The Institute of Brazilian Business and Public Management Issues
Minerva Cultural Institute
Minerva Program XIV – Fall 2001

The regulation of the financial system as an instrument for the promotion of economic and social efficiency

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Washington, DC, December 2001.

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1 Introduction

The financial system as a whole can be considered the main instrument that provides for the creation and circulation of money and wealth. By being the intermediary between resources and funds, it is able to promote business, wealth and development.

While the financial system promotes wealth and improvement, it can be used for the improvement of social problems such as illegal and criminal activities like terrorism, drugs, laundering, corruption, tax evasion, etc.

This is one of the main reasons why the financial institutions, especially banks, are so heavily regulated.

Considering the main role played by the financial institutions as intermediaries between resources and funds, the question becomes whether they have any duty of care or duty of loyalty or any social duty to society. Related to the former question is whether financial institutions have any social duty to meet the community's needs.

This paper concludes that the financial institutions do have duties of care, duties of loyalty and other social duties.

This paper also suggests that besides the regulation that provides for the achievement of economic efficiency by the financial system, there must be some other regulation that provides for the achievement of social efficiency, and that there must also be some sort of new regulation that provides for stopping or closing the doors of the payment system for illegal and criminal activities.

The objective of this paper is to analyze some particular aspects of the way in which the American law and the Brazilian law deal with these issues, to compare both systems of law in order to identify convergences and divergences, advantages and disadvantages of each one, and to eventually suggest possible improvements in the law.

2 – Definition of the issue

Because this topic covers such a vast area, this paper's subject of study shall be limited to a narrow focus in order to make it accessible.

Social efficiency, as intended here, is related to the success of the financial institutions in meeting the needs of the society: such institutions must be able to provide credit and financial products and services of good quality at low prices not only to big businesses and rich people but also to low income people, minorities and small businesses.

The problem is that poor people and small businesses generally do not have collateral to give and also present a higher risk of default. Because of this higher risk, financial institutions generally want to lend money to rich people and to big businesses but do not want to lend to poor people and small businesses.

In addition, there is another problem: the requirement of increased levels of capital adequacy for higher risk operation means higher costs in loans for poor people and small businesses.

According to the economic theory of the firm, management pursues profits. So management wants to maximize income, minimize costs, and avoid risks.

Obviously there is a conflict of interest between the financial institutions' purposes and the needs of the society. There is also a tradeoff in terms of economic policy, for it is well-known that governments want sound and safe financial institutions, but at the same time want those financial institutions to meet the needs of the society, which means accepting higher risks by providing loans to poor people and small businesses. Thus, considering that in the financial sector safety and economic efficiency are directly correlated, there is a tradeoff between social and economic efficiency,

Is this a market failure ? What is the best way to deal with this tradeoff ?

This paper will analyze and compare the way the American law and the Brazilian law deal with the tradeoff between social efficiency and economic efficiency in the financial sector.

In order to reach a conclusion, the paper will focus on specific legislation: the Community Reinvestment Act in the United States and the Federal Law number 10194 enacted on February 14, 2001 in Brazil .

3 - Theoretical Framework

Our methodological and theoretical framework shall be the one proposed by the economic analysis of comparative law. According to Mattei (1995), in this approach, theoretical tools of economic analysis are enriched by the tools offered by comparative law.[1]

In the inquiry of the convergences and divergences between the Brazilian and American models of regulation, this paper will employ the techniques established for comparative law and the comparative analysis of both normative texts.

This research adopts the methodology of the economic approach to law as initially presented by Richard Posner (1973) and Gary Becker (1976) and further developed by Robert Cooter (2000).

It is relevant to stress that according to Becker (1976), the usefulness of economics is not restricted to markets but rather any aspect of human behavior that arises from the deliberate pursuit of ends is amenable to economic methods.

As pointed out by Katz (1998:1), Becker was awarded the Nobel Prize in Economics in 1992 for his work extending the domain of economic analysis to a wide range of human behavior and interactions that had been traditionally considered outside the boundaries of the discipline.

Thus, the theory of rational choice according to which individuals are constantly engaged in the attempt to maximize their utility and business organizations engaged in the pursuit of profit maximization is adopted here, notwithstanding the fact that many critics argue that the unrealistic assumptions of utility and profit maximization that this theory assumes make them an unreliable foundation.

It does not matter if the assumptions are unrealistic. Models should not be judged by the realism of their assumptions, because whether a model is good or not depends on the accuracy of its predictions. Thus, a model that predicts well is useful to plan for the future and to govern the material world toward our desired ends, as Friedman used to say.

4 - Regulation

The main reason to regulate the financial sector is undoubtedly to enhance soundness and safety of the system. Other reasons could be mentioned such as the promotion of economic efficiency, competition and public (consumer and investor) protection.

[1] According to Mattei (1995:1), "In using the tools of law and economics together with those of comparative law,

As generally referred to in the literature, these are the main reasons behind regulation. But it is relevant to add another reason for regulation: the achievement of social efficiency. According to the hypothesis assumed in this paper, financial institutions do have a social duty to meet the needs of the communities, giving access to credit and to the payment system to all sectors of society.

But the problem then is how to achieve this goal. What kind of regulation could be used to encourage the financial market to comply with this social goal ?

To figure out what kind of regulation can be managed to improve soundness and economic efficiency in the financial sector is much easier than to figure out the one that can fit for promoting social efficiency.

In fact, to promote soundness and safety in the financial markets, there is a consensus among the developed countries in adopting the core principles enacted by the Basel Committee on Banking Supervision. In the same way, to improve efficiency in the financial markets, nearly everybody is in agreement about the usefulness of antitrust laws and competition defense laws. There is also some consensus about the usefulness of laws providing for consumer and investor protection.

However, for the promotion of social efficiency the situation is completely different - there is no agreement at all about this issue.

As a matter of fact, the adoption of the Community Reinvestment Act (CRA), the most important legislation addressed to the goal of improving social efficiency, was, and still is, very controversial in the United States.

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the notion of efficiency assumes itself a comparative meaning."

5- Market failure

The financial markets on their own will not give low income people and small businesses any access to credit. And, by not doing so, the financial institutions keep the doors for improvement, wealth and development closed for this segment of the population. And they also preserve, or maybe increase, the unfair income distribution that exist within society.

Is this market failure?

If the answer is yes, what can be done to deal with this market failure?

One could say that the best thing to do is nothing at all because any kind of government intervention will present costs higher than benefits. In other words, the costs of government intervention can be bigger then the costs of market failure.

Without a doubt, this can be an answer for our question, but is a very uncertain solution.

When the financial institutions decide who will and who will not receive credit, they exercise tremendous power upon the lives of individuals. They have the power to say who will and who will not have the chance to improve. This is a very serious issue that cannot be neglected by governments.

Low-income people and small businesses with no access to credit and to the financial system will be isolated, which means they will be excluded from the growth opportunity provided by the market. If the number of the people in this situation tends to increase, and this is the most probable possibility, the society will be threatened by the disintegration of its members: the bigger the number of outsiders the more disintegrated the society will become.

Governments certainly will not stand passively watching this situation unfold. Moreover, this is an issue that goes beyond this single economic implication. It is a matter of liberty and democracy. People who have no access at all to credit and to the financial system will have no access either to minimum level of property or wealth. Consequently, they will have no access to liberty or to democracy as well. Thus, a society in which poor people and small entrepreneurs have no access to credit and to the financial system cannot be considered democratic and there will be no liberty either. Democracy and liberty can only subsist if all the people have at least the chance to improve; without the opportunity to have access to credit, they will not have even the chance to participate.

Thus, if the financial markets on their own are not going to supply credit to everybody who must have at least the chance to get it, governments must do something to compensate for this failure.

There are different forms of intervention that can be adopted to manage this failure. For example, the government can allocate money from the budget to create a fund to make loans directly to the people that have no access to the financial market, leaving the financial institutions otherwise absolutely free to run their own business (the model adopted in Brazil is a variation of this). Another possibility could be to create a public fund, not to make the loans directly, but to provide guarantees on the loans made by the financial institutions to poor people and small businesses. The guarantee would be triggered in the case of a default. It would be a type of loan insurance. The government could, with this mechanism, encourage the private banks to expand the supply of credit to the people who otherwise would not have access to it. And a third possibility could be to create legislation to encourage the financial institutions to make loans to poor people and small business even if there is no guarantee and the risk of default is prominent (the model adopted in the United States with the CRA works in this way).

Which one of these actions is the best ? They all have costs and benefits. The question is to find out which one can achieve the best benefits with the lowest costs?

But this is not an experiment that can be tested in laboratories. The best that can be done in this case, therefore, is to analyze and compare the experiences of Brazil and the United States in addressing these issues in the past few decades.

6 – American Law

Notwithstanding the difficulties in figuring out some kind of regulation capable of managing with the tradeoff between economic and social efficiency, the American Congress has approved some important legislation in order to achieve the goal of improving social efficiency.

6.1 – Community Reinvestment Act

In order to achieve social efficiency, as defined in this paper, the most important statute enacted by the United States Congress is the Community Reinvestment Act (CRA).", 12 U.S.C. &&2901-2906.

The CRA was enacted in 1977 to ensure that the supply of credit is not cut off to particular communities because of their level of economic development, especially poor people and small businesses in low-income areas. In order to achieve these goals, the statute requires "appropriate Federal financial supervisory agencies," in connection with their examination of financial institutions, to "assess the institutions record of meeting the credit needs of its entire community, including low- and moderate- income neighborhoods, consistent with the safe and sound operation of such institution".(12 U.S.C. &2903). The agencies are required to "take such record into account in evaluation of an application for a deposit facility by such institution." (12 U.S.C. &2903).

The mentioned tradeoff between economic and social efficiency and the necessity to cope with it is specifically addressed in the Community Reinvestment Act when it says at section 2901 (3)(b) that the financial institutions should be encouraged to "meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions".

In the words of the law, it is clear that some way must be found to conciliate the credit needs of the local communities, which includes the needs of poor people and small businesses, with the safe and sound operation of the financial institutions.

The question is how to go about achieving this objective.

Is there a general formula to achieve this equilibrium or must there be a case by case assessment, or maybe some local policies designed for each specific community?

As matter of fact, from the beginning, the period between 1977 until 1989, the statute did very poorly. As stressed by Macey and Miller, for many years after its adoption in 1977, the CRA was little more than a vague statement of principle without much real-world effect. (1993:204)

Things started to change in 1989 when Congress greatly enhanced the enforcement of the CRA. However, the issue of evaluating the compliance of financial institutions with the aims of the statute was still a problem.

To face this problem, new regulations were adopted in 1995, establishing a complex methodology to guide the federal banking agency in deciding whether a financial institution has compiled a sufficient record of serving the needs of the community, specially the needs of low- and moderate – income residents. This complex methodology for assigning ratings sets basic rules applicable to most banks utilizing lending, investment, and service tests. In addition to this basic methodology, the regulations allow a depository institution the option of proposing its own strategy for meeting its CRA obligations.

According to Macey and Miller, CRA enforcement can only take the form of actions on applications for depository facilities; the agencies cannot initiate enforcement actions against recalcitrant depository institutions. (2001:191)

In the same sense, Marcus remarks that the CRA was meant to prod banks in to increasing lending in low-and moderate-income areas, but was not expected either to combat discrimination like the Fair Housing Act (FHA)[2] and the Equal Credit Opportunity Act (ECOA)[3] or to require banks to make particular kinds of loans to people in specified areas. Likewise, the CRA was not meant to force banks to lend without regard to the risk and return factors that normally govern any business venture. The CRA does not stipulate that such conduct is unlawful in the same manner that a discrimination is seen as violation of the FHA or the ECOA. Unlike the fair lending laws (FHA or the ECOA), which look for specific discriminatory practices, the CRA examines geographic patterns in the banking and credit markets. (Marcus: 1996, 3-4)

Notwithstanding, in a separate effort to combat the type of community disinvestment that was expected to be addressed by the CRA, the Department of Justice has attempted to assert enforcement authority over banks in this area by expanding the reach of the fair lending laws. Specifically, it has alleged violation of the FHA and the ECOA, relying upon the fact that the disinvestment also has a disparate impact on minorities due to their disproportionate representation in low- and moderate-income communities.

6.2 – Economic Analysis

The most common style of economic analysis of law evaluates changes in the legal system from the standpoint of the status quo.

[2] 42 USC ss 3601-3619 (1988 & Supp. V 1993)
[3] 15 USC ss 1691-1691f (1994).

In this case, we should ask whether changes in the CRA increase or diminish the law's efficiency.

As stressed by Cooter:

> [e]fficiency might refer to the Pareto standard – whether a change in law can make someone better-off without making anyone worse-off. Alternatively, 'efficiency' might refer to the cost-benefit standard – whether the winners from a change in law gain more wealth than the losers lose. Or 'efficiency' might refer to a welfare standard – whether the winners from a change in law gain more welfare than the losers lose. (2000: 265)

Macey and Miller have written a comprehensive critique of the CRA in which they conclude that it does more harm than good. They deem the ideology of the CRA as outdated for it is grounded in an ideology of localism in banking that traces back at least to the Progressive Movement of the early decades of the twentieth century. The underlying propositions are these: 1) banking is a local industry; 2) banks drain credit out of local communities; and 3) banks owe special duties to their local communities. (1993: 209)

In respect to the first proposition that banking is a local industry, they argue that, in recent years, banking has become far less local in scope. As stressed by these authors:

> The evolution of the American banking system from one composed of localized unit banks to one characterized by geographically dispersed, larger institutions has taken place on a number of fronts.... Improvements in information processing and communication technology have facilitated bank expansion by other means as well.... These changes suggest that

> banking today is much less of a local industry than it was in the past.... Thus, the principle that banking is essentially a local industry is no longer generally valid as an empirical matter, nor can the proposition that banks should be local, even if they are not, be defended on persuasive normative terms. (Macey and Miller, 1993,211).

In relation to the second proposition that banks drain credit out of local communities, they consider that:

> [P]roponents of community reinvestment have never satisfactorily explained why the mere fact that funds are obtained from a particularly locality ipso facto implies that these funds should be returned to the same locality. We would never insist that corn grown in Iowa farm country be returned to Iowa farms. The corn is shipped from the farms, where it is in surplus, to other areas where there is a deficit. It is not clear why credit should be different. Like corn or any other commodity, credit is allocated through a price system that directs the good to the user who values it the most. In the case of credit, the price is the terms that the banker can obtain on loans; and if the banker can earn better terms outside the local community than within, it is difficult to see why the laws should deter the transfer of the credit to the higher valued user." (Macey and Miller: 1993, 212).

With respect to the third proposition that banks owe special duties to their local communities, they object that the current banking environment has changed completely with depository institutions now "facing intense and growing competition from other types of firms for the transactions business of wholesale and retail customers...." and conclude that ".... the ideology of community reinvestment on which the CRA was premised was questionable at the time the statute was enacted and bears little resemblance to contemporary marketplace realities. Although the CRA might be justified on other grounds, it can no longer be supported by its original ideological foundations." (Macey and Miller: 1993, 214)

The economic analysis of Macey and Miller is absolutely correct specially when it claims that the CRA interferes with the pricing system and consequently affects the most efficient allocation of resources in the financial sector.

Notwithstanding, Macey and Miller acknowledge the value in the goals pursued by this legislation. In fact, they say from the beginning that they applaud the basic goals of the CRA. (1993:24)

The question becomes then how to improve or make the CRA regulation more efficient under both economic and social standing points. What kind of legislative reform could be suggested ?

7 – Markets work

From all of the alternatives to the CRA, the system of "tradable CRA obligations"[4] presented by Klausner (1995) seems to be the best. He proposes a system of "tradable CRA obligations" analogous to the emission trading programs currently being implemented in the area of environmental regulation.

According to Klausner:

> The proposal has two basic elements. First, all banks would be assigned an annual quota of CRA-qualified loans. Second, banks would be given several options regarding how to meet this quota, including the option of transferring it, or a portion of it, to another lender...

[4] Klausner remarks that his proposal would probably not be authorized by the CRA; it would require new legislation. Notwithstanding he uses the acronym "CRA" because of its familiarity.

> The CRA quota, or obligation, would be defined objectively and quantitatively. For instance, the annual volume of a bank's obligation could be a specified percentage of its assets or deposits...
>
> Under this proposal, a bank would have several options by which it could discharge its CRA obligation. The most straightforward option for a bank would be to originate and hold the requisite volume of loans. A second option would be to transfer the CRA obligation, or a portion of it, to another lender for an agreed-upon price. This is the key element of the proposal.... [for] a bank would have several options short of transferring its obligations. It could originate loans and sell them to third parties; it could originate no loans and instead buy loans from other lenders (in the form of whole loans, participations, or securitized loans); or it could lend through a consortium." (Klausner: 1995, 9-10).

The main problem of the current CRA regulation is that it conflicts with market mechanisms. To manage a market failure, it pushes the market to work in the opposite direction, interfering with the ordinary function of the pricing system as pointed out by Macey and Miller (1993).

Instead, the advantage of the Klausner proposal is that, to deal with the market failure, it tries to identify to help or stimulate the market to work better in the sense of achieving highest social efficiency. His proposal employ the market mechanisms and supported by them tries to manage with the failure. In sum, with the legislative intervention suggested by Klausner (1995), the financial markets are expected to work with more social efficiency than they are doing with the CRA.

Thus, Klausner (1995) is correct when he points out that his proposal is better suited than the CRA to responding to the market imperfections existing in the financial system.

Specially in respect to information costs and externalities, the system of "tradable CRA obligations" is better suited for promoting information efficiencies and the internalization of externalities. In fact, it is reasonable to believe that, in contrast to the current CRA, the system of tradable obligations would promote more specialization because banks and other lenders would have more incentives to develop expertise in lending in low-income neighborhoods because the most successful in developing that expertise could sell their services to other banks. Through competition, the most efficient lenders would emerge to serve low-income targeted neighborhoods.

The system of tradable obligation would also be better suited to promote the internalization of positive information and neighborhood externalities. As explained by Klausner:

> By accepting other banks' obligations and by originating loans that other banks will ultimately hold, a single bank operating under this system could originate a high volume of loans throughout a low-income neighborhood. Because of its large market share in a neighborhood, such a bank could expect to reap significant portions of the positive information and neighborhood externalities that its lending produces. The ability to reap information externalities would directly reduce its cost of lending. The ability to reap neighborhood externalities would lead a bank to target loans... in a manner that limits the impact of negative neighborhood externalities and that enhances synergies in positive neighborhood externalities. .. In addition, with a smaller number of banks involved in a neighborhood, banks could coordinate with one another to accomplish these results. By internalizing neighborhood externalities banks would produce more value per dollar lent than if they engaged in untargeted and uncoordinated lending. As a result, they would be able to make more loans per dollar of regulatory tax than they can under the CRA. (Klausner: 1995,13).

8 – Beyond the CRA

The market-oriented proposal presented by Klausner (1995), as was mentioned earlier, is the best alternative to the CRA, but it is not enough to resolve the problem of the low-income communities, especially the poorest ones.

These communities will continue with no access to credit, no matter how perfect markets work because this is not a problem of market failure. It is a problem of income distribution. Credit is a tradable good and, because of its huge demand, it is a very expensive one. Therefore, the low-income people and small businesses have no purchase power to buy it.

Thus, the problem of inaccessibility to credit that hurts the low-income communities is not just a problem of reinvestment. It is a problem of income distribution that will not be resolved by markets.

Markets can provide for economic efficiency and perhaps for social efficiency as defined in this paper, but they cannot provide for problems of income distribution. Markets work in the sense that they tend to promote competition and efficiency. But at the same time, they tend to promote income concentration. This is due to fact that they award the best (most skillful, quick intelligence and good judgment as required for business), which are a minority, at the expense of others, the less-gifted, which are the majority.

As a matter of fact, the income distribution data from World Bank reports show that there was tremendous income concentration in the United States in the last two decades. In 1980, the percentage share of the poorest 20% of the population received 5.3% of the total household income in the United States while the richest 20% had 39.9% of the total income and the richest 10% had 23.3% of the total income. In 1997, the lowest 20% received 5.2%, the highest 20% had 46.4% and the highest 10% had 30.5% of the total income.

It is possible to say that, in these last decades, inequality has greatly increased in the United States. It is also possible to say that, if the CRA was not enough to change this situation it could be much worse without the CRA. This data supports the claim that the CRA is not enough. As was said before, no matter how perfect a program such as the CRA works, it will not be enough. There must be something else. It is necessary to go beyond these types of programs.

The tradable obligation system proposed by Klausner (1995), like the CRA, is essentially a regulatory tax on the financial institutions. Therefore, it imposes costs on them and, beyond a certain level, a quota (tax) would not produce efficiency gains.

A second troubling aspect of this kind of legislative intervention (CRA or any possible alternative) is the fact that it forces the shareholders of the financial institutions to bear the costs of intervention.

Thus, if a more comprehensive program is needed to manage the problem of low-income people, consideration might be devoted to spreading the costs more widely, perhaps all the way to the taxpayer, by providing financial institutions with compensating tax benefits or other transfers.

9 - A more effective program

The creation of a fund to provide guarantees on the loans made to low-income people, could perhaps be a good policy to the problem of non-access to credit.

The federal government and state governments could provide for the creation of public funds that would function as a guarantee on the loans made to low-income people and businesses. According to this program, states and federal governments, in a coordinated effort, would identify the communities in which this problem of no access to credit is most prevalent. Then governments would offer the financial institutions a public guarantee for the loans made in these areas. Therefore, in case of a default, the public fund would be triggered to payback the financial institutions.

At this point, it should be stressed that this would be a market-oriented program in the sense that it utilizes the market forces to achieve its goals.

With the public guarantee, the loans made to low-income areas would be zero-risk for the financial institutions, actually, better than a AAA rating. Therefore, it would represent a profitable loan with zero-risk for the financial institutions, which certainly translates into a good deal. At the same time, it would also be a very useful benefit to these low-income areas, which otherwise would have no access to credit. And it would also be a good policy for governments because it maximizes the benefits of public expenditure. In this case, if we suppose a default rate of 50%, with an expenditure of $50, governments can promote a benefit of $100. In other words, the benefit for these low-income areas of receiving a credit of $100 is certainly much higher than the benefit of a single direct transfer of $50.

One could say that this public insurance would promote bad behavior in the sense that the borrowers would not have an incentive to pay back the loans. To avoid this kind of bad behavior, governments could offer incentives, like premiums, to the people that pay back their loans correctly. The premium could be, for example, a raise in the amount of the next loan, which means more credit for the good borrowers.

Another aspect that should be stressed is that, as an AAA rating credit, these loans could have low interest rates and longer terms, which is also another benefit for these low-income areas.

A final consideration is that this subsidy would encourage loans that otherwise would not happened and therefore would help to generate huge positive externalities as the reduction of poverty, the improvement of inner cities, the growth of small businesses, the creation of new jobs etc. This subsidy would also allow, at least in some amount, the internalization of these externalities.

10 – Brazilian Law

In this section, the Brazilian legal system will be briefly analyzed in order to compare it with the American system and reach some conclusions. It is important to stress at this point that the differences between common law and civil law will not be addressed here for it is irrelevant to the purposes of this paper, which is to compare specific regulation within the financial system.

10.1 – Brazilian Constitution

The current Brazilian Constitution, enacted in 1988, says at article 5, XXIII, that the use of property must serve a positive social function. The second article states four fundamental objectives of the Federal Republic of Brazil: 1) to build up a society that is free, equitable and based in solidarity; 2) to guarantee national development; 3) to end poverty and exclusion and to reduce the social and regional disparities; 4) to promote the welfare of everyone with no discrimination based on origin, race, sex, color, age or any other reason. The Constitution also states that the financial system must be designed to promote balanced development and to serve the interests of the community (article 192).

Notwithstanding all these principles that are in perfect harmony with legislation such as the CRA, the Brazilian system has no legislation similar to the CRA. Instead, there is some specific legislation that provides for transfers and other types of incentives to the low-income people and businesses.

It is beyond the purpose of this paper to address all of this legislation. Therefore, it will focus only on the Federal Law number 10,194.

10.2 – Federal Law number 10194

In addition to all the fundamental principles mentioned above, the Brazilian Constitution establishes at article 170, IX, that the small businesses should receive favored treatment.

In compliance with this article of the Constitution, the Brazilian Congress enacted the Federal Law number 10194, published on February 14, 2001, which authorizes the creation of a special kind of partnership whose main objective is to supply credit to small businesses.

As has happened with many other laws in Brazil, this will not have any real-world effect and quite probably will be forgotten because it is unreasonable under an economic point of view.

It should be obvious that private investors will not be interested in putting their money in a partnership that has as its main purpose the provision of credit to small businesses for the same reason that banks do not want to do this: the risk of default is very high and small businesses can offer no collateral and no other type of guarantee.

This situation, however, could be completely changed if the Brazilian Congress were to adopt the system of "tradable CRA obligations" formulated by Klausner (1995) or some similar type of legislation.

10.3 – The Brazilian financial system

The current Brazilian Constitution establishes at article 192 that the financial system must be regulated by supplementary law in order to promote a balanced development and to serve the interests of the community.

In order to regulate the Brazilian financial system in this aspect of serving the interests of the community what could be learned from the American experience of regulation and deregulation?

Notwithstanding the differences of the economies and the financial systems, the economic analysis of law made earlier for the United States is valid for the Brazilian legislation as well.

More to the point, the system of "tradable CRA obligations" proposed by Klausner (1995) as an alternative to the CRA would be a good improvement of the Brazilian legislation. And the claim that in addition to this system of "tradable CRA obligations" a more comprehensive program is needed to manage the problem of low-income people and businesses is valid as well.

It must be stressed that both of these proposals are in perfect harmony with the principles and values established in the Brazilian Constitution. This is especially true when one considers that they fit perfect with the goals of providing for dignity, according to social equity (article 170) and with freedom of enterprise (art.1º , IV) as well as the protection of property rights (article 5º , XXII). These proposals also provide for giving real-world effect to article 170, IX, of the Brazilian Constitution which states that small businesses should have a favored treatment.

In Brazil, as was said before, there is some specific legislation that provides for transfers and other types of incentives to the low-income people and small businesses.

These programs are carried out by public banks, that are operated by the federal and state governments.

The problem with this public funding is that it tends to be captured by middle and high-income people, as Brazilian history has showed, which is the worst thing that can happen. That is to say, if the money (public money from the budget) is addressed to subsidize and benefit low income people in order to reduce poverty and promote a more equal income distribution and this money is captured by the medium and high income people, the problem of poverty and income distribution will be increased instead of being relieved.

The creation of a federal fund to guarantee loans made to low income people instead of trying to give them the money directly can be a good way of avoiding this problem. That is loans made to low income people by the private financial institutions can be a safe way to assure that the money is going to the right target. There would be no increase in costs for the banks because they would not have to worry about collecting information from the community. To make this task easier and more reliable (trustful) a law could be enacted that establishes that the applicant for the loan must agree to opening his accounts (bank secrecy) to the financial institutions and the authorities involved in the enforcement of the program. This law could also make it a crime to give false information to these financial institutions and authorities. If the financial institution uses this public insurance for any purpose other than providing loans to low income people and small businesses, including following its own political agenda, it should be severely penalized.

The positive aspect of this program is that there is no direct supply of public money to people or financial institutions. The public insurance would only be triggered in case of a default on these loans to poor people. In this sense, the public fund would work in the same way as private insurance to ensure that a loan is made in compliance with the regulation.

11 – Conclusion

The financial markets, on their own, will not provide credit and access to the financial system to anybody as it should. No matter how perfectly the financial markets work, many low-income people and small businesses will still not be able to access credit.

This is a problem of income distribution and not a problem of market failure. It is, however, a problem serious enough to justify government intervention oriented to promote social efficiency consistent with the goal of achieving economic efficiency, and with the safe and sound operation of the financial institution.

In the task of reconciling the tension between the needs of the community and the main objective of profit maximization of the financial institutions, market forces cannot be neglected. Instead, they must be considered and employed in order to achieve better results. Therefore, an intervention that is market-oriented is better suited to responding to market imperfections and to the other problems that exist in the financial system.

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