonds through Fannie Mae and Freddie Mac to support the economy, and it still maintains a substantial portion of these securities on its balance sheet.<sup>19</sup> The Fed should focus, for purposes of this proposal, on housing construction specifically, and not necessarily on purchasing more mortgage bonds.
- **Commercial Development:** The Fed should look for financing opportunities to redevelop urban space for commercial use. This goal would need to align with any housing program, to ensure that the community itself is supportive and that any new retail space is sustainable.

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*Reports*, Fed. Res. Bank of Phila., <https://www.philadelphiafed.org/community-development/publications/special-reports> (last visited Mar. 10, 2020).

<sup>15</sup> See *Community Development Financial Institution (CDFI) and Community Development (CD) Bank Resource Directory*, OFF. OF COMPTROLLER OF CURRENCY, <https://www.occ.gov/topics/consumers-and-communities/community-affairs/resource-directories/cdfi-and-cd-bank/index-cdfi-and-cd-bank-resource-directory.html> (last viewed Mar. 6, 2020).

<sup>16</sup> See *Impact Investing*, GOLDMAN SACHS, <https://www.goldmansachs.com/what-we-do/investing-and-lending/impact-investing/> (last viewed Mar. 8, 2020).

<sup>17</sup> Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects* (Fed. Res. Working Paper), [https://www.federalreserve.gov/communityaffairs/national/CA\\_Conf\\_SusCommDev/pdf/zeilenbachsean.pdf](https://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/zeilenbachsean.pdf) (showing that the average loan for CDFIs is between \$10,000 and \$1 million).

<sup>18</sup> Cf. ST. LOUIS FED. RES., COMING UP WITH THE MONEY: FIVE PRINCIPLES FOR LAUNCHING A SUCCESSFUL COMMUNITY DEVELOPMENT INITIATIVE.

<sup>19</sup> See Joy Wiltermuth, *The Fed is Buying Billions Mortgage Bonds—Here’s Why it Matters*, MarketWatch (Nov. 18, 2019), <https://www.marketwatch.com/story/here-are-5-things-to-know-about-the-surge-in-fed-mortgage-bond-buying-2019-11-16>.

- **Education Infrastructure:** Most education funding for yearly operational expenses is supplied through property taxes. Poorer communities have lower property values and typically collect less tax revenue. In addition, most education bonds have long-term maturities. The Fed should purchase education bonds specifically to support a new wave of education building in low-income communities.
- **Green Investment:** Often, environmentally-conscious investment is the privilege of wealthier communities and companies. The Fed should ensure that the securities it purchases are climate friendly, so that the development it stimulates is sustainable.

Local communities issue state-based and municipal bonds for similar projects on a regular basis, but these tend to have maturities of greater than six (Federal Reserve Act limitation) or thirty-six months (Municipal Lending Facility limitation), limiting Fed involvement. This policy advocates for direct investment in the communities through the purchase of local bonds, in a manner far wider than what private institutions and community development banks pursue.

### III. Problems

Community development bond buying could pose several challenges. First, Fed bond buying has proven controversial both during the financial crisis and the COVID-19 recession. Here, the Fed would no longer have a passive role in community development. Claims of political bias could challenge the Fed's long-standing independence allowing it to play the role of honest broker in economic policymaking. Structurally, Fed governors receive fourteen-year terms to insulate them from the day-to-day political intrigue. Directly investing in certain communities and extending bond buying indefinitely risk added politicization. That said, other central banks leverage these tools to tackle controversial policy issues, and most people view government institutions through a political lens regardless of structure (e.g. the judiciary). Therefore, the Fed ought not let fear of politicization stop it from engaging in larger-scale community development efforts.

Linked to political bias, choosing which projects to support and invest in raise questions about geographic or constituent favoritism. The Fed would need a more systematic process to determine which development-based securities to purchase. Again, each of the regional banks have community development offices to support CRA efforts, and the data collected could be leveraged to determine which projects to support. That said, internal regulations that describe the size and aim of purchases should be written to ensure consistency, and community development offices would require expansion to accommodate this new mandate.

A final concern is timing because historically such drastic bond buying or bond buying have only occurred during periods of economic instability, not necessarily on an ongoing basis. Since the financial crisis, several rounds of bond buying in the United States and elsewhere resulted in a normalization of the program, and it is now, whether problematically or not, viewed as an enduring tool instead of a last resort.<sup>20</sup> Community development bond buying could be a policy specifically for economic downturns, but it would preferably be used to promote ongoing local investment, which might draw political backlash. Nevertheless, this program would not reach the trillions of

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<sup>20</sup> George Selgin, *The Fed's Dangerous 'New Normal'*, POLITICO (May 29, 2019), <https://www.politico.com/agenda/story/2019/05/29/the-feds-dangerous-new-normal-000902>.

dollars' worth of securities purchased after the financial crisis. That stimulus technique could be limited to periods of financial crisis, while smaller-scale community development efforts could continue on an ongoing basis, hopefully without stirring up the same level of criticism.

#### **IV. Implementation**

The Federal Reserve Act limits which securities the Fed may purchase: (a) federal government debt or (b) local bonds with shorter maturities.<sup>21</sup> To implement community development bond buying, the central bank could take two routes.

- **Federal Community Development Bonds:** The Fed could work with Treasury to issue a new type of community-based debt security. This would be an obligation of the federal government, but it would also implicate principles of federalism whereby the United States issues debt to local communities and projects. Therefore, it is not the ideal path.
- **Federal Reserve Act Amendments:** The Fed could call for legislative action to amend the Federal Reserve Act and expand the breadth of securities that the central bank could purchase in an ongoing basis. It could extend the maturity beyond the six-month timeframe for local and municipal securities, or it could create exceptions for purchases of community development bonds related to this specific program. This would be the preferred route, expressing a clear mandate for the policy.

To avoid the political problems associated with bond buying and favoritism, the Fed ought to consider a pilot program or small-scale investment at the outset. Such a policy could spark controversy, but community development departments already exist in each of the Fed's branches. This program merely turns the current passive approach into a more proactive agenda. To ease concerns about this shift in Fed direction, the central bank could begin by choosing one target city to test these policies or limiting its purchases to only certain investments (e.g. housing programs). If over time community development bond buying became popular and the investments normalized, then the Fed could expand to other cities and purchases.

In sum, the Fed has engaged in bond buying since the financial crisis. Other central banks are using this tool creatively to target important issues like climate change, so the Fed should do the same and use its authority to proactively support and invest in low- and middle-income communities.

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<sup>21</sup> See 12 U.S.C. § 355.