CREDIT WHERE IT COUNTS: THE COMMUNITY REINVESTMENT ACT AND ITS CRITICS

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ABSTRACT

Despite the depth and breadth of U.S. credit markets, low- and moderate-income communities and minority borrowers have not historically enjoyed full access to credit. The Community Reinvestment Act (CRA) was enacted to help overcome barriers to credit for low- and moderate-income communities, and minority borrowers. Scholars have long leveled numerous critiques against CRA as unnecessary, ineffectual, costly, and lawless. But I argue, using recent empirical evidence, that CRA has enhanced access to credit for low-income, moderate-income, and minority borrowers at relatively low cost. I contend that market failures and discrimination exacerbate credit problems in low-income and minority communities and justify CRA. Critics argue that if such problems exist, there are better alternatives to CRA. By contrast, I argue that CRA should not be abandoned in favor of existing alternatives, such as the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Home Owner's Equity Protection Act, and government subsidies, and that CRA compares favorably with other alternative forms of regulation and subsidies that could be deployed. In sum, contrary to previous legal scholarship, I demonstrate using recent empirical evidence that CRA has been successful in expanding access to credit for low-income, moderate-income, and minority households at a reasonable cost. I also suggest further enhancements to CRA designed to respond to valid critiques and to build on its past successes.

Credit Where It Counts: The Community Reinvestment Act and Its Critics

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CREDIT WHERE IT COUNTS: THE COMMUNITY REINVESTMENT ACT AND ITS CRITICS

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I. INTRODUCTION

Despite the depth and breadth of U.S. credit markets, low- and moderate-income communities, as well as minority borrowers, have not enjoyed full access to those markets. Community advocates have long argued that "redlining"—a practice of not lending to borrowers in neighborhoods with higher concentration of minority households—has, at least historically, limited the flow of capital from depository institutions for homeownership in minority communities. Enormous progress has been made in expanding access to home mortgage lending,[1] but there is evidence that minority borrowers still face discrimination. Others have argued that low-income communities generally have lower access to capital than they would in a fully functioning market because of market failures in addition to discrimination. For example, information externalities and collective action problems may have impeded credit markets in low-income communities.[2] More recently, as capital from "subprime"[3] and other lenders has increased in low-income areas, consumer advocates have argued that the increased flows of credit have in some cases been accompanied by "predatory" or abusive lending practices targeted at minorities, the elderly, and other segments of the population.

In response to these and other concerns, Congress has enacted a wide range of federal laws and subsidy programs that affect the provision of credit.[4] This article focuses on perhaps the most controversial of these laws: the Community Reinvestment Act of 1977 (CRA).[5] Passed in response to concerns about redlining of minority and low-income areas,[6] and market failures in low-

[1] This article focuses on home mortgage lending. Home mortgage lending is an important aspect of financial security for low- and moderate-income borrowers, has attracted the greatest attention in the literature, and has different market and regulatory features from other forms of credit. I take up issues of short-term consumer debt and transactional financial services in Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121 (2004).

[2] *See infra* Part III.

[3] The label "subprime" refers to the status of borrowers who pay higher interest rates at least in part because they are thought to have credit histories below the quality of prime borrowers. Subprime lenders are lenders who specialize in lending to such borrowers. For a more thorough discussion, see *infra* Part III.

[4] *See, e.g.*, Lawrence J. White, *Focusing on Fannie and Freddie: The Dilemmas of Reforming Housing Finance*, 23 J. FIN. SERVICES RES. 43 (2003). I take up the broader topic of different modes of credit market regulation in a work in progress, *Democratizing Access to Capital*.

[5] 29 U.S.C. §§ 2901, 2902, 2903, 2906 (2000); 12 U.S.C. § 1831u(b)(3) (2000) (CRA requirement for interstate mergers); *see also* 12 U.S.C. § 1831y (CRA Sunshine Requirements); *Id.* § 1843(l)(2) (2000) (CRA requirement for financial subsidiaries engaging in expanded financial activities).

[6] *See, e.g.*, 123 CONG. REC. 17, 604 (1977) (statement of Sen. Proxmire) ("[CRA] is intended to eliminate the practice of redlining by lending institutions."). In its structure, CRA focuses

income communities,[7] CRA encourages federally insured banks and thrifts to meet the credit needs of the entire communities that they serve, including low- and moderate-income areas, consistent with safe and sound banking practices.[8] Federal banking agencies examine banks and thrifts periodically on their CRA performance and rate the institutions. Regulators consider a bank's or thrift's CRA record in determining whether to approve that institution's application for a deposit facility, which encompasses mergers with or acquisitions of other depository institutions. Such applications also provide the public with an opportunity to comment on the CRA performance of the institution.

CRA has strengthened over time, particularly during the 1990s, because of both legal and market developments.[9] Legislative changes to CRA enacted in 1989 required regulators to disclose publicly the institution's rating and performance evaluation.[10] Also in 1989, a bank regulator denied for the first time, on CRA grounds, an application for merger.[11] Changes to the regulations implementing CRA issued in 1995[12] focus CRA evaluations more on objective performance measures rather than more subjective and process-oriented factors that regulators had previously used and that scholars, banks, and community organizations had often criticized. These new regulations require banks and thrifts to disclose information about their small-business, small-farm, and community-development lending. Under the 1995 regulations, large banks, small banks, and wholesale or limited-purpose institutions have tailored examinations. Large banks are evaluated on a three-part test of their lending, investments, and services. Institutions are rated under four categories: outstanding, satisfactory, needs to improve, and substantial noncompliance.

These legislative and regulatory changes occurred during a time of increasingly intense consolidation in the banking industry, providing greater opportunities for community organizations and regulators to evaluate bank and thrift performance under CRA in the context of merger applications. With the passage of the Gramm-Leach-Bliley "Financial Modernization" Act of 1999,[13] CRA was again strengthened. Banks and thrifts must have a satisfactory CRA

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on market failures, rather than on discrimination per se, but as I discuss in Parts III & IV, market failures and discrimination are intertwined.

[7] For the theories underlying CRA, see *infra* Part III.

[8] 29 U.S.C. §§ 2901.

[9] *See, e.g.*, the discussions with lenders and community organizations described in ERIC S. BELSKY ET AL., INSIGHTS INTO THE PRACTICE OF COMMUNITY REINVESTMENT ACT LENDING, A SYNTHESIS OF CRA DISCUSSION GROUPS (Joint Center on Housing, Harvard U., Working Paper CRA00-1, 2000), *at* http://www.jchs.harvard.edu/publications/governmentprograms/cra001.pdf. I discuss CRA's effectiveness in further detail *infra*, Part IV.

[10] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

[11] Continental Bank Corporation, 75 FED. RESERVE BULL. 304 (1989).

[12] 12 C.F.R. 228.41 et seq. (2004).

[13] Pub. L. No. 106-102 (1999).

record if they, or their holding companies, are to engage in newly authorized financial activities, such as certain insurance and securities functions.[14]

CRA has been since its enactment, and remains today,[15] the subject of extensive debate. For example, in July 2004, two of the four federal banking regulators pulled out of a joint CRA rulemaking process. The Office of Thrift Supervision made a unilateral announcement that it was going to curtail CRA examinations for nearly 90 percent of institutions that it regulates, those holding less than $1 billion in assets, and all indications are that the Federal Deposit Insurance Corporation will soon follow suit.[16] If the two agencies follow through, their plans would seriously undermine community development in a vast number of low-income communities. The Federal Reserve Board and the Office of the Comptroller of the Currency have balked at this move, and Congress is debating whether and how to intervene.[17]

Legal scholars question vigorously the theoretical and empirical claims that motivated CRA, and many advocate eliminating the policy.[18] A large body of literature suggests that competition in credit markets has driven (or will drive) out discriminatory[19] or abusive practices, and that market failures are illusory.[20] Critics of CRA argue that CRA is trying to address a nonexistent problem. Moreover, they argue that problems in credit markets are insufficient to justify intervention, and that even if intervention is warranted, CRA is the wrong policy to pursue. Earlier legal scholarship suggested that CRA was

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[14] 12 U.S.C. § 2903(c) (2000); *Id.* §1843(l)(2) (2000).

[15] *See, e.g.*, Michelle Heller, *Reg Relief? Senator Puts Everything on the Table*, AM. BANKER, June 10, 2004, at 1 (noting that CRA is high on Senate Banking Committee list for regulatory relief).

[16] Michelle Heller, *FDIC Seen Siding with OTS on CRA*, AM. BANKER, July 20, 2004, at 1.

[17] *Id.* I discuss these developments further in Part VII.

[18] *See*, *e.g*., Charles W. Calomiris et al., *Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 J. MONEY, CREDIT & BANKING 634 (1994); Jeffery W. Gunther, *Should CRA Stand for "Community Redundancy Act"?*, 23 REG. 56 (2000); Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending,* 17 YALE J. ON REG. 197 (2000); Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act,* 143 U. PA. L. REV. 1561 (1995); Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993); Craig E. Marcus, *Beyond the Boundaries of the Community Reinvestment Act and the Fair Lending Laws: Developing a Market-Based Framework for Generating Low- and Moderate-Income Lending,* 96 COLUM. L. REV. 710 (1996); Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533 (1995) [hereinafer Swire, *Equality of Opportunity*]; Peter P. Swire, *Safe Harbors and A Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993) [hereinafter Swire, *Safe Harbors*]; Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction,* 20 FORDHAM URB. L.J. 281 (1993). Criticisms of CRA are discussed in detail in Part II.

[19] This view is usually derived from Kenneth Arrow, *The Theory of Discrimination, in* DISCRIMINATION IN LABOR MARKETS 3 (Orley Ashenfelter and Albert Rees eds., 1973), and GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION (2d ed. 1971).

[20] *See, e.g.,* Jeffrey M. Lacker, *Neighborhoods and Banking,* 81 ECONOMIC QUARTERLY 13 (1995).

having little, if any, positive effect, and at a high cost. For example, Jonathan Macey and Geoffrey Miller attempted to demonstrate the weak foundations and high cost of CRA in the wake of the 1989 reforms, charging that CRA undermines the safety and soundness of the banking system, and empowers community group rent-seeking at the expense of bank profitability.[21]

This Article systematically rebuts prior criticisms of CRA and lays a solid theoretical and empirical foundation for the Act. The Article first establishes the theoretical and empirical case for the persistence of credit market imperfections and discrimination. Of course, at the most basic level, no market is perfect.[22] This Article explores why such market imperfections might be relatively greater in low-income communities, or more appropriate as targets of government intervention, given the social benefits of expanded access to capital.[23] The Article argues that market failures and discrimination do warrant CRA in particular as a governmental policy.

The Article deploys recent empirical analysis to re-evaluate and ultimately refute (or at least cast doubt on) many of the critics' claims about the costs and benefits of CRA. Such evidence shows that CRA appears to have created far greater benefits than previously contended in the legal scholarship. Earlier articles suggested that the costs of CRA were exceedingly high; this article argues that, although some costs incurred are unnecessary, such costs have been overstated. In addition, this Article argues that some of the costs incurred, for example, those caused by the lack of bright line rules under CRA, also represent benefits, previously ignored, in the form of increased citizen participation and local, contextual "rulemaking." In sum, I contend that CRA has a reasonable foundation,[24] and that it can be defended as socially efficient, in the sense that the benefits of CRA likely far exceed the private costs.[25]

Some critics argue that CRA should be eliminated in favor of other regulatory steps taken to improve access to capital in low- and moderate-

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[21] *See* Macey & Miller, *supra* note 18.

[22] The existence of transaction costs, for example, implies that markets are not perfect. *Cf.* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[23] For discussion of circumstances disfavoring government intervention to correct market failures, *see*, *e.g.*, JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 8-10 (3d ed. 2000).

[24] *See infra* Parts III-IV.

[25] Kaldor-Hicks efficiency is achieved when the benefits of a policy exceed its costs, regardless of whether winners in fact compensate losers for their costs. N. Kaldor, *Welfare Propositions of Economics and Inter-personal Comparisons of Utility*, 49 ECON. J. 549 (1939); J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939). Pareto efficiency is achieved when no one is made worse off by a transaction. *See, e.g.,* Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211 (1991) (criticizing use of the Pareto principle)*; see also* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES 31-32 (1994). I take up distributional arguments for CRA in Part VI. For the argument that social welfare needs to include distributional consequences, see John Nash, *The Bargaining Problem*, 18 ECONOMETRICA 155 (1950). *See also* JOHN RAWLS, A THEORY OF JUSTICE (1971); *but see* Louis Kaplow and Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEG. STUD. 667 (1994) (arguing that distributional issues should not be addressed by legal rules).

income areas, such as targeted subsidies or fair lending laws. By contrast, I argue that CRA seems particularly effective when compared with other types of existing credit market regulation. I also analyze CRA compared with other modes of regulation and subsidy that CRA's critics contend should be pursued instead of CRA, if governmental intervention should occur at all. I show that tax and transfer systems, different forms of subsidy, and rules backed by fines all suffer from deficiencies that make them problematic as alternatives to CRA.

The article proceeds as follows. Part II recounts the scholarly critiques of CRA. Part III elaborates the theories of market failure and discrimination that rebut the theoretical critique and establish the need for CRA. Part IV analyzes the recent empirical evidence regarding the costs and benefits of CRA and argues that the case for CRA is strong. Given that critics often contend that CRA should be abandoned in favor of other alternatives, Part V analyzes CRA in the context of other existing home mortgage credit market policies, and Part VI compares CRA to other alternative models of regulation and subsidy. Part VII suggests policyreform s. Part VIII then concludes.

II. CRITIQUES OF CRA

The Community Reinvestment Act has been widely criticized.[26] This Part summarizes the key arguments against CRA. These may be grouped into five main critiques: CRA constitutes poor regulatory design with high costs and contradictory goals. Arbitrary enforcement of CRA presents opportunities for rent-seeking by community organizations and regulators, who subvert CRA for private purposes. CRA distorts the market and impedes financial market efficiency. CRA provides little benefit for low-income communities. Lastly, there are better alternatives to CRA. After laying out these arguments in detail in this Part, the remaining Parts look at the available evidence and actual regulatory and market practices to assess these contentions.

First, critics charge that the CRA statute is vague, blunt, and contradictory. CRA's goals, such as they may be adduced, have been criticized as self-contradictory or out-dated. CRA expects banks to expand credit to households to whom they would not otherwise lend but maintain safety and soundness, which critics deride as mutually inconsistent.[27] The Act does not make explicit whether it is targeted at discrimination,[28] or explain whether low-income communities or individuals are to be helped. CRA may be designed to address market failures, to combat discrimination, to achieve redistributive goals, or perhaps to advance an old-fashioned notion of "local" depositors' funds being lent locally (an ideal now irrelevant in global credit markets).[29]

Opponents of CRA argue that these mushy, overlapping goals lead to mushy, inconsistent regulation and that all these goals conflict with bank safety

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[26] *See, e.g.*, sources cited *supra*, note 18.
[27] *See* Gunther, *supra* note 18, at 56; Hylton, *supra* note 18, at 197, 238.
[28] *See* Calomiris et al., *supra* note 18, at 637.
[29] *See* Klausner, *supra* note 18, at 1561-64; Swire, *Safe Harbors*, *supra* note 18, at 366.

and soundness regulation. To the extent that CRA forces banks to lend locally, CRA undermines the ability of banks to diversify their lending geographically, undermining the soundness of their portfolio.[30] To the extent that CRA forces banks to lend to less creditworthy borrowers, CRA increases the risk of the bank's lending. Moreover, critics charge, in economic downturns, when banks must necessarily reduce their risk profiles, CRA examiners would give them bad ratings just for prudent reductions in risk.[31]

Opponents charge that CRA distorts the market in a manner that undermines the banking system. They dispute the existence of market failures and argue that CRA forces banks to engage in unprofitable, risky lending.[32] It deters efficiency-enhancing mergers[33] and cost reductions through closures of low-return bank branches. Critics deny that one can justify CRA as a quid pro quo for a net subsidy from the federal government to banks. Even if a net subsidy exists (which some commentators doubt[34]), critics say the appropriate response would be to eliminate the distortion directly, not enact CRA.[35]

Critics also contend that CRA distorts the market in a way that actually hurts low-income communities. Opponents argue that banks can avoid their vague CRA obligations by moving out or staying out of low-income and minority neighborhoods so that their "assessment" area for lending excludes such communities.[36] Defining communities by the geographical "accident" of deposit facilities, they argue, is itself a difficult process with perverse effects on bank locational decisions.[37] They argue that CRA creates incentives to avoid branches in poor neighborhoods in the first place, in order to avoid having to comply with CRA by lending in those communities.[38] Requiring banks to lend wherever they take deposits is bad economics, critics allege, because it undermines innovation, specialization and scale economies. In their view, CRA impedes specialization because it requires banks to invest in learning about all their communities, rather than permitting banks to invest the high fixed costs of such knowledge in one area.[39] CRA thwarts innovation because it requires a high level of lending once an initial investment in branches in a poor area is made. CRA undermines the ability of banks to

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[30] *See* Macey & Miller, *supra* note 18, at 324.
[31] *See* Gunther, *supra* note 18, at 60.
[32] *See* Calomiris et al., *supra* note 18, at 654; Klausner, *supra* note 18, at 1578; Macey & Miller, *supra* note 18, at 295; White, *supra* note 18, at 282.
[33] *See* Macey & Miller, *supra* note 18, at 322-23.
[34] *See, e.g.*, Kenneth Jones & Barry Kolatch, The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization, 12 FDIC BANKING REV. 1, 3 (1999).
[35] *See, e.g.*, Macey and Miller, supra note 18.
[36] *See* Macey & Miller, *supra* note 18, at 296, 340; White, *supra* note 18, at 287.
[37] *See* Klausner, *supra* note 18, at 1584.
[38] *See* Macey & Miller, *supra* note 18, at 296; Hylton, *supra* note 18, at 238.
[39] *See* Calomiris et al., *supra* note 18, at 655; Klausner, *supra* note 18, at 1574; Swire, *Safe Harbors*, *supra* note 18, at 355.

benefit from scale economies[40] and to internalize the positive externalities of their lending because it requires many institutions to lend in the community.[41]

Thus, critics contend that CRA has provided little benefit. They argue that economic growth, bank deregulation, technological innovation and competition would have driven banks to lend in low-income areas even without CRA.[42] Headline-getting loan commitments are a public relations boon but simply represent what the banks would do anyway.[43] They further argue that any benefit that does accrue to low-income communities is effectively an unwarranted cost to lenders, since any lending induced under CRA would necessarily be less profitable and more risky to undertake. Others contend that city renewal policies and community development financial institutions were responsible for increased lending.[44] Critics contend that lending not covered by CRA and lending by banks and thrifts outside their CRA assessment areas spurred the lending increases in low-income areas, so CRA could not have been responsible for any increased lending in these communities.[45]

Critics argue that CRA gives regulators unfettered discretion that they wrongly use to benefit some interest groups over others. For example, Macey and Miller decry the manner in which CRA empowers activist pressure groups, who, they allege, engage in rampant rent-seeking by holding banks hostage to give the groups funds for their own purposes.[46] Others charge that inner-city developers gain advantage from the regulation.[47] One scholar contends that, presumably because of scale economies and the commodification of mortgage markets, large banks benefit from CRA relative to small banks so that they impede any changes to CRA.[48] Critics further posit that the bank agencies themselves are major beneficiaries of CRA because it gives them a lever to use against banks in mergers they are concerned about for other reasons or allows them to pursue political goals unrelated to CRA.[49] According to this view, the power of interest groups and regulators under CRA leads banks to engage in CRA compliance in a way that does not actually help low-income or minority communities. Banks, motivated by the desire to satisfy pressure groups and regulators, engage in wasteful spending on public relations and headline-making loan commitments,[50] and spend inordinate hours and dollars on compliance and generation of data reporting and other wasteful paperwork.[51]

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[40] *See* Calomiris et al., *supra* note 18, at 652, 655; Klausner, *supra* note 18, at 1574-75.
[41] *See* Gunther, *supra* note 18, at 58; Klausner, *supra* note 18, at 1577; *cf.* White, *supra* note 18, at 285.
[42] *See* Gunther, *supra* note 18, at 56; Hylton, *supra* note 18, at 205.
[43] *See supra* note 50 and accompanying text.
[44] *See* Hylton, *supra* note 18, at 205.
[45] *See* Gunther, *supra* note 18, at 58.
[46] *See* Macey & Miller, *supra* note 18, at 333-37.
[47] *See* Hylton, *supra* note 18, at 237.
[48] *See id.* at 198.
[49] *See* Macey & Miller, *supra* note 18, at 342.
[50] *See id.* at 295, 330-33; *see also* Calomiris et al., *supra* note 18, at 638.
[51] *See* Swire, *Safe Harbors*, *supra* note 18, at 361; White, *supra* note 18, at 283.

CRA enforcement has been described as costly, arbitrary and inconsistent,[52] depending on the strength of local community groups, competitive factors in the financial sector and the decisions of banks to merge, and the whims of regulators. There is reported to be wide variation in toughness of regulators, both among agencies, and within agencies by geographic region.[53] The costs of compliance are alleged to be extraordinarily high,[54] and scholarship suggested that the 1995 regulatory reform did not reduce compliance costs or enhance shareholder value.[55]

CRA has been described as overly blunt because it does not differentiate between originating and holding loans,[56] or between wholesale and special purpose banks and other commercial banks.[57] Critics also say it fails to give appropriate weight to innovation rather than numbers of loans made.[58] Others charge that CRA uses loan rejection rates as a measure of performance, when this would punish banks for outreach into harder to serve communities,[59] and penalizes minority-owned banks that do not serve the community, when regulators should understand that these banks serve important other purposes.[60]

Moreover, CRA is bad economics, in the critics' view, because it places a regulatory burden on one type of financial institution (banks and thrifts) while letting comparable institutions (credit unions, independent finance companies) and other financial market participants (insurance companies, securities firms) off without any similar obligations.[61] In this view, it is irrational to apply CRA to banks and thrifts, but not to other financial companies, or, for that matter, every participant in every market, including, say, packagers of frozen peas.

Finally, critics argue that if one wants to achieve CRA's goals, superior alternatives exist. They argue that if CRA is rooted in distributional goals, these can best be met through the tax and transfer system, rather than legal rules.[62] Others argue for in-kind demand-side subsidies, supply-side subsidies, or tax incentives.[63] Others urge enforcement of existing anti-discrimination

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[52] *See* Calomiris et al., *supra* note 18, at 637; Hylton, *supra* note 18, at 203; Macey & Miller, *supra* note 18, at 295; Swire, *Safe Harbors*, *supra* note 18, at 362.

[53] *See* KENNETH H. THOMAS, THE CRA HANDBOOK (1998).

[54] *See* Calomiris et al., *supra* note 18, at 641; Klausner, *supra* note 18, at 1590; Macey & Miller, *supra* note 18, at 295.

[55] *See* David B. Ely & Kenneth J. Robinson, *Is the Community Reinvestment Act in need of Further Reform? Evidence from Equity markets during the 1995 Reform Process*, J. FIN. SERVICES RES., Feb. 2003.

[56] *See* Klausner, *supra* note 18, at 1587.

[57] *See* Macey & Miller, *supra* note 18, at 315-316.

[58] The 1995 CRA regulations take account of this critique. *See infra*, Part VII.

[59] *See* Hylton, *supra* note 18, at 233.

[60] *See id.* at 238; Macey & Miller, *supra* note 18, at 296, 340-41.

[61] *See* Calomiris et al., *supra* note 18, at 655; Macey & Miller, *supra* note 18, at 312-13; White, *supra* note 18, at 287-90.

[62] *Cf.* Swire, *Safe Harbors*, *supra* note 18, at 368 (responding to tax and transfer system as an alternative to CRA).

[63] *Cf.* Swire, *Safe Harbors*, *supra* note 18, at 368 (describing the subsidy alternative).

law.[64] Some contend that the market solution—in particular, the growth of the subprime mortgage market—answers any concerns about underserved low-income communities.[65] Other scholars call for an increased focus on community development banks and peer-lending based on ethnic communities.[66] Within the framework of CRA, some scholars call for tradeable CRA obligations akin to those used in environmental regimes,[67] while others call for safe harbors under CRA for the top bank performers.[68]

In sum, critics contend that CRA suffers from poor design, forces banks and thrifts to make unsound loans, impedes the efficiency of the financial services sector, promotes rent seeking, imposes high compliance costs with burdensome reporting requirements and regulatory uncertainty, does little good, and therefore should be eliminated. Some of these arguments have strong theoretical force. Market failures are difficult to establish empirically, and "[t]he existence of important credit market failures is uncertain."[69] Moreover, it is unclear whether financial institutions will respond to incentives in desired ways. The regulatory discretion embedded in CRA could create agency problems and increase regulatory costs. Moreover, incentives are targeted to some, but not all, financial intermediaries, so the incentives may simply shift the composition of lending and not expand it or change its terms.[70]

This debate cannot be decided in the abstract, nor on the basis of anecdotal evidence. I evaluate these criticisms of CRA in Parts III and IV. Part III explains the theoretical justification for CRA, while Part IV assesses the criticisms in light of recent empirical evidence that takes account of regulatory changes and market experience during the 1990s. I demonstrate that CRA has considerable benefits and much lower costs than previously suggested, and that other policy criticisms of CRA are misguided. Parts V and VI address critics' remaining arguments, discussed above, that existing or potential alternatives are preferable to CRA. I show that CRA compares favorably with these alternatives on many dimensions. In conclusion, I contend that CRA's critics have it wrong. On balance, CRA should be supported.

III. THEORETICAL FOUNDATIONS OF CRA

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[64] *See* White, *supra* note 18, at 283-84.
[65] *See* Gunther, *supra* note 18, at 57.
[66] *See* Calomiris et al., *supra* note 18, at 654-57; Swire, *Safe Harbors*, *supra* note 18, at 354-59, 367-68.
[67] *See* Calomiris et al., *supra* note 18, at 652; Klausner, *supra* note 18, at 1580.
[68] *See* Swire, *Safe Harbors, supra* note 18, at 353-69.
[69] JONATHAN ZINMAN, THE EFFICACY AND EFFICIENCY OF CREDIT MARKET INTERVENTIONS: EVIDENCE FROM THE COMMUNITY REINVESTMENT ACT 1 (Joint Center for Housing Studies, July 2002) (citing Allen N. Berger & Gregory F. Udell, *Some Evidence on the Empirical Significance of Credit Rationing*, 100 J. POL. ECON. 1047 (1992)). *But see* Mitchell A. Petersen & Raghuram G. Rajan, *The Effect of Creditor Competition on Firm-Creditor Relationships*, 110 Q.J. ECON 407 (1995) (finding empirical support for credit constraints).
[70] ZINMAN, *supra* note 69, at 2.

The theoretical support for CRA derives from three bases. First, CRA addresses market failures from imperfect information, collective action problems, agency costs, and neighborhood externalities that are more acute in low-income neighborhoods and for low-income borrowers than in credit markets generally. Second, CRA helps to reduce discrimination against minority borrowers and communities. CRA was *not* designed to address racial discrimination against individual borrowers directly, but the significant correlation between race and income, and between race of homeowner and racial composition and income of neighborhood, gives CRA leverage to overcome barriers to credit faced by minority households. In some ways, this leverage is greater than that of fair lending laws.[71] Third, CRA could help to break down inefficient barriers between the bifurcated prime and subprime credit markets by enhancing competition between prime and subprime lenders in low- and moderate-income neighborhoods. CRA can help make the subprime and prime markets more efficient by completing the market.

A. MARKET FAILURE

Credit market imperfections impede lending in low- and moderate-income communities. First, information externalities and asymmetries may lead to credit rationing that excludes credit worthy borrowers and causes banks to overlook profitable loans.[72] Information externalities can produce credit constraints because the efficiency of bank lending is in part a function of "market thickness."[73] Second, collective action problems exacerbate information externalities and inhibit entry into these communities.[74] CRA could help to mitigate these credit constraints by providing "an effective commitment device to coordinate lending…."[75] Third, agency costs make it difficult to align corporate interest in profitable lending with the behavior of loan agents, which CRA can help to address by providing additional incentives to reform corporate structures. Lastly, neighborhood externalities provide grounds for governmental intervention.[76] I take up these points in turn.

Information externalities contribute to lower rates of lending in low-income communities than would be socially optimal. Borrowers in low-income neighborhoods find it more difficult to obtain mortgage loans in part because lenders lack sufficient information on home sales in these thin markets, that is,

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[71] *See infra* Part V (comparing CRA to fair lending laws).

[72] Janusz Ordover & Andrew Weiss, *Information and the Law: Evaluating Legal Restrictions on Competitive Contracts*, 71 AM. ECON. REV. PAPERS & PROC. 399 (1981).

[73] William W. Lang & Leonard I. Nakamura, *A Model of Redlining*, 33 J. URB. ECON. 223 (1993). Market thickness refers to the amount of economic activity, as measured by number of participants, or number or total value of transactions, over some time period.

[74] Petersen & Rajan, *supra* note 69.

[75] ZINMAN, *supra* note 69.

[76] *See, e.g.*, JACK M. GUTTENTAG & SUSAN M. WACHTER, REDLINING AND PUBLIC POLICY 39 (1980).

markets with a relatively low level of economic activity.[77] The small number of transactions in a low-income community will make appraisals difficult. Any one financial institution will not want to be the only participant in a market with uncertain collateral values. The reduction in market participants will further decrease the amount of information availableabout property values and reduce the liquidity of other loans to that neighborhood. Lenders will not want to lend in areas with low levels of liquidity. Property values will decline as the market becomes less liquid, reinforcing the downward trend in lending.

The information required to offset this trend is costly. In low-income communities, such information externalities are likely to be more costly to overcome, and the benefits of overcoming them are likely to be smaller, than in high-income neighborhoods.[78] Creditors will face the up-front costs of developing expertise in neighborhoods that they have not previously served, and about which there is less information available from other creditors, appraisers, and real estate professionals. In addition, creditors will need to spread the fixed costs of finding information about low-income neighborhoods over fewer transactions and smaller loan sizes.[79] Creditors will have to train their personnel to search for creditworthy borrowers and sound residential neighborhoods in locations where lenders have not previously conducted a large number of transactions. Such information creates positive externalities that benefit all lenders. Information about collateral values and the existence of creditworthy borrowers will likely—if lenders report credit histories—inure to the benefit of all lenders. Thus, the lender that invested in the additional information will not be fully compensated for its investment.

Lenders that do enter the market will charge higher prices to offset these risks. Lenders may seek to internalize more of the benefits of customer information by not reporting credit histories to the credit bureaus.[80] By failing to report credit histories, they gain market share, which would induce them to spend more on information and lend more. Borrowers, however, will face higher prices and will not be able to demonstrate to other lenders, including prime lenders, that they are creditworthy. Moreover, the higher prices may drive more borrowers out of the market or increase defaults, making it less likely that other lenders will be willing to serve the market.

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[77] *See* STEPHEN ROSS & JOSH YINGER, THE COLOR OF CREDIT (2002) (analyzing Lang & Nakamura, *supra* note 73); Paul S. Calem, *Mortgage Credit Available in Low- and Moderate-Income Minority Neighborhoods: Are Information Externalities Critical?*, 13 J. REAL EST. ECON. 71 (1996); David M. Harrison, *The Importance of Lender Heterogeneity in Mortgage Lending*, 49 J. URBAN ECON. 285 (2001); Klausner, *supra* note 18, at 1569-70; David C. Ling & Susan M. Wachter, *Information Externalities and Home Mortgage Underwriting*, 44 J. URBAN ECON. 317 (1998).

[78] *See generally* Klausner, supra note 18, at 1569-70.

[79] *See id*.

[80] *See, e.g.,* Consumer Credit Reporting Practices, Federal Financial Institutions Examination Council Advisory Letter, Jan. 18, 2000, at http://www.occ.treas.gov/ftp/bulletin/2000-3a.txt.

In addition to neighborhood information externalities, asymmetries in information between lenders and borrowers that are costly to overcome can also lead to credit rationing. Joseph Stiglitz and Andrew Weiss have demonstrated that credit rationing can occur when seemingly similar borrowers differ in unobserved ways in their willingness and ability to repay.[81] If lenders charge higher interest rates to compensate themselves for the uncertainty regarding the risk of a given pool of borrowers, they will face higher default rates. Adverse selection would mean that riskier borrowers will take out loans from the bank because they cannot get access to lower-priced loans elsewhere. These riskier borrowers will tend to default more often because moral hazard increases as interest rates increase, and because higher-priced loans will simply be more difficult for low-income borrowers to repay. These incentives increase the likelihood low-income borrowers will default even if they did not present a similar risk of defaulting on a lower-cost loan.

It is costly to overcome information asymmetries regarding low-income borrowers. These borrowers often lack credit histories, and may not even have a bank account,[82] so determining their creditworthinessis more difficult and costly. Many low-income households could provide indicia that they are likely to repay their loans, such as a strong record of paying rent and utilities on time, but banks are not used to relying on such information. There is not yet a clearinghouse or standardized method of determining creditworthiness on the basis of these factors,[83] making these other measures of creditworthinessmore uncertain than the standard credit scores produced by the credit bureaus. Additionally, low-income households often have lower levels of educational attainment, and thus may require more assistance in completing loan applications.[84] Creditors might rationally choose not to spend the additional sums necessary to lend to creditworthy borrowers in low-income communities.

Creditors considering whether to enter a low-income market also face collective action problems. Information externalities and other factors may delay some lenders' entry into an otherwise profitable market, further diminishing the economic prospects of the area and reinforcing other lenders' decisions not to lend. Even if there are credit worthy borrowers and sufficient collateral values, a lender might rationally avoid the risk of lending in an uncertain market because other lenders are not lending there. One can characterize this delayed entry as a collective action problem.[85] By contrast, if

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[81] Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

[82] *See* Barr, *supra* note 1, at 121 (showing that 22 percent of low-income households lack a bank account).

[83] For innovative pilots in this regard, *see, e.g.*, "Pay Rent, Build Credit" at www.payrentbuildcredit.com.

[84] *See* Klausner, *supra* note 18.

[85] Contrary to previous scholarship, *see* Klausner, *supra* note 18, at 1577, I argue that CRA is an effective response to collective action problems because it does help banks and thrifts coordinate their lending. *See infra* Part IV.

lenders know that others will participate, their collateral is more likely to have knowable values, their collateral and loans are more likely to be liquid, and property values may be able to rise more quickly, all other things being equal.

The strength of other institutions in a community also reinforces differential access to capital. For example, to the extent that higher-income communities could, in theory, exhibit information externalities or collective action problems, such failures are overcome by real estate developers and agents (who gather and disseminate information about price and quality), neighborhood associations (who enforce rules such as lawn maintenance that bolster uniform reliability of collateral values), and the like. These institutions are generally weaker or unavailable in low-income communities, and their absence exacerbates market failures. CRA has helped to bolster these community-based organizations in some communities, which in turn reinforces the effectiveness of CRA in overcoming market failures.

Neighborhood externalities that result from credit market failures also undergird CRA.[86] Neighborhoods with low access to credit see declines in property values, increased vacant properties, and other indicia of distress. Households find it more difficult to get credit if they live in distressed neighborhoods. Lower access to credit can increase neglect of properties.[87] Adjacent property owners may decide not to invest in maintenance or to move out of the neighborhood.[88] Conversely, increased access to credit and homeownership can help to turn neighborhoods around, increasing property values for adjacent properties and neighborhoods.[89] Government policies designed to increase homeownership can thus have positive externalities in communities not directly affected by the government programs.[90]

B. Racial Discrimination

CRA was not enacted to address racial discrimination against particular borrowers. That role was assigned to the Equal Credit Opportunity Act of 1974 (ECOA).[91] Yet CRA had its origins in claims that banks were "redlining" borrowers living in low-income, minority communities, and CRA has helped to open up mortgage markets for minority borrowers. Thus, in this Section, I explore the theory and evidence regarding credit market discrimination as a basis for CRA.[92]

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[86] *See* GUTTENTAG & WACHTER, *supra* note 76; Klausner, supra note 18, at 1570-71.

[87] *See, e.g.*, Klausner, *supra* note 18, at 1571.

[88] *See* GEORGE C. GALSTER, HOMEOWNERS AND NEIGHBORHOOD REINVESTMENT (1987).

[89] Ingrid Gould Ellen, Michael H. Schill, Scott Susin, & Amy Ellen Schwartz, *Building Homes, Reviving Neighborhoods: Spillovers from Subsidized Construction of Owner-Occupied Housing in New York City*, 12 J. HOUSING RES. 185 (2001); Michael H. Schill, Ingrid Gould Ellen, Amy Ellen Schwartz, & Ioan Voicu, *Revitalizing Inner-City Neighborhoods: New York City's Ten-Year Plan*, 13 HOUSING POL'Y DEBATE 529 (2002).

[90] *Id.*

[91] 15 U.S.C. § 1691-1691f (2000). The Federal Reserve Board implements ECOA under Regulation B, 12 C.F.R. pt. 202 (2004).

[92] *See* Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431 (1995) (arguing that CRA should be understood as a response to racial discrimination).

The standard view, derived from the work of Gary Becker, is that, in the long run, in a perfect market, discrimination will disappear.[93] Long run equilibrium will probably occur sooner in credit markets than in, say, labor markets, because credit markets are more efficient. Nonetheless, at a given point in time, one would need to specify the parameters of Becker's model to test his hypothesis, and competing theories suggest that the model is too limited. Credit rationing theory can explain the persistence of lending discrimination. In addition, Becker's model assumes that only racial animus is illegal; however, statistical discrimination, in which lenders use factors correlated with race as proxies for creditworthiness, violates ECOA.[94] Lastly, price discrimination can persist in segmented credit markets.

Credit rationing enables discrimination to persist even in competitive markets. Credit rationing can occur because of asymmetric information, adverse selection and moral hazard.[95] If credit rationing occurs, identical marginal applicants will be treated differently; some borrowers will get loans while others will not, and lenders will not charge differential prices to sort borrowers by risk. The single-price model in Stiglitz and Weiss accurately describes the prime credit market dominated by banks and thrifts,[96] while the subprime market differentiates by risk. Since lenders in credit-rationing models do not provide loans to all members of a class of identical loan applicants, they could discriminate without losing profits (absent legal liability under anti-discrimination laws). Moreover, tests of lending discrimination

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But see Klausner, supra note 18, at 1563-64 (arguing that ECOA, not CRA, should address racial discrimination). For a defense of the view that CRA should be seen as a legitimate response to racial discrimination in addition to ECOA, see Part IV.

[93] *See* BECKER, *supra* note 19

[94] *Compare* ROSS & YINGER, *supra* note 77, *and* FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, INTERAGENCY FAIR LENDING EXAMINATION PROCEDURES (1999) [hereinafter FFIEC] (explaining that statistical discrimination violates fair lending law), *available at* http://www.ffiec.gov, *with* BECKER, *supra* note 19 (arguing that discrimination only occurs if the institution foregoes profits in order to satisfy the "taste" for discrimination); *see also infra* Part V (comparing CRA to fair lending laws).

[95] *See* Stiglitz & Weiss, *supra* note 81 and accompanying text. Under an alternative theory, Ferguson and Peters show that even with symmetric information, credit rationing can occur when a lender's marginal cost of making a loan to a given class of borrowers increases with the size of the lender's portfolio for reasons unrelated to borrower creditworthiness. Michael F. Ferguson & Stephen R. Peters, *Is Lending Discrimination Always Costly?*, *21* JOURNAL OF REAL EST. FIN. & ECON. 23 (2000). Such portfolio effects might arise, they argue, from higher resale or management costs from risk diversification, or regulatory costs, see MICHAEL F. FERGUSON & STEPHEN R. PETERS, A SYMMETRIC-INFORMATION MODEL OF CREDIT RATIONING (University of Cincinnati, Working Paper, 1997). Credit rationing could also occur when lenders use low interest rates but high denial rates to separate low-risk from high-risk borrowers. Paul S. Calem & Michael Stutzer, *The Simple Analytics of Observed Discrimination in Credit Markets*, 4 J. OF FIN. INTERMEDIATION 189 (1995); *see also* David Besanko & Anjan V. Thakor, *Collateral and Rationing: Sorting Equilibria in Monopolist and Competitive Credit Markets*, 28 INT'L ECON. REV. 671 (1987) (showing credit rationing when low-risk borrowers lack downpayments to distinguish as low-risk).

[96] For discussion of the subprime market, see *infra*, Part III.C.

based on profitability would not identify lending discrimination, because lenders who discriminated would be just as profitable as lenders who did not.

Statistical discrimination could be profitable if race is correlated with an aspect of creditworthiness that is costly to observe directly. It is rational for financial institutions to avoid information costs by making statistical assessments about creditworthiness, even if such factors are correlated with race. Competitive markets will not drive out statistical discrimination in the short term.[97] Still, statistical discrimination will be less accurate than a direct measure of individual creditworthiness. As technology and innovation drive down the costs of obtaining such measures, one would expect statistical discrimination to diminish in competitive markets over the long term.[98]

The evidence on discrimination in credit markets is hotly contested.[99] Disparities in the rates at which whites and African Americans (among others) are denied home mortgage loans continue to be large. But disparities alone do not prove discrimination; the empirical debate revolves around controls for creditworthiness and other factors that legitimately affect lending decisions. The debate intensified with the release of the first Home Mortgage Disclosure Act (HMDA) data containing race in 1991 and the publication of a study by economists at the Federal Reserve Board of Boston in 1992.[100] The Boston Fed Study found that African Americans were nearly twice as likely as whites to be denied home mortgage loans after adjusting for an array of variables related to risk.[101] The study has come under a barrage of attacks,[102] but rebuttals have affirmed the study's central findings.[103] On balance, the evidence suggests that disparities between African-American and white borrowers persist.[104] Matched pair testing has also found differential

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[97] The short term and long term are not defined here. In the context of higher education, Justice O'Connor suggested that affirmative action would no longer be needed in 25 years. Grutter v. Bollinger, Slip Op. No. 02-241, at 31, 539 U.S. __, __ (2003). Alan Kreuger has pointed out that 25 years may not be long enough, given that the black-white wage gap is cut in half only over a generation. N.Y. TIMES Apr. , 2003, at __.

[98] *See* Stuart I. Greenbaum, *Twenty-Five Years of Banking Research*, 25 FIN. MGMT. 86 (1996). *But see* Peter P. Swire, *The Persistent Problem of Credit Discrimination A Law and Economics Analysis*, 73 TEXAS L. REV. 787 (1995) (arguing that discrimination reduces the returns to investing in creditworthiness for minorities, which would perpetuate discrimination); Stanley D. Longhofer & Stephen R. Peters, Self Selection and Discrimination in Credit Markets (1998) (unpublished manuscript, Federal Reserve Bank of Cleveland) (describing equilibria in which borrowers sort themselves among discriminatory and non-discriminatory lenders based on their creditworthiness and discrimination persists).

[99] *See generally* ROSS & YINGER, *supra* note 77

[100] *See* ALICIA H. MUNNELL, ET AL., MORTGAGE LENDING IN BOSTON: INTERPRETING THE HMDA DATA (Federal Reserve Bank of Boston, Working Paper 92-97, 1992) (initial publication); *see also* Alicia H. Munnell et al., *Mortgage Lending in Boston: Interpreting HMDA Data*, 86 AM. ECON. REV. 25 (1996) (final publication with responses to critics).

[101] *See* Ross & Yinger, supra note 77, at ___.

[102] *See, e.g.*, ROSS & YINGER, *supra* note 77, at __ (analyzing these studies).

[103] *See, e.g.*, *id.* at __ (analyzing these studies).

[104] *See generally id.*

treatment.[105] These disparities suggest either disparate treatment of, or disparate impact on, minorities.[106] Studies of redlining on the basis of neighborhood composition face greater empirical challenges and provide inconclusive results. Two studies have found that largely African-American census tracts received fewer loans than other tracts, after controlling for tract characteristics, while one study suggests that there may be redlining on the basis of income.[107] In sum, recent analysis suggests that "extensive underwriting discrimination existed in 1990, and there is no more recent evidence to show that this discrimination has gone away."[108]

In addition to discrimination in loan denials, price discrimination can also occur because of market fragmentation.[109] Prime lenders offer a single price to borrowers who meet their criteria and ration credit among the others. Subprime lenders offer differential pricing of loans on the basis of risk and other factors. Although the growth of risk based pricing in the subprime market has broadened the eligible pool of borrowers,[110] differentiated pricing may also result in racial discrimination. Using credit scores, creditors can determine the price at which they would be willing to lend to a particular borrower, but the subprime market's fragmented nature prevents all potential borrowers from learning about lenders' pricing schemes. This permits lenders to distinguish among similar borrowers in pricing loans. Creditors price loans based on factors other than risk, including a borrower's willingness to pay. Differential pricing can facilitate market clearing, but these pricing techniques lead to systematically different prices for minorities than for whites.

Under ECOA, price discrimination is unlawful.[111] Price discrimination occurs in a range of credit markets.[112] Comprehensive loan pricing data are

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[105] *See, e.g.*, MORTGAGE LENDING DISCRIMINATION: A REVIEW OF EXISTING EVIDENCE (Margery Turner & Felicity Skidmore eds., 1999).
[106] ROSS & YINGER, *supra* note 77, at 211.
[107] *See id.* at 230 (citing Stephen L. Ross & Geoffrey M.B. Tootell, Redlining, the Community Reinvestment Act, and Private Mortgage Insurance (1998) (unpublished manuscript); ROSS & YINGER, *supra* note 77, at 232; *see also* Consent Agreement, United States v. Chevy Chase Federal Saving Bank, No. 94-CV-1824-JG (D.D.C. Aug. 22, 1994). Income redlining does not violate ECOA, although it would affect an institution's performance under CRA.
[108] ROSS & YINGER, *supra* note 77, at 367-68.
[109] *See, e.g.*, IAN AYRES, PERVASIVE PREJUDICE? NON-TRADITIONAL EVIDENCE OF RACE AND GENDER DISCRIMINATION (2002).
[110] *See infra* Part III.C (discussing growth of subprime market).
[111] *See, e.g.*, Consent Agreement, United States v. First National Bank of Vicksburg, No. 5-94-CV-6(B)(N) (S.D. Miss., Jan. 21, 1994).
[112] *See, e.g.*, Ian Ayres, Expert Report, Cason v. Nissan, No. 3-98-0223, (M.D.T.N. May 25, 2001); AYRES, PERVASIVE PREJUDICE?, *supra* note 109; ROSS & YINGER, *supra* note 77; Business Access to Capital and Credit, A Federal Reserve Board Research Conference, March 8-9, 1999; Ian Ayres & Peter Siegelman, *Race and Gender Discrimination in Bargaining for a New Car*, 85 AM. ECON. REV. 304 (1995).

not available for home mortgages.[113] Studies have focused on "overages," the amount by which negotiated loan rates exceed the lender's minimum rates set forth on "rate sheets" for loan officers.[114] Strikingly, mortgages obtained by African Americans more often contain overages, and much higher ones, than mortgages obtained by others.[115] African Americans fare worse in negotiations with mortgage brokers and loan officers.[116]

Other factors may reinforce discrimination. Automatic credit systems can have a disparate impact on minorities if the factors used are correlated with race, and allow disparate treatment if brokers treat borderline cases differently. Firms adopt reward structures for loan officers that favor high-income areas, with higher concentrations of white borrowers. Loan officers or brokers may discriminate but their practices might go undetected by creditors because of agency problems.[117] Banks may underinvest (from a social perspective) in branches or in training loan officers in how to make loans in underserved, minority neighborhoods. Credit discrimination might lead minorities to underinvest in creditworthiness, diminishing their prospects for a loan.[118] Discrimination in the housing market[119] or the labor market may be transmitted to credit markets. Differences in the collateral values of homes or fears of racial integration could depress housing prices, leading to lower sales, fewer loans, and higher interest rates in minority neighborhoods.

C. PROBLEMS IN THE SUBPRIME SECTOR

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[113] The Federal Reserve Board now requires certain price data for high cost loans to be reported. Home Mortgage Disclosure; Final & Proposed Rule, 67 Fed. Reg. 7,221 (Feb. 15, 2002).

[114] On the problem of the differential effects based on race of yield spread premiums, which compensate brokers for getting borrowers to accept higher interest rates than they qualify for, see HOWELL E. JACKSON & JEREMY BERRY, KICKBACKS OR COMPENSATION: THE CASE OF YIELD SPREAD PREMIUMS (Harvard working paper, 2003).

[115] ROSS & YINGER, *supra* note 77, at 223-27, 307.

[116] *Id.* at 307; *see also* Harold A. Black et al., *Is There Discrimination in Mortgage Pricing? The Case of Overages*, 27 J. OF BANKING & FIN. 1139 (2003); Henry Buist et al., *Residential Lending Discrimination and Lender Compensation Policies*, 27 J. AM. REAL EST. & URBAN ECON. ASSOC. 695 (1999); McKinley Blackburn & Todd Vermilyea, Racial Discrimination in Home Purchase Mortgage Lending among Large National Banks (2001) (unpublished manuscript, on file with Moore School of Business, U. of S. Carolina). Possible explanations include borrower anxiety based on experience with past discrimination, greater risk aversion, higher levels of information asymmetry, or discrimination by the originator or broker.

[117] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 8-15 (1991) (discussing agency costs).

[118] *See* Swire, *supra* note 98 (arguing that discrimination reduces the returns to investing in creditworthiness for minorities).

[119] For the history of discrimination in government housing policy and in real estate markets, *see generally,* Anthony Pennington-Cross & Anthony M. Yezer, *The Federal Housing Administration in the New Millennium*, 11 J. OF HOUSING RES. 357, 358 (2000); ROSS & YINGER, *supra* note 77; MARGERY TURNER ET AL., DISCRIMINATION IN METROPOLITAN HOUSING MARKETS (Nov. 2002), *at* http://www.huduser.org/Publications/pdf/Phase1_Report.pdf.

Banks and thrifts have increased their lending to low- and moderate-income borrowers in ways that suggest that CRA is working.[120] But subprime lending—a sector outside CRA's purview—has grown dramatically at the same time.[121] Subprime lenders specialize in making loans to borrowers with impaired or limited credit history. Most subprime loans are refinance loans. Although refinancing may be used to obtain better rates, subprime refinance loans are usually used for home improvement or consumer purchases, to pay for education expenses, or to consolidate other consumer debt.[122] With new sources of funding available from the secondary market, and advances in information and risk management, subprime lending has grown sevenfold from 1994 to 2002, reaching $241 billion, or 9 percent of the market.[123] In 2001, there were nearly 200 subprime and manufactured home lenders.[124]

The subprime market is plagued by serious problems. Some subprime borrowers who could have qualified for loans from prime lenders end up in the subprime market, paying higher rates. Research suggests that between 10 and 35 percent of subprime borrowers could qualify for prime mortgage loans.[125] Some minority borrowers may have been improperly "steered" to higher cost lenders.[126] Moreover, studies have documented abusive practices in the subprime sector.[127] These practices have included "flipping," repeatedly refinancing a loan in a short period of time. Flipping subjects a borrower to high fees, including prepayment penalties, which diminish the borrower's home equity without providing significant benefit. Loans have been "packed" with additional products (such as credit life insurance) without the borrower understanding that the products were optional or unsuitable. Loans have included fees unrelated to risk or servicing, and which are structured to disguise their true costs. Some brokers have made home mortgage loans without regard to the borrower's ability to repay. These so-called "asset based" loans were often made by brokers who earned high fees and were less

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[120] For a fuller discussion of this point, see *infra* Part IV.

[121] For evidence that CRA nonetheless can be demonstrated to have been an important factor in driving increased lending in low-income areas, see infra, Part IV.

[122] *See* National Home Equity Mortgage Association, Frequently Asked Questions, *at* http:///www.nhema.org/About/Questions.htm.

[123] *See* Governor Edward M. Gramlich, Remarks at the Texas Association of Bank Counsel (Oct. 9, 2003).

[124] HUD, HUD SUBPRIME AND MANUFACTURED HOME LENDER LIST, *available at* http://www.huduser.org/datasets/manu.html (last visited Aug. 10, 2003).

[125] FREDDIE MAC, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA'S FAMILIES (2002).

[126] Alternatively, minorities may misperceive their own creditworthiness, believe that prime lenders would deny their loans, or make bad choices.

[127] For a full discussion of such practices, see U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT AND U.S. DEPARTMENT OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT (2000). I co-directed this report while at Treasury. *See also* Michael S. Barr, *Access to Financial Services in the 21st Century*, 16 NOTRE DAME J. L. ETHICS & PUB. POL'Y 447 (2002).

concerned about their reputations among lenders. In other cases, "unscrupulous mortgage brokers, lenders, home improvement contractors, appraisers, and combinations thereof" engaged in "outright fraud" as well as "deceptive or high-pressure sales tactics," and often "prey[ed] on . . . the elderly, minorities, and individuals with lower incomes and less education . . . ."[128]

While credit risk is a key determinant of whether a borrower receives a prime or subprime loan, a recent study suggests that "credit risk alone may not fully explain why borrowers end up in the subprime market."[129] For example, borrowers who are older, Hispanic, or search less for interest rates are more likely to end up in the subprime market.[130] Having a subprime loan is an important determinant of refinancing with a subprime loan even after controlling for relevant factors: Sixty percent of subprime borrowers who refinanced did so with subprime loans rather than prime ones,[131] indicating that subprime borrowers get stuck in the subprime market. Subprime borrowers are more dissatisfied with the mortgage process than prime borrowers.[132]

The price that borrowers pay is a function not only of using a subprime lender, but also of negotiating with mortgage brokers, who dominate the subprime market. Brokers are compensated for getting borrowers to pay higher rates than those for which the borrower would qualify. Such "yield spread premiums" are widely used. In loans with yield spread premiums, unlike other loans, there is wide dispersion in prices paid to mortgage brokers. Within the group of borrowers paying yield spread premiums, African Americans paid $474 more, and Hispanics $590 more, than white borrowers; thus, even if minority and white borrowers could qualify for the same rate, minority borrowers are likely to pay much more.[133] Minority borrowers and white borrowers tend to go to different lenders and "some lenders use particularly aggressive rate-setting rules with minority customers."[134]

Moreover, borrowers in the subprime market form a pool whose risk characteristics are worse and more widely dispersed than borrowers in the prime market.[135] Even though there is rough risk-based pricing in the subprime market, defaulting borrowers create an externality that raises interest rates on all subprime borrowers. Regulation of the subprime sector is in part a response to the problem of incomplete contracts. Borrowers cannot contract

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[128] U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT AND U.S. DEPARTMENT OF THE TREASURY, *supra* note 127, at 2.
[129] Marsha J. Courchane et al., *Subprime Borrowers: Mortgage Transitions and Outcomes*, 29 J. REAL EST. FINANCE & ECON. (forthcoming 2004).
[130] *Id.*
[131] *Id.*
[132] *Id*.
[133] *See* JACKSON & BERRY, *supra* note 114, at 125-28; *see also* JACK GUTTENTAG, ANOTHER VIEW OF PREDATORY LENDING 8 (Wharton Financial Institutions Center Working Paper No. 01-23-B, Aug. 2001) ("According to the brokers, [a] major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer").
[134] ROSS & YINGER, *supra* note 77, at 344.
[135] Pennington-Cross & Yezer, *supra* note 119.

with one another to allocate the costs of the negative externality of default. Foreclosures concentrated in low-income neighborhoods can also cause negative externalities to neighboring property owners.[136]

Some critics believe that the subprime market's growth obviates the need for CRA, but I argue in Parts IV and V that CRA is uniquely positioned to overcome the bifurcation between the prime and subprime markets by enhancing competition from banks and thrifts. Overcoming that bifurcation would improve market efficiency, reduce racial discrimination, and speed the process of correcting other market failures. Lending by subprime specialists does not replace lending by banks and thrifts. First, subprime creditors specialize in refinance loans rather than in home purchase originations. That is, subprime lenders free-ride on the information generated by firms engaged in home purchase lending. Second, subprime lenders have failed to report credit scores for sound borrowers in order to capture the informational benefits from their investment. As a result, the positive externalities from increased lending in low-income areas are not realized. Third, borrowing from a subprime lender signals to prime lenders that a borrower is a bad credit risk. Rather than increasing access to prime lending, subprime borrowing helps to keep borrowers in the subprime market, where borrowers pay more for credit. Moreover, minority households are much more likely to remain stuck in the subprime market even after accounting for creditworthiness.

D. SUMMARY

Market failures, racial discrimination, and bifurcated credit markets justify CRA. CRA helps to overcome information externalities and collective action problems by helping to coordinate bank lending. CRA responds to racial discrimination by encouraging banks and thrifts to lend in low-income areas and to low-income borrowers, where and among whom minorities are disproportionately represented. CRA could offer a strong response to the market failures that have arisen from bifurcated credit markets. In Part IV, I explain how CRA is effectively overcoming many of these barriers.

IV. NEW EMPIRICAL EVIDENCE THAT CRA IS EFFECTIVE

Part III offered theoretical foundations for CRA. This Part explores recent empirical evidence showing that CRA, on balance, constitutes defensible policy. The first Section relies on empirical evidence, part of which I directed at the Treasury Department, to demonstrate that CRA has a positive impact on access to credit, despite the empirical difficulty of isolating CRA as a cause of recent, positive developments in credit markets.[137] The second Section

[136] *Id.*

[137] It should be re-emphasized that in this Part, as in the discussion of market imperfections, empirical studies in an area as complicated as credit markets cannot prove any contention with certainty. Technological and economic change exacerbate this difficulty, as do the multiplicity of regulations and the pervasiveness of subsidies.

analyzes how the costs of CRA are generally overstated. In particular, the claim that CRA induces banks and thrifts to make dangerously unprofitable loans is not substantiated by the data. Similarly, I present evidence to rebut claims of rampant rent seeking and other costs. Even a rough sense of the costs and benefits of CRA adduced thus far suggests that it is socially efficient. The third Section shows how other arguments that CRA is the wrong policy response miss the mark. Parts V and VI address the remaining arguments of the critics that alternatives to CRA should be preferred.

A. THE BENEFITS OF CRA ARE SUBSTANTIAL

Initiatives by financial institutions over the last decade suggest that CRA – in combination with other factors – is helping banks and thrifts to eliminate or reduce barriers to credit. With impetus from CRA, lenders have: formed multi-bank Community Development Corporations (CDCs) and loan consortia to reduce risk, overcome collective action problems, and share the costs and benefits of developing information about low-income markets; invested in locally based Community Development Financial Institutions (CDFIs) to develop specialized market knowledge, share risk, and explore new market opportunities; engaged in special marketing programs to targeted communities; experimented with more flexible underwriting and specialized servicing techniques to determine if a broader range of applications could be approved without undue risk; and funded credit counseling to improve the creditworthiness of potential borrowers. Many larger institutions have developed specialized units within their organizations that focus on the needs of low- and moderate-income communities. A positive lending cycle has begun in many communities: once lenders know that others will be making loans to a community, they face less liquidity risk, gather and disseminate information more quickly, and produce positive information externalities. Experience suggests that increased lending to low-income communities has occurred, and that such lending has not led to the kind or the extent of unprofitable, excessively risky activity predicted by critics.

Studies have found evidence that CRA improved access to home mortgage credit for low-income borrowers during the 1990s, as CRA enforcement increased. One study found that the share of CRA-eligible loan originations by banks, thrifts, and their affiliates in the 1990s increased; it also found evidence of gains to minorities and low-income areas from alllenders , which the authors attribute in part to increased fair lending enforcement.[138] Other researchers have found evidence consistent "with the view that the CRA has been effective in encouraging bank organizations, particularly those involved in consolidation, to serve [low- and moderate-income] and minority borrowers and neighborhoods."[139] Lending to low- and moderate income borrowers grew

[138] Douglas D. Evanoff & Lewis M Siegal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, 20 FED. RESERVE BANK OF CHICAGO ECON. PERSP. 19 (1996).
[139] Robert B. Avery et al., *Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act*, 85 FED. RESERVE BULL. 81 (1999). *See also* Glenn B. Canner &

much faster than lending to other groups in the 1990s, which may have been attributable to both CRA and other factors.[140] A case study found that one lender had extended loans to low-income and minority borrowers with lower credit scores than it normally required, at least in part because of CRA.[141]

Research that I directed at the Treasury Department found that, in absolute terms, between 1993 and 1999, depository institutions covered by the CRA and their affiliates made nearly $800 billion in home mortgage, small business, and community development loans to low- and moderate-income borrowers and communities.[142] The number of CRA-eligible mortgage loans increased by 39 percent between 1993 and 1998, while other loans increased by only 17 percent.[143] Affiliates are included in CRA assessments only at the lender's discretion. Even excluding all affiliates, banks and thrifts themselves increased their lending to low- and moderate-income borrowers and areas by 10 percent, compared with no growth at all for these lenders in their other markets.[144] Over this period, the portfolio share of CRA-covered lender and affiliate loans going to these borrowers and areas increased from 25 to 28 percent as these institutions increasingly focused on underserved markets.[145]

Lenders covered by CRA primarily specialize in prime lending. In the prime market, covered lenders and their affiliates increased their market share of lending to low- and moderate-income borrowers and areas from 66 percent in 1993 to 71 percent in 1998.[146] Yet the dramatic expansion of non-covered lenders in the *subprime refinance* market meant that banks and thrifts lost market share overall in low- and moderate-income communities. Fully 85 percent of non-covered institutions' growth is attributable to lending by

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Dolores S. Smith, *Home Mortgage Disclosure Act: Expanded Data on Residential Lending*, 77 FED. RESERVE BULL. 859 (1991).

[140] Robert B. Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RESERVE BULL. 621 (1996).

[141] MICHAEL LACOUR-LITTLE, DOES THE COMMUNITY REINVESTMENT ACT MAKE MORTGAGE CREDIT MORE WIDELY AVAILABLE? SOME NEW EVIDENCE BASED ON THE PERFORMANCE OF CRA MORTGAGE CREDITS (Citicorp Mortgage, Inc. , May 4, 1998).

[142] *See* ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT (U.S. Dep't of the Treasury, Apr. 2000) [hereinafter LITAN ET AL., BASELINE REPORT]; ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A FINAL REPORT (Jan. 2001) [hereinafter LITAN ET AL., FINAL REPORT]. The author directed this research project while serving at the Treasury Department. For further analysis of these reports, see ERIC S. BELSKY ET AL., THE EFFECTS OF THE COMMUNITY REINVESTMENT ACT ON BANK AND THRIFT HOME PURCHASE MORTGAGE LENDING, JOINT CENTER FOR HOUSING STUDIES, HARVARD UNIVERSITY (Aug. 2001). Mortgage loans made between 1993 and 1998 constituted $467 billion of that total. *See* LITAN ET AL., BASELINE REPORT, *supra*, at ES-3. In 1998 alone, CRA-covered institutions and their affiliates made $135 billion in mortgage loans to these borrowers, an 80 percent increase over their lending in 1993. *See* LITAN ET AL., BASELINE REPORT, *supra*, at ES-3.

[143] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at ES-3.

[144] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at 46.

[145] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at ES-4.

[146] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at ES-7.

specialists in subprime and manufactured home lending. More than 77 percent of this subprime lending growth is attributable to refinances rather than home purchase loans.[147] As a result of the growth in subprime refinance lending, non-covered institutions increased their overall market share of lending to low- and moderate-income borrowers and areas from 35 percent in 1993 to 37 percent in 1998.[148] Thus, banks and thrifts increased their home purchase lending, while others focused on subprime refinance loans.

HMDA data also show improvements in lending to minority and low-income borrowers, although HMDA data need to be treated with caution.[149] From 1993 to 1999, the number of home purchase loans made to Hispanics increased 121.4 percent; to Native Americans, 118.9 percent; to blacks, 91.0%; to Asians, 70.1 percent; and to whites, 33.5 percent. Over that period, the number of home purchase loans extended to applicants with incomes less than 80 percent of the median increased 86.2 percent, much higher growth than any other income group experienced. In 1999, conventional home purchase loans extended in neighborhoods that are predominantly minority were up 17 percent over the previous year, compared with 6 percent growth in other neighborhoods.[150]

Without more evidence, however, one cannot attribute the rapid growth in lending to low-income, moderate-income, and minority borrowers and areas to CRA. A series of other factors undoubtedly contributed to these gains. First and foremost, strong economic growth during the 1990s led to rapid income growth and lower unemployment rates for minorities in many of the largest central cities. Real interest rates for mortgages were at low levels during much of this period. Second, financial and technological innovation helped drive down the costs of assessing creditworthiness, offering mortgage products, effectuating transactions, and funding loans through securitization. Third, extensive consolidation in the financial services sector heightened the potential to magnify the adverse consequences of poor performance under CRA on major transactions., Consolidation also enhanced competition for the delivery of credit in many markets, including low-income communities. Fourth, it is difficult to disaggregate the effects of CRA, HMDA, ECOA, Federal Housing Administration (FHA) lending, and the government-sponsored enterprise (GSE) Affordable Housing Goals, which all operated in intensified ways on different mortgage market participants during this period.

Controlling for the effects of these factors, however, the Treasury research that I directed found that CRA provides important benefits. Evidence benchmarking banks and thrifts against non-CRA lenders facing similar market

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[147] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at 43.

[148] *See* LITAN ET AL., BASELINE REPORT, *supra* note 142, at ES-6.

[149] *See*, *e.g.*, WILLIAM APGAR ET AL., JOINT CENTER FOR HOUSING STUDIES, HARVARD UNIVERSITY, THE 25TH ANNIVERSARY OF THE COMMUNITY REINVESTMENT ACT: ACCESS TO CAPITAL IN AN EVOLVING FINANCIAL SERVICES SYSTEM 34-35 (2002) [hereinafter 2002 JOINT CENTER CRA REPORT].

[150] HMDA data are available at http://www.ffiec.gov/hmcrpr/hmda03.pdf.

and legal conditions (other than CRA) suggests that CRA is effective. The report found that CRA lenders (with or without their affiliates) increased their CRA-eligible home purchase lending faster than those not regulated by CRA from 1993 to 1999.[151] Similarly, analysis of CRA lending across metropolitan areas with divergent economic circumstances and divergent levels of home mortgage activity reinforces the view that CRA helps expand access to home mortgage credit for low- and moderate-income borrowers.[152] Case studies of metropolitan areas also support that view.[153] On these measures, CRA appears to make a difference.[154] Additional analysis of this data by authors of the Treasury report—controlling for economic situation, demographics, housing market, market organization, Federal Housing Administration (FHA) insurance, secondary market sales, and other factors—found that "CRA has increased the flow of credit to [low- and moderate-income] borrowers and areas by CRA-covered lenders and their affiliates over the period studied."[155]

The Joint Center on Housing at Harvard University followed up this research by examining the behavior of CRA lenders, the portion of CRA-eligible market share held by banks and thrifts, and price changes and turnover rates in low-income neighborhoods.[156] This research again found that CRA has positive effects. The models used in the report do not "reveal[] with precision the exact magnitude of the impact of CRA,"[157] and so should be interpreted cautiously. By one measure, however, the report found that the effect of CRA on home mortgage lending to low- and moderate-income borrowers and areas was equivalent to the effect of a 1.3 percentage point decrease in unemployment.[158] The report found:

> CRA lenders have changed their behavior. CRA lenders originate a higher proportion of CRA-eligible loans than they would if CRA did not exist, and they seem to reject fewer CRA-eligible loan applications than they would if CRA did not exist.

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[151] *See* LITAN ET AL., FINAL REPORT, *supra* note 142, at ES-4.
[152] *Id.*, at 36.
[153] Id., at 62.
[154] *See id.,* at ES 3-4. This research stands in contrast to the approach taken by Gunther, *supra* note 18 (arguing that CRA is ineffective). Gunther examines data from 1993 and 1997, years that because of differences in refinancings are not comparable. Gunther fails to distinguish between home purchase and refinance loans, and between prime and subprime lending. He also excludes loans to low- and moderate-income borrowers outside of low- and moderate-income areas even though such loans count for CRA purposes and are important in expanding opportunity for low-income households. Lastly, Gunther repeats arguments that CRA lending is unsound, ignoring the contrary evidence from the Federal Reserve Board's report, *see infra* note 176 and accompanying text.
[155] BELSKY ET AL., *supra* note 142, at 22.
[156] 2002 JOINT CENTER CRA REPORT, *supra* note 149, at 59.
[157] *Id.* at 58.
[158] *See id.* at 59.

> CRA lenders appear to have captured a higher share of the CRA-eligible lending market than they would have if CRA were not in place.
>
> CRA-eligible neighborhoods seem to have more rapid house price increases and higher turnover rates than other neighborhoods, which is consistent with an expansion of credit in those areas.[159]

In reaching these conclusions, the report used two key variables: one measuring lending within as opposed to outside assessment areas, and one denoting whether community groups had signed CRA agreements.[160] Some findings from the study are open to conflicting interpretations. On the one hand, the growth of the subprime market may mean that CRA is less important than it once was, or even undermine the suggestion that CRA has improved lending by banks and thrifts, since the growth of subprime lending has been much stronger. In addition, some portion of the increased lending by CRA-covered, prime lenders represented levels of lending that shifted from subprime lenders to prime lenders, rather than a net increase in loans. Moreover, much of the increase in lending that the Joint Center attributed to CRA came from lending to low- and moderate-income borrowers in middle- and high-income neighborhoods, with presumably lower neighborhood effects.

On the other hand, each of these points is amenable to a contrary and often more plausible interpretation. The Joint Center's approach may actually understate the effect of CRA on changing banking practices both within and outside assessment areas. Banks may change their business practices to meet the credit needs of low-income communities, and then apply those changed practices across all of the areas that they serve, low-income or not, and not simply within their assessment areas. The costs of developing products and training personnel may make consistently applying these business practices across all lending areas more efficient. Moreover, if bank performance under CRA has a demonstration effect on other lenders, and helps to thicken the market, as information externality theory would predict, then the success of CRA contributed to the relative growth in low- and moderate-income lending by non-CRA regulated lenders. As the Joint Center report notes, the "fact that many large independent mortgage companies (i.e., mortgage lenders not subject to CRA) have been stunningly successful at serving the lower-income market is highly suggestive that this dynamic has indeed played out and that a reasonable portion of the CRA-eligible market is now being served economically."[161]

In addition, in the absence of CRA, banks and thrifts may not have behaved the same as independent mortgage firms in lending to low- and moderate-income borrowers, but worse, given their higher costs of funds and

[159] *Id.* at 58.
[160] *Id.* at 61.
[161] *Id.* at 60.

business plans that tend to focus on higher cost services to higher income clientele.[162] Thus, comparisons between bank and nonbank lending to low-income borrowers would tend to understate CRA's impact on banks and thrifts. Furthermore, a focus on CRA lending in low-income neighborhoods is too narrow. CRA lending to low-income borrowers outside of poor neighborhoods improves social mobility by helping low-income borrowers move to better neighborhoods and is an important element of CRA's success. In addition, GSE affordable housing goals and fair lending laws likely increased lending by nonbanks and banks, so it is difficult to measure what mortgage companies would have done in the absence of these laws. Lastly, even if some gains in prime lending merely represent a substitution of subprime lending for prime lending, such shifts lower prices and move industry practice in low-income neighborhoods towards the standards of the prime market, which provides significant benefits to low- and moderate-income and minority households.

Thus, the evidence on home mortgage lending confirms that, at bottom:

> CRA-regulated entities still lead the market in the provision of mortgage capital to lower-income people and communities, especially lower-income minorities. Detailed multivariate analysis confirms that CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if CRA did not exist. Moreover, lower-income neighborhoods targeted by CRA appear to have more rapid price increases and higher property sales rates than other neighborhoods.[163]

Evidence from small business markets also reinforces the view that CRA has been effective. The 1995 changes to the CRA regulations required large commercial banks and savings associations to report on small business lending for the first time. In 2002, the most recent year for which data is available, banks and thrifts subject to CRA's small business reporting requirement made $111 billion in loans to firms with revenues under $1 million, nearly double the 1996 figure.[164] Banks and thrifts made $27.8 billion in community development loans in 2002, $10 billion more than they had made in 1996.[165]

A recent empirical study found that CRA "does increase lending to small businesses as intended."[166] The study suggests that CRA increases the number of firms that can access credit by four to six percentage points.[167] The study

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[162] *See, e.g.*, LACOUR-LITTLE, *supra* note 141; Glenn B. Canner et al., DOES THE COMMUNITY REINVESTMENT ACT (CRA) CAUSE BANKS TO PROVIDE A SUBSIDY TO SOME MORTGAGE BORROWERS?, (Fed. Reserve Bd. Fin. & Econ. Discussion Series No. 2002-19, 2002).

[163] 2002 JOINT CENTER CRA REPORT, *supra* note 149, at 135.

[164] CRA National Aggregate Table 1, *at* http://www.ffiec.gov/webcraad/RetrieveTablesNA.htm?as_Year=2002&as_table=1+Originations.

[165] CRA National Aggregate Table 3, *at* http://www.ffiec.gov/webcraad/RetrieveTablesNA.htm?as_Year=2002&as_table=3++Community development lending.

[166] ZINMAN, *supra* note 69, at 2.

[167] *See id*. at 20.

found that CRA generally increased access to credit for small firms, as intended by CRA, but did not find any evidence that CRA increased access to credit for small firms located in low- and moderate-income areas, holding other factors constant.[168] Moreover, the study determined that the increased lending to small businesses induced by CRA provided benefits to the real economy—increased payrolls and reduced bankruptcies—without any evidence that such lending crowded out other financing available to small businesses or adversely affected bank profitability or loan performance.[169] It is somewhat remarkable that studies of CRA's effect on small business lending show any effect at all, given that small business data collection is relatively new, data are not as comprehensive, and the examinations for small business lending are not as well developed as for home mortgage lending.

Aside from lending activities, financial institutions have also increased their community development investments in low-income communities under CRA. Although comprehensive data on investments are not available, one can assemble some broad aggregate statistics using data from other regulatory provisions.[170] For example, national bank community development investments totaled $15 billion from 1965 to 2002, with well over half the investments coming during the last decade.[171] Such investments are in addition to community development loans, which totaled $42.3 billion in 2003 alone.[172]

Changes in financial services industry may mean that CRA covers less and less of the financial services world. Banks and thrifts' share of financial assets has declined dramatically since the end of World War Two, from 60 percent to about 25 percent today. Moreover, for business organization reasons unrelated to CRA, banks and thrifts may pursue a greater portion of their lending activity through affiliates not covered by CRA, particularly mortgage finance company affiliates. According to the Joint Center, the reach of CRA is likely declining:

> In combination, the changing industry structure, along with the fact that CRA expanded the capacity of all industry players to better

[168] *See id.*
[169] *Id.* at 3.
[170] 12 C.F.R. Part 24 (2004), implementing 12 USC §§ 24 (Eleventh), 93a, 481, & 1818 (investments designed to promote the public welfare) (2000). Banks are only required to use the "Part 24" authority for investments that would otherwise not be authorized for national banks, so data collected under this authority understates CRA-eligible investments.
[171] *See* OCC, 2002 Directory of National Bank Community Development Investments, *at* http://www.occ.treas.gov/cdd/2002Part24Dir.pdf, at 4 & 6 (visited Aug. 18, 2004) (author's calculations). A similar authority is available for state member banks, and bank holding companies, as a "public welfare" investment, *see* paragraph 23 of section 9 of the Federal Reserve Act (12 U.S.C. § 338a (2000)) or a "community development" investment under Regulation Y (12 C.F.R. § 225.25(b)(6) (2004)). For recent investments, *see* Federal Reserve Board, 2002 Directory, Community Development Investments, Bank Holding Companies, State Member Banks, *at* http://www.federalreserve.gov/DCCA/Directory/cdi02.pdf, (visited Aug. 18, 2004).
[172] Press release, Federal Financial Institutiosn Examination Council (July 26, 2004), *at* http://www.ffiec.gov/hmcrpr/cra072604.htm (visited Aug. 18, 2004).

> serve lower-income borrowers, has diminished the extent that CRA-regulated organizations now lead the market. Econometric analysis suggests that on average over the period 1993 to 2000, CRA may have increased the share of loans going to CRA-eligible borrowers by 2.1 percentage points (or from 30.3 to 32.4 percent). Estimates for individual years suggest, however, that the CRA impact has declined from 3.7 percentage points in 1993 to 1.6 percentage points in 2000.[173]

In part, this decline may be less momentous than community-based organizations suggest: although assets subject to CRA are declining as a share of financial assets, such assets continue to grow in absolute terms. Moreover, as CRA-covered institutions develop new products, train employees, and alter organizational structures to meet the credit needs of low-income communities, such changes may have important influences on uncovered affiliates of banks and thrifts. In addition, CRA enforcement through mergers and acquisitions will continue to be important. Consolidation in the banking industry, after a brief respite during the recession of 2001–2002, has picked up again, and long-term forecasts suggest that more will likely come.[174] Furthermore, the Gramm-Leach-Bliley Act made expansion into new activities, such as insurance and securities, contingent on banks' CRA performance. Therefore banking organizations will have to pay attention to their CRA performance for many years to come, as they seek to enter new financial markets.

Admittedly, market and technological forces are tending to reinforce access to some types of credit, particularly home mortgage loans that are now easily commodified, as some critics of CRA have suggested. Nonetheless, market pressures will also mean that financial intermediaries are under increasing pressure to serve the highest end of the market. Increasingly, community banks and thrifts, and community development financial institutions, may find that a larger portion of the local market (in particular the market for small business loans) is of less interest to larger banks and thrifts. This will open up new business opportunities for smaller institutions, while CRA's effect on larger institutions will likely push advances in commodified lending markets, including home mortgages and credit-scored small business loans that can be sold into the secondary markets.

In sum, recent evidence shows that CRA provides important benefits to low-income communities. Other factors undoubtedly contributed to the growth in lending to low-income communities during the 1990s, but careful studies have found support for an independent and important role for CRA. Given the difficulty of finding such effects in policy analysis generally, these findings are remarkable.

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[173] 2002 JOINT CENTER CRA REPORT, *supra* note 149, at 135.

[174] *See, e.g.*, *Playing to the endgame in financial services*, THE MCKINSEY QUARTERLY (Aug. 2004).

B. THE COSTS OF CRA HAVE BEEN OVERSTATED

1. Profitability

While CRA undoubtedly has costs, recent empirical evidence suggests that those costs were significantly overstated by CRA's critics.[175] CRA loans appear to be reasonably profitable. A Federal Reserve Board report issued in 2000[176] casts significant doubt on the claims made by critics about the likely performance of CRA loans. The report found that most institutions responded that CRA lending was profitable or marginally profitable: 82 percent indicated that CRA-related home mortgage lending was profitable, 86 percent indicated that CRA-related home improvement lending was profitable, 93 percent indicated that CRA-related community development lending was profitable, and 96 percent indicated that CRA-related small business lending was profitable.[177] The median difference between return on equity for CRA home mortgage loans and all such loans, and between CRA small business loans and all such loans, was zero.[178] Most respondents reported that CRA lending was as profitable or more profitable than all lending.[179] The profitability of serving these borrowers and communities helped drive the increase in CRA-eligible lending by banks and their affiliates between 1993 and 1998.[180]

Many respondents reported other benefits from such lending, which suggest that CRA lending, while strengthening communities, is also profitable for banks. Eighty-one percent of respondents, for example, developed new business opportunities from their CRA small business lending.[181] Seventy-one percent of respondents cited "source of additional profits" as a benefit of their community development lending, and 96 percent cited promoting "community growth and stability."[182] These broader societal benefits also represent benefits for the banks operating in these communities because they reduce the risk of bank lending in those communities, further contradicting the notion that CRA forces banks to engage in unprofitable activity.

2. Risk

CRA loans appear not to be overly risky. The loss rates that surveyed banks and thrifts reported for CRA loans are quite low. The median difference in charge-off rate between CRA home mortgage loans and all such loans was zero.[183] The institutions responding to the survey reported weighted median

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[175] *See, e.g.,* Macey & Miller, *supra* note 18, at 319-22.

[176] The Performance and Profitability of CRA-Related Lending, Report by the Board of Governors of the Federal Reserve System, submitted to Congress pursuant to section 713 of the Gramm-Leach-Bliley Act of 1999 (July 2000) [hereinafter Performance and Profitability].

[177] *Id.* at xvii, chart1a, xix, chart 3a, xxi, chart 5a, and xxiii, chart 7a.

[178] *Id.* at 46 & 58.

[179] The exact percentages of as "profitable" or "more profitable" responses were: 56 percent for home purchase and refinance loans, 72 percent for home improvement loans, and 84 percent for small business loans. *Id.* at 45-46, 52, 58.

[180] *See supra* text accompanying note 143.

[181] Performance and Profitability, *supra* note 176, at table 8.

[182] *Id.* at table 6.

[183] *Id.,* at table 3c.

charge-off rates of 0.18 percent on CRA-related home mortgage loans and 0.40 percent on CRA-related small business loans.[184] About 70 percent of respondents reported credit losses for CRA home mortgage lending that were the same as or less than other such lending, and 91 percent of respondents reported credit losses for CRA small business loans that were the same as or smaller than for all small business loans.[185] Community development loans had a median charge-off rate of zero.[186] Separate analysis by the Federal Reserve Board indicated that CRA lending loss rates were stable from 1993 to 1998, even as CRA lending increased dramatically. Generally speaking, the categories of loans made pursuant to CRA—home mortgage, small business, multifamily, and community development lending—have had relatively low loss rates.

3. The Risk-Access Tradeoff

Pushing further into low-income markets has not weakened banks' profitability and soundness as White, Macey and Miller, and others predicted. As one would expect, the performance of CRA "special programs" is not as strong as the performance of CRA loans in the institutions' general portfolio. Special programs account for only 17 percent of CRA-eligible lending as the Federal Reserve Board defines it. These programs serve as the banks' and thrifts' lending "laboratories," employing new and innovative strategies – such as lower downpayment requirements – to deliver credit to underserved borrowers. Once these strategies are refined, they are often "graduated" to borrowers in the institution's core product lines.[187] Despite the programs' experimental status, the Board reported that 61 percent of respondents found CRA special programs to be profitable.[188] Moreover, most institutions reported low delinquency and charge-off rates; the median charge-off rate on these programs was zero.[189]

The survey finding that CRA loans are generally profitable is consistent with other studies. Federal Reserve Board economists determined that, after adjusting for creditworthiness and the benefits of the home mortgage interest deduction, banks do not offer borrowers substantially lower mortgage rates to make CRA-eligible loans.[190] Earlier studies found that institutions with strong CRA performance were as profitable as those with less CRA activity.[191]

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[184] *Id.*, at table 3e (home mortgage), table 5e (small business).
[185] *Id.*, at table 3d (home mortgage), table 5d (small business).
[186] Id., at table 7c.
[187] *See* Robert B. Avery et al., *CRA Special Lending Programs*, 86 FED. RES. BULL. 711 (2000).
[188] Performance and Profitability, *supra* note 176, at table 14a.
[189] *Id.*, at table 14c.
[190] GLENN B. CANNER ET AL., DOES THE COMMUNITY REINVESTMENT ACT (CRA) CAUSE BANKS TO PROVIDE A SUBSIDY TO SOME MORTGAGE BORROWERS? (Fed. Reserve Bd. Fin. & Econ. Discussion Series No. 2002-19, 2002). The upper bound on such a subsidy, if any, is "tiny." *Id.*
[191] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON COMMUNITY DEVELOPMENT LENDING BY DEPOSITORY INSTITUTIONS (1993); Glenn B. Canner

Similarly, an earlier survey by the Federal Reserve Bank of Kansas City had found CRA lending to be profitable, though not as profitable as other lending.[192]

That is not to say that the Federal Reserve Board's survey found no differences in the performance of CRA loans and other loans. As noted by the Board's report,[193] previous studies had found that borrowers with lower incomes were more likely to have their loans become delinquent,[194] and that a combination of negative home equity[195] and a "triggering" event such as job loss was correlated with delinquency and default.[196] Affordable home mortgage products with significant layering of risk were also found to be more prone to default.[197] However, research also concluded that although borrower and neighborhood income were inversely related to delinquency rates, the differences were slight, and loan-to-value ratios were far more important.[198] Moreover, lenders compensate for such differences in deliquency rates by charging higher interest rates.

4. Mergers and Acquisitions

Critics overstate the contention that CRA is a costly barrier to efficient mergers and acquisitions. Treasury Department analysis shows that CRA likely imposes little costs from disapproval or delay of mergers, acquisitions, or other applications subject to CRA review.[199] From 1985 to 1999, only 692 out of 92,177 applications subject to CRA review received any adverse public comment—less than 0.7 percent. Of those applications, most received adverse

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& Wayne Passmore, *The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks*, 7 FIN. & ECON. DISCUSSION SERIES 1 (FRB, July 1997); Glenn B. Canner & Wayne Passmore, *The Relative Profitability of Commercial Banks Active in Lending in Lower-Income Neighborhoods and to Lower-Income Borrowers*, PROC. 32D ANN. CONF. ON BANK STRUCTURE & COMPETITION, FED. RES. BANK OF CHICAGO (1996); David Malmquist et al., *The Economics of Low-Income Mortgage Lending*, 11 J. FIN. SERVICES RES. 169 (1997).

[192] Larry Meeker & Forest Myers, *Community Reinvestment Act Lending: Is It Profitable?*, 1996 FIN. INDUSTRY PERSP. 13.

[193] *See generally* Performance and Profitability, *supra* note 176, at 6-14.

[194] James A. Berkovec et al., *Discrimination, Competition, and Loan Performance in FHA Mortgage Lending*, 2 REV. ECON. & STAT. 241 (1988); George M. von Furstenberg & Jeffery R. Green, *The Effects of Race and Age of Housing on Mortgage Delinquency Risk,* 12 URBAN STUD. 85-89 (1975); George M. von Furstenberg & Jeffery R. Green, *Home Mortgage Delinquency*, 29 J. FIN. 1545 (1974).

[195] Dennis R. Capozza et al., *Mortgage Default in Local Markets*, 25 REAL EST. ECON. 631 (1997); Roberto G. Quercia & Michael A. Stegman, *Residential Mortgage Default: A Review of the Literature*, 3 J. HOUSING RES. 341 (1992).

[196] Chester Foster & Robert Van Order, *An Option-based Model of Mortgage Default*, 3 HOUSING FIN. REV. 351 (1984); Kerry D. Vandell & Thomas Thibodeau, *Estimation of Mortgage Defaults Using Disaggregate Loan History Data*, 2 J. AM. REAL EST. & URBAN ECON. ASSOC. 292 (1985).

[197] Michael K. Stamper, *Revisiting Targeted Affordable Lending: Fresh Evidence Finds Far Lower Default Rate,* 14 SECONDARY MORTGAGE MARKETS 16 (1997).

[198] Robert Van Order & Peter Zorn, *Income, Location and Default: Some Implications for Community Lending*, 28 REAL EST. ECON. 385 (2000).

[199] Treasury Department, Internal Analysis (July 7, 2000) (on file with author).

public comment or regulatory scrutiny on both CRA and other grounds. Only 1 percent of the applications receiving comment were denied, 4 percent withdrawn, and 1 percent returned (for reasons that may or may not have related to CRA), leaving 94 percent approved. Thus the agencies denied less than one tenth of one percent of the applications subject to CRA review. Adverse CRA comments also generally lead to little delay. Since CRA's enactment, the bank agencies processed 63 percent of applications facing CRA protests within 90 days, and processed 88 percent of such applications within 180 days. This has improved under the 1995 CRA regulations: almost 75 percent of all applications subject to CRA review are now decided within 90 days and more than 94 percent are decided within 180 days. Regulators exercise their discretion to ignore frivolous comments.

Of course, the lack of delay or denial is not evidence that CRA is either ineffective or without cost. Banks and thrifts presumably internalize the risk of delay or denial and modify their behavior to minimize that risk. A recent study found that CRA had a significant effect on expanding lending to low-income communities, controlling for bank characteristics. The study found that banks increased their lending to low- and moderate-income neighborhoods in anticipation of the regulatory and public scrutiny from CRA that accompanies mergers.[200] The effects were more pronounced for larger institutions, which face the most public and regulatory scrutiny, and the effects became stronger as public and regulatory attention increased under CRA during the 1990s.[201] This altered behavior might constitute a cost if CRA loans were not profitable, yet the Federal Reserve Board's evidence suggests that CRA lending is relatively profitable.[202]

5. Rent Seeking

Macey and Miller argued that CRA creates fertile ground for "extortion" by community groups using the application process to force banks and thrifts to make grants to their organizations.[203] But available evidence suggests that rent seeking under CRA is not of the size or scale alleged. As noted above, only a small percentage of applications receive public comment, and few are delayed or denied on that basis. The fact that community protests get banks and thrifts to issue voluntary pledges or make agreements with community groups to do more lending is not improper. Moreover, NCRC analysis suggests that only a small fraction of "CRA agreements," which are themselves a small fraction of CRA activity, result in payments—for services

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[200] RAPHAEL BOSTIC ET AL., REGULATORY INCENTIVES AND CONSOLIDATION: THE CASE OF COMMERCIAL BANK MERGERS AND THE COMMUNITY REINVESTMENT ACT 18 (Fed. Reserve Bank of Chicago, Working Paper No. WP-2002-06, 2002).
[201] *Id*. at 15-16.
[202] *See supra* text accompanying notes 175-180.
[203] There are theoretical grounds for believing there is less rent-seeking than suggested, given the highly public nature of CRA examinations, merger reviews, and "protests."

or otherwise—to the community groups making the "protest."[204] Even with respect to agreements involving payments, one must examine whether the payments are appropriate payments for services in furtherance of making sound loans (such as home buyer credit counseling), or are used for some unrelated purpose. Recent disclosures required under the "sunshine" amendments to CRA have revealed little evidence of the rent seeking feared.

6. Compliance Costs

Banks and thrifts also face other costs of compliance, such as paperwork burdens and the geocoding of loan data, but they are difficult to measure. The bank and thrift regulators estimated in 1999 that the annual compliance burden from CRA for data collection and reporting was about 550 to 625 hours per year for large banks, and about 10 hours per year for small banks, totaling 1.25 million hours per year and costing $35.4 million industry-wide.[205] That year, such a compliance burden would have constituted essentially zero percent of the $6 trillion in bank assets and 3 billion hours of total bank employee time,[206] and less than two tenths of one percent of the cost of bank regulation.[207] These estimates for large banks are much higher than they had been at the time of the 1995 reforms, as regulators had underestimated geocoding costs, but such costs have likely decreased since 1999.[208] Moreover, the 1995 regulations streamlined CRA compliance for small banks. Small banks are not required to collect or report small business or small farm lending data under CRA and examiners evaluate their performance based on data collected either in the normal course of business or pursuant to other regulations, including HMDA.

Surveys of bank compliance officers also suggest that the 1995 reforms reduced the compliance burdens of CRA. The overall compliance costs of CRA do not rank high, relative to previous years, in the most recent ABA survey of compliance burdens.[209] CRA ranked ninth out of twenty laws and regulations studied, just after Flood Insurance Rules.[210] This rank represents a

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[204] See National Community Reinvestment Coalition, CRA Commitments, 1977-1998 and internal Treasury analysis (on file with author).

[205] Submission for OMB Review, Comment Request, 64 Fed. Reg. 29083 (May 28, 1999).

[206] Sheshunoff Database, December 1998 (CRA-Banks and Thrifts with Assets Over $250 Million).

[207] This calculation derives from Gregory Elliehausen, The Cost of Bank Regulation: A Review of the Evidence (April 1998), at 23, *at* http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf (noting that total costs of bank regulation in 1991 were $15.7 billion). Presumably, the total cost of bank regulation increased between 1991 and 1999, thus the two-tenths of one percent estimate if anything overstates the relative cost of CRA data reporting.

[208] Geocoding costs have likely come down significantly since then, now that the fixed costs of new systems have been absorbed and loans can be entered automatically rather than manually.

[209] *The Nationwide Bank Compliance Officer Survey*, ABA BANKING JOURNAL, June 2003, at 35.

[210] The top 10 of the 20 studied, in order from most costly to least, were Bank Secrecy, Privacy, Truth in Lending, Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act, Truth in Savings, Fair Lending, Flood Insurance, CRA, and Electronic Funds Transfer Act. *Id.*

dramatic improvement over just a decade ago, when CRA often topped the ABA survey for most burdensome regulation before the 1995 reforms.[211]

7. Uncertainty

Some lenders are concerned that uncertainty about what will be required of them in the CRA examination itself raises compliance costs.[212] Costs may be higher because lenders spend more time documenting activities that turn out to be relatively unimportant to the examination, or because uncertainty induces them to undertake activities that in their best judgments are not safe and sound. One might categorize banks undertaking more CRA-eligible activity than necessary to achieve the bank's desired rating as a cost, even if the activity is profitable and sound. Although this additional activity may have an opportunity cost from the bank's perspective, the additional CRA activity, if prudent, also confers a social benefit that must be weighed in addition to the profit to the institution.

Although Macey and Miller charged that the pre-1995-reform CRA process was so vague as to give regulators unfettered discretion,[213] recent evidence suggests that CRA was generally consistently applied during the early 1990s. A recent study analyzing CRA examinations for several thousand commercial banks from 1990 to 1996 found that the scheduling of CRA examinations and the persistence of examination ratings tracked home mortgage loan levels and other key, objective factors.[214] In scheduling examinations, "supervisors allocate[d] their resources toward institutions with observed CRA compliance inadequacies."[215] Moreover, the "level of residential lending" influenced the CRA ratings of banks.[216] The study concluded that "CRA enforcement during this period reflected, at least in part, objective evaluation criteria."[217] Regulator consistency has likely improved under the 1995 reforms, which focus more on objective lending measures.

8. Shareholder Value

Shareholder value is another possible measure of compliance costs. One study argued that the 1995 CRA reforms had little effect on shareholder value and so did not reduce compliance costs.[218] The general problems faced by

[211] *See Bank Compliance Costs Equal More Than Half of Industry Profits*, BANKING POL'Y REP., July 6, 1992, at 5.
[212] 2002 JOINT CENTER CRA REPORT, *supra* note 149, at 117.
[213] Macey & Miller, *supra* note 18, at 326-29; *see also* Leonard Bierman et al., *The Community Reinvestment Act: A Preliminary Empirical Analysis*, 45 HASTINGS L.J. 383 (1994).
[214] Drew Dahl et al., *The Timing and Persistence of CRA Compliance Ratings*, 23 J. OF FINANCIAL SERVICES RESEARCH 113 (2003).
[215] *Id*. at 123.
[216] *Id*. at 130.
[217] *Id*. at 113.
[218] David P. Ely & Kenneth J. Robinson, *Is the Community Reinvestment Act in Need of Further Reform? Evidence from Equity markets during the 1995 Reform Process*, 23 J. OF FIN. SERVICES RES. 59 (2003).

event studies in general are well-known,[219] but carefully designed event studies can shed light on regulatory changes designed to enhance shareholder value. Yet an event study of a reform (like CRA) whose purpose was not solely to increase shareholder value, but rather to reduce compliance costs, increase lending, and focus on "performance, not paperwork," is more complicated to evaluate from an event-study perspective. For example, the CRA reforms may have had zero net effect on shareholders, while shifting compliance costs from less productive processes to investments that lead to more effective lending. In addition, given that the 1995 CRA reforms continued to employ a standard, with room for regulatory discretion, it is not surprising that the reforms did not generate a measurable increase in shareholder value immediately after the final rule was released. Gains (or losses) to shareholders would take a long time for even informationally efficient financial markets to transmit, as banks and thrifts and their regulators gained experience under the new CRA standards. As the authors acknowledge, their results "could also reflect substantial uncertainty over the benefits and costs that might arise from reform until it becomes clear how the new rules will be implemented."[220]

C. RESPONSES TO OTHER CRITIQUES

1. CRA Reasonably Addresses Market Failures

Michael Klausner argued at the time of the 1995 CRA reforms that CRA was the wrong response to market failures that he deemed likely to exist in low-income communities.[221] In particular, he contended that CRA impedes specialization among banks in serving low-income communities and makes it difficult for banks to internalize information externalities, either directly or indirectly through lending consortia. Klausner argued that banks and thrifts could not efficiently invest in the expertise needed to lend successfully in all the low-income communities within their assessment areas. Moreover, he argued, if many banks and thrifts seek to serve the same low-income area, each lender will not be able to internalize its information costs, as successful lending will benefit competitors in that area. Furthermore, with large numbers of creditors involved, coordination to develop loan consortia would be more difficult. In addition, Klausner suggested that competition from big banks seeking to meet CRA obligations would hurt specialized lenders focusing on low-income areas.

Klausner argued that less competition among banks for scarce loans in low-income areas, rather than more competition, would permit banks to internalize more of their costs and develop expertise in low-income areas. Instead of CRA, Klausner suggested a quota for lending to low-income borrowers that could be met by trading obligations among banks. In his view, a tradable quota would permit banks to specialize in lending to particular communities

[219] *See*, *e.g.*, Lucian Bebchuck et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1783 (2002) (discussing the problem of confounding events).
[220] Ely & Robinson, *supra* note 218, at 65 n.3 (internal citation omitted).
[221] Klausner, *supra* note 18, at 1564.

where they could invest in information, or in funding loans rather than originating them. Specialization would mean less competition, greater cost internalization, and easier coordination among fewer lenders seeking to form loan consortia in low-income areas. Lastly, he argued that a tradable quota would cost less than the discretionary standards implicit in CRA.

Based on nearly a decade of experience since the 1995 reforms, I argue that CRA is reasonably aimed at overcoming the market failures both Klausner and I believe to exist in low-income communities, and that the current CRA standard is preferable to the quota-and-trade system Klausner proposed.

First, fostering competition among banks and thrifts in serving low-income areas is good, not bad. Banks generally do not want to be the sole lender in a low-income community. Banks perceive less risk when other lenders are serving a low-income community after applying their own credit criteria regarding property values and neighborhood characteristics, loan terms, and borrower credit scores. Larger volumes of lending from diverse sources add liquidity to the market that decreases the riskiness of each bank's loan.

Second, CRA has helped, not deterred, banks in developing specialization in serving low-income communities. One important type of specialization spans geographic areas: innovation in developing products that meet the credit needs of low-income areas with manageable risks. And CRA does encourage banks to develop specialization in serving particular geographic areas. For example, banks partner with CDFIs and community-based organizations to penetrate low-income markets where they have not operated at scale before.

Third, competition from banks and thrifts under CRA has helped, not hurt, specialized lenders; these lenders complement, but do not replace, large institutions. Under CRA, banks and thrifts have entered markets where only specialized institutions such as ShoreBank had worked before. But the effect of entry has been positive. ShoreBank and other institutions like it demonstrated the possibility of lending in low-income communities and have partnered with banks on an ongoing basis. Specialized lenders provide local expertise, cover some of the costs of lending in low-income areas (such as financial education and counseling), and take portions of the risk of a particular loan or project that banks do not want to bear. In turn, banks have invested in CDFIs in record numbers, largely spurred by the CRA investment test. Investments in CDFIs strengthen the ability of banks and thrifts to serve low-income markets. As banks offer services once only offered by CDFIs, the local institutions move further "downstream," reaching lower-income or harder-to-serve borrowers, and developing new approaches that mainstream institutions may later find cost-effective. Specialized lenders play important roles in low-income communities, but they are no substitute for robust and competitive markets that include mainstream banks and thrifts.[222]

Fourth, CRA provides a pre-commitment device that actually helps banks coordinate lending to reduce information costs. Because CRA requires all

[222] *See supra*, Part VI.

insured depositories to lend to their entire communities, it reduces the free rider problems that would otherwise plague loan consortia. As evidence from the last decade attests, CRA has spurred the development of loan consortia to learn how to serve low- and moderate-income communities more effectively. The 1995 regulations treat loans made by such consortia as "community development lending" rather than home mortgage or small business lending. Yet community development lending is an important part of an institution's performance under the CRA lending test. Moreover, institutions can and do easily move consortia home mortgage or small business loans onto their own books as home mortgage or small business originations or purchases when appropriate, where they "count" toward the CRA lending test.[223]

Lastly, CRA after the 1995 reforms provides much of the flexibility and other benefits Klausner's proposal would have offered. And it does so without the downside of fixed quotas for lending, which are not required for a trading system to work. Under the 1995 reforms, banks and thrifts get equal CRA consideration for both originating and purchasing eligible loans, creating a sort of trading system. Institutions can rely on the origination expertise of others to purchase loans on the robust market for CRA loans. The development of this CRA loan market increases liquidity and reduces loan prices. It also improves transparency in CRA loan pricing, providing valuable information to regulators, communities, and banks and thrifts themselves about the performance and profitability of CRA lending.

2. CRA Does Not Make Banks Avoid Low-Income Communities

Macey and Miller charged that CRA created incentives for banks and thrifts to avoid opening deposit facilities in low-income communities because of the expense of complying with CRA.[224] Their contention was subject to challenge even at the time that they made it.[225] Today, the revised rules mean that view is clearly incorrect. Under the 1995 regulations, assessment areas "[c]onsist generally of one or more [metropolitan statistical areas] . . . or one or more contiguous political subdivisions, such as counties, cities, or towns" that include the census tracts "in which the bank has its main office, its branches, and its deposit-taking ATMs, as well as the surrounding [census tracts] in which the bank has originated or purchased a substantial portion of its loans."[226] A bank or thrift "may adjust the boundaries of its assessment area(s) to include only the portion of a political subdivision that it reasonably can be

[223] *See* 12 C.F.R. § 25.22(a)(3), (d) (2004); Community Reinvestment Act Regulations, Supplementary Information, Lending Test, Direct and indirect lending, 12 C.F.R. pt 25 (2004) ("Loans originated directly on the books of the institution or purchased by the institution are considered to have been made directly by the institution, even if the institution originated or purchased the loans as a result of its participation in a loan consortium.").

[224] Macey & Miller, *supra* note 18, at 296; *see also* Hylton, *supra* note 18, at 233.

[225] See, e.g., George Galster, *A Response to Schill and Wachter's The Spatial Bias of Federal Housing Law and Policy*, 143U . PA. L. REV. 1343 (1995).

[226] 12 C.F.R. § 25.41(c) (2004).

expected to serve."[227] However, assessment areas "[m]ay not reflect illegal discrimination" and "[m]ay not arbitrarily exclude low- or moderate-income geographies."[228] Banks can delineate their assessment areas as they see fit, subject only to these regulatory requirements.

The current definitions for assessment areas render Macey and Miller's critique inapt. Assessment areas are drawn broadly to comport with political boundary lines and usually include a diverse range of neighborhoods measured by income, race and other demographics. Putting a branch into a low-income neighborhood in a metropolitan area where a bank operates does not affect the bank's obligations under the lending test, which will already be based on the entirety of the community's income spectrum. Moreover, the regulation bars "arbitrarily exclud[ing]" low- or moderate-income areas regardless of whether the bank has a branch in such a neighborhood. Finally, regulators have discretion to evaluate a bank's lending outside its assessment areas, diminishing the importance of the areas' precise boundaries.

3. Applying CRA to Insured Depositories Is Justified

Critics of CRA argue that it makes little sense to apply CRA to banks and thrifts while exempting credit unions, independent mortgage companies and other finance companies—let alone securities firms, insurance companies, and non-financial companies—from similar regulation. There is some validity to the critique, but let me offer some basic reasons why applying CRA to banks and thrifts is not as illogical as critics suggest. Federally insured depository institutions benefit from numerous government subsidies, such as deposit insurance and access to the Federal Reserve Board's discount window. The first subsection details these and other subsidies while the next explains why such subsidies provide additional justification for applying CRA to banks and thrifts. The final subsection explains how depository institutions' specialized role in financial markets justifies CRA's application to them.

a) Subsidies

Deposit insurance subsidizes banks and thrifts by lowering their cost of capital. As Federal Reserve Chairman Alan Greenspan has described:

> [A] major reason the Congress is called upon to involve itself in … financial markets is the safety net. Institutions covered by it receive a subsidy because insured depositors correctly perceive their risk exposure as virtually zero. These depositors--and other creditors who benefit from the stability brought to the banking system by the safety net--are willing therefore to provide funds to banks at much lower rates than are available to competing institutions.[229]

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[227] *Id.* § 25.41(d).

[228] *Id.* § 25.41(e).

[229] *Hearing on H.R. 10 – "the Financial Services Act of 1998" – Before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. (1998) (testimony of Fed. Res. Bd. Chairman Alan Greenspan), *at* http://www.federalreserve.gov/boarddocs/testimony/1998/19980617.htm.

Most banks receive the benefits of deposit insurance at no annual cost to them. Under rules prescribed by the Deposit Insurance Fund Act of 1996, almost all banks—ninety-two percent—do not pay annual deposit insurance premiums.[230] More than nine hundred institutions have never paid any premiums for deposit insurance, and many institutions that have grown rapidly have paid low premiums compared with their coverage.[231] Even the weakest institutions pay only a $0.27 premium on every $100 of deposits.[232] While these rules strongly need reform, better risk-based pricing would not fully eliminate the governmental subsidy.[233] The government subsidy probably benefits small banks disproportionately to their asset size. Small banks rely more on insured deposits for funding than large banks. Furthermore, small banks would have a relatively hard time attracting funding in the absence of deposit insurance because they would be perceived as riskier.

Large banks and thrifts also likely benefit from a market perception that regulators will not let large institutions fail because the consequences to the financial system would be too severe. Regulators fostered this perception through a series of interventions, including in one instance an explicit "too big to fail" policy statement.[234] Important legal changes at the end of the 1990s that significantly curtailed the discretion regulators have to bail out uninsured depositors.[235] Yet the market perception likely persists that the government will intervene to assist large institutions[236] and that such assistance will benefit

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[230] Memorandum from Arthur J. Merton, Director of the Division of Insurance and Finance, FDIC, to Board of Directors, FDIC 16 (May 5, 2004), *at* http://www.fdic.gov/deposit/insurance/risk/2004_02/bif_2004_02.pdf.

[231] *Hearing on Federal Deposit Insurance Reform, Before the Sen. Comm. on Banking, Housing and Urban Affairs* (2002) (testimony of Fed. Res. Bd. Chairman Alan Greenspan), at http://www.federalreserve.gov/boarddocs/testimony/2002/20020423.

[232] Federal Deposit Insurance Corporation (FDIC), "Risk-Based Assessment System - Current Assessment Rate Schedule," *at* http://www.fdic.gov/deposit/insurance/risk/assesrte.html (visited July 19, 2004).

[233] *Hearing on Federal Deposit Insurance Reform*, *supra* note 231 (testimony of Fed. Res. Bd. Chairman Alan Greenspan) ("[W]e should not delude ourselves that even a wider range in the risk-based premium structure would eliminate the need for a government back-up to the deposit insurance fund, that is eliminate the government subsidy in deposit insurance.").

[234] *See* Harold A. Black et al., *Changes in Market Perception of Riskiness: The Case of Too-Big-to-Fail*, 20 J. FIN. RES. 389, ___ (1997) (finding that the 1984 announcement of the OCC's explicit "too-big-to-fail" policy resulted in increases in institutional holdings in bank holding companies, even among those not named by the Comptroller, providing evidence of an indirect subsidy to banks from the policy).

[235] *See*, *e.g.*, 12 U.S.C. § 1831o (prompt corrective action); *id.* § 1823(c)(4) (least cost resolution). Congress enacted both sections in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

[236] *See* JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION 248 (3d ed. 2001) (noting "the widespread public perception—substantially confirmed by the handling of the Continental Illinois National Bank failure—that certain banks are "too big to fail"). *But see Hearing on Federal Deposit Insurance Reform*, *supra* note 231 (testimony of Fed. Res. Bd. Chairman Alan Greenspan) (arguing that "the

creditors and shareholders even if they must bear some loss in the process. Evidence from the Federal Reserve Board's intervention when the hedge fund Long Term Capital Management (LTCM) collapsed in 1998 suggests that markets may have perceived a "too big to fail" subsidy. Large, complex banking organizations saw their cost of funds decline after the Federal Reserve Board's intervention, although such effects are difficult to disentangle from investors' general "flight to safety" following the LTCM collapse.[237] The subsidy from a "too big to fail" policy may have grown over the last decade, as consolidation has led to the growth of enormous banking institutions, with fewer intermediaries holding a larger percentage of deposits.[238]

Banks uniquely receive subsidies from other sources as well. The Federal Reserve Board's sponsorship of the payments network,[239] and its provision of riskless financial settlement by guaranteeing large payments among banks,[240] are additional sources of subsidy to the banking system.[241] Direct access to the Federal Reserve Board's discount window provides assurance to the market about banks' and thrifts' stability. It therefore allows institutions to obtain lower cost of funds, regardless of whether they draw on the window and of the price the Board charges. Lastly, banks benefit from subsidies through government-sponsored enterprises and other government programs. For example, bank members of the Federal Home Loan Bank (FHLB) system accrue 90 percent of the $3 billion in flows of governmental subsidy to the FHLBs, while only 10 percent is passed on to home buyers in lower mortgage rates.[242] Admittedly, the gross subsidies to banks are offset to some degree by the costs of bank regulation, including reserve requirements.[243]

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market clearly believes that large institutions are not too big for uninsured creditors to take at least some loss").

[237] CRAIG FURFINE, THE COSTS AND BENEFITS OF MORAL SUASION: EVIDENCE FROM THE RESCUE OF LONG-TERM CAPITAL MANAGEMENT 18-20 (2001).

[238] The share of deposits held by the top ten bank holding companies grew from 19 percent in 1993 to 34 percent in 2003. The largest bank holding company by deposit size held 7.6 percent of all deposits in 2003, compared with 3.7 percent a decade earlier. The number of banks and thrifts dropped over the last decade by 32 percent. The number of banks with over $10 billion in assets grew from 64 in 1994 to 110 a decade later, and the share of deposits held by such large institutions doubled over the last decade, from 30 percent in 1994 to over 60 percent last year. Author's calculations, based on FDIC Statistics of Deposits, at http://www.fdic.gov/sod.

[239] *See* Federal Reserve's Key Policies for the Provision of Financial Services, at http://www.federalreserve.gov/paymentsystems/pricing/default.htm (visited July 23, 2004).

[240] Kenneth Jones & Barry Kolatch, The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization, 12 FDIC BANKING REV. 1, 3 (1999).

[241] *Hearing on H.R. 10*, *supra* note 229 (testimony of Fed. Res. Bd. Chairman Alan Greenspan) ("The markets place substantial values on these safety net subsidies [such as the discount window and riskless financial settlement], clearly in excess of the cost of regulation. . . . [W]ere it otherwise, some banks would be dropping their charters.")

[242] Congressional Budget Office (CBO), "Federal Subsidies and the Housing GSEs," May 2001, *available at* http://ftp.cbo.gov/28xx/doc2841/GSEs.pdf, at 25-28 [hereinafter "CBO

b) Aligning Subsidies with PublicP urposes

Given that insured depositories receive significant governmental subsidies, the question remains whether such subsidies provide any justification for applying CRA to banks and thrifts. The first-best policy response to bank subsidies is to reduce such subsidies directly. For example, one could reduce subsidies from deposit insurance by establishing better risk-based pricing and ensuring that all institutions pay some premium. Regulators' refusal to intervene in financial markets could reinforce that there is no institution "too big to fail." The Federal Reserve Board could continue to move towards more market-based pricing of access to the payments system and the discount window.[244] GSE subsidies that are passed through to banks and thrifts could be reduced through higher capital standards and other means.

However, each of these first-best solutions to reduce bank and thrift subsidies has faced enormous political opposition and would entail significant costs. Deposit insurance reform legislation invariably includes increases in the amount subject to deposit insurance, and even better risk-based pricing would leave some significant governmental subsidy remaining. Refusal to intervene in financial markets is an important principle to announce in the abstract, but officials faced with difficult choices and uncertain information often intervene to prevent financial collapse. Pricing payment system services at true market rates might result in socially suboptimal development of payment networks.[245] Efforts to reduce GSE subsidies by increasing capital requirements and affordable housing goals while reducing indicia of government support have faced enormous political opposition. Moreover, squeezing subsidies out of Fannie Mae and Freddie Mac may simply balloon subsidies going to the FHLBs and insured depositories.[246]

Study 2001"]. Some portion of the subsidy that accrues to banks is passed on to non-home-mortgage borrowers of the banks.

[243] *See* Jones & Kolatch, *supra* note 240. Whether a net subsidy exists sparked vociferous debate during negotiations over financial modernization, with the Federal Reserve Board taking the self-interested position that such a subsidy was significant and thus new activities should be undertaken in affiliates within a holding company, and the OCC taking the self-interested position that no such subsidy exists, so that new activities could be undertaken in subsidiaries of national banks. The debate was effectively resolved by legislating "firewalls" between the bank and its affiliates and subsidiaries such that any net subsidy could not be effectively passed through to other entities engaged in new activities.

[244] *See, e.g.*, Federal Reserve Board, Press Release (Oct. 31, 2002) (noting changes to discount window regulations that would result in credit being provided through the discount window at rates above the target federal funds rate), at http://www.federalreserve.gov/boarddocs/press/bcreg/2002/200210312/default.htm.

[245] *See, e.g.*, Barr, *supra* note 1, at 222 (arguing that the Federal Reserve Board should consider lowering prices for certain electronic payment services in order to expand access to banking services for the poor).

[246] *See* White, *supra* note 4. Moreover, FHLB "reform" has tended to expand, rather than restrict, use of subsidized advances, and given the fungibility of money, nominally restricting use of advances, rather than reducing them, is unlikely to prevent FHLB members from absorbing the advances as undifferentiated subsidies in any event.

Given that we live in a second-best world in which these subsidies to banks and thrifts will remain, simply removing CRA would not restore credit markets to a "free market." Existing subsidies, taxes, and regulations distort the free market in a variety of ways. As a theoretical matter, one cannot assert, given these distortions, that moving from an "nth" best world with CRA to the next best world without CRA would be efficient. In a regulated, subsidized credit market world, it is not improper to ensure that some portion of the subsidy goes to a public purpose by applying CRA to banks and thrifts.[247]

c) Role in Financial Markets

Market failures have plagued low-income communities and that minority households have faced discrimination in credit and housing markets.[248] Given these problems, government regulation should encourage depositories to overcome them. Banks play a special role in financial markets by focusing on relational lending and investing in techniques to "thicken" the markets within which they operate by generating and analyzing information on opaque values.[249] This role is distinct from that of capital markets,[250] which focus on information-rich, transparent, and larger firms. It is even distinct from that of independent mortgage companies, which focus on transactions rather than relationships and thus have not similarly developed the technologies and expertise that permit banks to manage higher-risk borrowers.[251] CRA is consistent with insured depositories' specialized role.

The fact that credit unions are not subject to CRA is an anomaly in this regard. There is little justification in not extending CRA to credit unions, most of which enjoy federally insured deposit insurance, are subject to comprehensive regulation and supervision, and benefit from many of the subsidies available to banks and thrifts. Moreover, credit unions enjoy tax exemption not available to banks and thrifts and are chartered with a public purpose to serve "people of modest means."[252] For that reason, CRA should be extended to credit unions.[253]

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[247] *Cf., e.g.*, White, *supra* note 4 (explaining why eliminating the GSEs would not necessarily lead to more efficient policy outcomes).

[248] *See supra* Part III.

[249] *See, e.g.*, CANNER ET AL., *supra* note 190.

[250] *See id., (citing* P. Bolton & X. Freixas, *Equity, Bonds, and Bank Debt: Capital Structure and Financial Market Equilibrium Under Asymmetric Information*, 108 J. POL. ECON. 324 (2000); Boot & Thakor, *Financial System Architecture*, 10 REV. FIN. STUD. 693 (1997); Boot & Thakor, *Can Relationship Banking Survive Competition?*, 55 J. FINANCE 679 (2000)).

[251] CANNER ET AL., *supra* note 190. This may help to explain why subprime lenders focus on making loans to existing home mortgage borrowers as to whose creditworthiness others have already invested in learning.

[252] Credit unions are tax exempt, 12 U.S.C. § 1768 (2000), because their mission is to serve "people of modest means," 12 U.S.C. § 1751 (2000).

[253] I advocated this position as part of the Treasury team that developed a proposal to extend community investment obligations to credit unions, but the measure was defeated and was not included in the Credit Union Membership Act, Pub. L. No. 105-219 (Aug. 7, 1998).

4. Current Enforcement Methods Compare Favorably with Enforcement Through Safe Harbors

Peter Swire argued prior to the 1995 reforms that enforcement of CRA through both regular examinations and reviews after "episodic" protests of applications for mergers ought to be replaced with a safe harbor for institutions that achieve some given level of CRA performance.[254] In his view, a safe harbor would provide a strong incentive for banks to make more loans or invest in CDFIs at lower compliance cost. Under his proposal, regulators would set a target level of community development investment. If a bank met the target, the institution would not undergo CRA examinations or face CRA scrutiny during merger applications. Variations of the Swire proposal, under which banks receiving an "outstanding" rating on their most recent examination would not face CRA scrutiny during merger reviews, were discussed in 1995, and have been introduced in Congress repeatedly since then.

A safe harbor based on a bank's CRA rating has a number of disadvantages. First, a bank's CRA rating can become stale. Circumstances can change after an examination, examiners may miss evidence with respect to a particular market, or applications may involve new markets not covered under the examination. Banks and thrifts are usually examined every two to three years. A bank's performance may change significantly in the interim. The "safe harbor" would prevent regulators from considering such matters.

Second, CRA ratings are not conclusive. The ratings are intended to reflect a bank's performance in meeting the credit needs of all its communities. But an outstanding rating does not necessarily mean that the depository institution's record is exemplary in every market that it serves. Many of the communities served by depository institutions are not evaluated during an examination. In the case of large banks serving multiple markets, regulators only sample a portion of these markets to determine the lender's CRA rating. In addition, CRA performance in larger communities receives more weight. Thus, a bank may receive a "satisfactory" CRA rating even when there is documented poor performance in small communities.

Third, providing a safe harbor would eliminate or severely curtail the role of the public in shaping regulatory norms. As I argue more fully in Part VI, public engagement in setting CRA standards, while costly, is a value worth preserving. Under the safe harbor proposals, public input would be confined to regular examinations. It would be inefficient and costly for small community organizations to provide extensive comment on every bank examination. Public comment is more focused in the context of a change in a financial institution that is likely to have a significant impact on the community. Materials received during application processes often provide relevant and valuable information to regulators on an institution's CRA performance.

Under the Swire proposal, regulators would set numerical targets for investment and institutions meeting that target would not even be subject to

[254] Swire, *supra* note 18.

examination. The public role in CRA examinations would be eliminated. Numerical targets would ignore important contextual factors that influence a bank's or thrift's ability to make sound loans in low-income communities. A safe harbor could encourage banks to make less profitable and riskier loans than under the current approach, which takes into account the performance context within which the institution operates. A numerical target also raises serious objections on the grounds of credit allocation. Moreover, without regular CRA examinations, regulators would have no context in which to learn about how the best institutions meet the community's credit needs—which would seriously hamper the regulators' ability to set appropriate numerical targets, and would also undermine regulators' ability to share information about best practices with other institutions. Such sharing of best practices lowers the cost of innovation and provides significant benefits to banks and the communities that they serve. Fixed numerical targets, whether promulgated as a rule or a safe harbor, should be eschewed.

Fourth, the 1995 CRA regulations provide incentives for banks to achieve outstanding CRA ratings that safe harbors would not. The frequency of CRA examinations is based in part on previous CRA performance. Moreover, in CRA reviews during mergers, the regulators place great weight on the previous CRA examination. Despite some cases to the contrary, a strong prior CRA record is usually a good indicator for successful completion of CRA reviews during mergers.[255] Thus, current policy combines efficient use of agency resources with incentives for good performance, while ensuring that new information that comes to light during applications can be properly assessed.

As part of the Gramm-Leach-Bliley Financial Modernization Act, Congress codified additional incentives for small banks with good CRA ratings. Rejecting Senator Gramm's proposals for both a complete small bank exemption from CRA and a safe harbor for small banks with outstanding CRA ratings, Congress enacted a provision that generally increased the time between CRA examinations for small banks with outstanding and satisfactory CRA ratings. Under the Act, small banks with outstanding ratings will generally be examined every five years.[256] Small banks with satisfactory ratings will generally be examined every four years.[257] Notwithstanding these provisions, small banks will still be examined in connection with applications for deposit facilities and mergers, and may be examined more frequently when the regulator determines that there is reasonable cause.[258] While in my judgment such time periods are too long, they do provide an incentive for small banks with less frequent mergers to perform better under CRA. Unlike safe harbors, the Act retains regulators' discretion to examine banks more frequently when

[255] *But see* Macey & Miller, *supra* note 18, at 328-29, 334-37 (citing examples of community protests of institutions that had generally received good CRA ratings on prior examinations).
[256] 12 U.S.C. § 2908(a)(1) (2000).
[257] *Id.* § 2908(a)(2).
[258] *Id.* § 2908(b), (c).

appropriate and to undertake a CRA review when small banks merge or apply for deposit facilities, which can have significant effects on local communities.

5. Localism

Critics charge that CRA had its origins in "localist" rhetoric that has no place in the globalized financial marketplace. In a sense, they are correct. Some support for CRA has been, and is, rooted in old-fashioned notions that the local bank should lend locally or even that the local bank should use funds raised locally to lend locally. Today, bank geographic restrictions have largely given way to real competition in interstate banking and to massive consolidation in the industry. An emphasis on local lending loses a lot of its meaning in this context. Moreover, geographic diversification is an important element of most banks' safety and soundness. Still, there are some reasons to favor local lending, in the sense of having some local presence from which banks gain expertise and use their superior knowledge to find creditworthy borrowers and make profitable loans.

Yet supporters of CRA need not rely on localist theories, given that market failures and discrimination provide adequate foundations for CRA. Besides, CRA's current formulation does not lean heavily on localist policies. Large institutions operate across wide geographic areas and can raise funds and make loans consistent with their nationwide (or international) business plans. Institutions are not measured based on how the size of their lending in a particular location relates to the size of their deposits in that location, but rather to the lending of their peer institutions and other contextual factors. Loan consortia, as well as the active secondary market for CRA loans, which permits banks to purchase loans in order to enhance their CRA performance, further diminishes the "local" nature of CRA-eligible lending.

V. CRA Compared with Other Credit Market Regulations

Critics of CRA have argued that if the government must intervene in credit markets, it should do so through other means. The presence of market failures are an insufficient determinant of policy. The government may be ill equipped to intervene, and may choose strategies that either make the problems worse or cost more than their benefits. Government agencies might not possess the requisite information to regulate effectively, the agencies may not be able to induce the private sector responses sought, the bureaucracy might not faithfully execute the laws, or the political process might lead Congress or the bureaucracy to create laws that improperly favor the regulated entities or some other preferred groups.[259] The extent of these problems cannot be assessed in the abstract. One needs to compare CRA with other potential systems for redressing market failures.[260] Thus, to evaluate CRA, I compare it to a series

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[259] *See, e.g.*, Joseph E. Stiglitz, *supra* note 23, at 8-10.

[260] *See, e.g.*, Neil Komesar, Imperfect Alternatives (1994); Stiglitz, Economics of the Public Sector, *supra* note 23 (applying such types of comparative analysis).

of other policies designed to expand access to capital. This Part examines existing alternatives, while the next Part focuses on broader potential ones.

I classify credit market policies into five types. First, CRA sets forth a broad affirmative obligation on insured depository institutions to lend in their service areas. Second, negative prohibitions, such as the Equal Credit Opportunity Act (ECOA),[261] bar discrimination against minority borrowers. Third, disclosure laws may be thought of as having two sub-types. Some laws, such as the Home Mortgage Disclosure Act (HMDA),[262] assist in the enforcement of other legal rules or social norms by requiring public disclosure of lending data. Other disclosure laws, such as the Truth in Lending Act (TILA),[263] rely on providing information to consumers to ensure a well functioning market, backed by enforcement of the disclosure requirement. Fourth, Congress enacted substantive regulation of loan products in the Home Owners Equity Protection Act (HOEPA).[264] Fifth, government subsidies are pervasive in the housing credit market.[265] This Part compares CRA to the other four approaches to credit market regulation. I argue that on many measures, CRA is no worse, and in some cases better, than these alternatives. Further comparative institutional analysis based on empirical research will be critical to understanding the relative efficiency of these laws.

A. Background

This Section sets out a brief background on each of the relevant laws. A trio of laws—CRA, HMDA, and ECOA—was enacted in the 1970s to address perceived problems in credit markets. HMDA requires most home mortgage creditors annually to disclose to the public information about home mortgage loans made or purchased, as well as loan applications denied.[266] Regulations require disclosure of race, ethnicity, sex, and income of borrowers. Unlike TILA,[267] HMDA is not designed to enhance borrower information. Rather, HMDA is designed to increase the ability of the public, regulators, and fair

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[261] 15 U.S.C. §§ 1691-1691f.

[262] 12 U.S.C. § 2801. The Federal Reserve Board implements HMDA under Regulation C, 12 C.F.R. pt. 230.1.

[263] 15 U.S.C. §§ 1601, 1602(aa), 1639(a)-(b). The Federal Reserve Board implements TILA under Regulation Z, 12 C.F.R. pt. 226.1.

[264] Pub. L. No. 103-325, § 151, 108 Stat. 2190 (1994).

[265] *See, e.g.*, White, supra note 4 (arguing that it "is possibly only a slight exaggeration to claim that when it comes to housing and especially home ownership, the ethos of public policy has been (and continues to be) 'too much is never enough' ").

[266] 12 U.S.C. §§ 2801, 2803 (2000). HMDA was enhanced significantly in 1989, for example, by requiring data to be not only reported to the regulators, but also disclosed to the public.

[267] TILA was designed to help consumers compare the costs of credit offered by requiring the disclosure of the Annual Percentage Rate (APR), the finance charge, the amount financed, and the total of all payments. The theory was that enhanced disclosure would improve price information and thereby enhance competition. *See* Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information*, 127 U. PA. L. REV. 630, 635 (arguing for disclosure rather than product regulation). Unfortunately, TILA is extraordinarily complex. *See, e.g.*, Emery v. Am. Gen. Fin., Inc., 71 F. 3d 1343, 1346 (7th Cir. 1995) (Posner, J.) ("So much for the Truth in Lending Act as a protection for borrowers.").

lending enforcement agencies to assess whether lenders are engaged in discriminatory practices and how lenders are meeting their CRA obligations. Because HMDA does not include information on creditworthiness, loan terms, or property characteristics, HMDA data alone provide poor measures of discrimination. However, wide availability of these data has empowered the public to assess on financial institution performance.

ECOA prohibits creditors from discriminating in the provision of credit on the basis of "race, color, religion, national origin, sex or marital status, or age."[268] For home mortgage lending, that prohibition is also reinforced by the Fair Housing Act of 1968.[269] The federal banking regulators supervise and examine depository institutions for compliance with ECOA and may take enforcement action against institutions found to discriminate. While the Federal Trade Commission enforces ECOA against non-depository creditors, it lacks the authority to supervise or examine these creditors. The Department of Housing and Urban Development (HUD) has responsibility for investigating complaints under the Fair Housing Act, and the Department of Justice has responsibility for bringing cases alleging a "pattern or practice" of fair lending violations under either act against any creditor.

Congress enacted HOEPA[270] in 1994 to respond to unscrupulous lending practices in the subprime home equity mortgage market. For some "high cost" loans, HOEPA imposes restrictions on certain contract provisions, provides for enhanced disclosures, and enhances remedies for violations.[271] HOEPA restricts prepayment penalties, balloon payments, and negative amortization under some circumstances. Lenders are forbidden from engaging in a pattern or practice of making high-cost loans without regard to the borrower's ability to repay from income (rather than from home equity). For any mortgage loan, the Federal Reserve Board has regulatory authority to prohibit acts or practices that the Board finds to be unfair, deceptive, or designed to evade HOEPA. The Board can also prohibit acts or practices in connection with refinance loans that the Board finds to be abusive or not in the interest of the borrower.

In addition to product regulation, HOEPA provides directly and indirectly for enhanced disclosures for borrowers facing high cost loans. HOEPA directly enhances disclosure by requiring creditors to disclose mortgage terms

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[268] 15 U.S.C. §1691.

[269] 42 U.S.C. §3605. The Fair Housing Act also covers other forms of discrimination in residential real estate transactions beyond fair lending violations.

[270] Pub. L No. 103-325, § 151, 108 Stat. 2190 (1994).

[271] HOEPA covers mortgage refinancing loans and closed-end home equity loans with annual percentage rates more than 8 percentage points above the yields on comparable Treasury securities or loans with certain points and fees that exceed 8 percent of the loan amount or an amount adjusted for inflation (just under $500 for 2004). The statute sets a default rate of 10 percentage points above comparable Treasuries, but the Federal Reserve Board has the authority to adjust downward to 8 percentage points or upward to 12 percentage points. The Board adjusted the APR to 8 percentage points in 2001. Final Rule, Federal Reserve System, 12 C.F.R. Part 226, Truth in Lending, 66 Fed. Reg. 65604, Dec. 20, 2001.

three days in advance of closing. Indirectly, HOEPA product restrictions tend to drive more of the cost of the loan into the APR so that consumers can better understand the costs of the loan and comparison shop.

Finally, there are a series of subsidies to credit. Most housing subsidies are not aimed at improving access to credit for low- and moderate-income borrowers or redressing housing discrimination. Rather, they mostly subsidize the "American dream" of homeownership for all. Subsidies to home mortgage credit include government insurance (through the Federal Housing Administration (FHA), and the Government National Mortgage Association ("Ginnie Mae")) and government-sponsored enterprises (GSEs),[272] including the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Federal Home Loan Bank (FHLB) system. Tax expenditures and grant programs, including the home mortgage interest and property tax deductions, as well as a wide range of other programs, also affect housing markets. I leave analysis of the housing subsidies in the tax code for others,[273] or another day. Here I focus only on comparing CRA to FHA and the GSEs as illustrative.[274]

During the Great Depression, Congress established FHA, the FHLBs, and Fannie Mae to fill a gap left by the collapse of the private mortgage insurance industry "under the weight of a default rate approaching 50 percent and foreclosures exceeding 1,000 per day…."[275] FHA, which operates within

[272] "In general, GSEs are financial institutions established and chartered by the federal government, as privately owned entities, to facilitate the flow of funds to selected credit markets…." Congressional Budget Office (CBO), "Federal Subsidies and the Housing GSEs," May 2001, *at* http://ftp.cbo.gov/28xx/doc2841/GSEs.pdf, at 1 [hereinafter "CBO Study 2001"].

[273] *See*, EDWARD L. GLAESER & JESSE M. SHAPIRO, THE BENEFITS OF THE HOME MORTGAGE INTEREST DEDUCTION (Harvard Inst. of Econ. Research, Discussion Paper No. 1979, Oct. 2002), *at* http://post.economics.harvard.edu/hier/2002papers/2002list.html (demonstrating that the home mortgage interest deduction largely benefits upper income married homeowners who would have owned a home in any event); BRADY ET AL., REGIONAL DIFFERENCES IN THE UTILIZATION OF THE MORTGAGE INTEREST DEDUCTION (Office of Tax Analysis Working Paper 88, U.S. Dep't of Treasury, 2001) (finding that the subsidy from the mortgage interest deduction benefits high income homeowners more than twice as much as homeowners earning at or below the median); *see also* Steven C. Bourassa & William G. Grigsby, *Income Tax Concessions for Owner-Occupied Housing*, 11 HOUSING POL'Y DEBATE 521, 523 (2000); James R. Follain & Robert M. Dunsky, *The Demand for Mortgage Debt and the Income Tax*, 8 J. HOUSING RES. 155 (1997); James R. Follain & Lisa Sturman Melamed, *The False Messiah of Tax Policy: What Elimination of the Home Mortgage Interest Deduction Promises and a Careful Look at What It Delivers*, 9 J. HOUSING RES.179 (1998); John C. Weicher, *Comment on Steven C. Bourassa and William G. Grigsby's "Income Tax Concessions for Owner-Occupied Housing,"* 11 HOUSING POL'Y DEBATE 547 (2000).

[274] In addition to subsidies in the credit markets, subsidies affect other aspects of the home mortgage transaction, and other subsidies assist households who rent, including the section 8 voucher program and the Low Income Housing Tax Credit. While these non-credit-market subsidies are beyond the scope of this article, they nonetheless alter the market context for home mortgage credit, and themselves may be alternatives to subsidizing the credit market.

[275] Pennington-Cross & Yezer, *supra* note 119, at 358.

HUD, insures home mortgage loans made by private lenders in the event of default. FHA is intended to serve borrowers "who lack the savings, credit history or income to qualify for a conventional mortgage."[276] Ginnie Mae, also within HUD, provides a credit enhancement to pools of FHA loans and places them for sale on the secondary market. From its inception in 1934 to 2001, the FHA insured nearly 30 million home mortgages.[277] In 2002 alone, FHA insured $150 billion in mortgages for nearly 1.3 million households.[278]

The housing GSEs—Fannie Mae, Freddie Mac, and the FHLBs—were created to "provide liquidity and stability to the home mortgage market, thereby increasing the flow of funds available to mortgage borrowers."[279] Fannie Mae and Freddie Mac issue debt to buy and hold mortgages in portfolio, and insure mortgage-backed securities issued to investors.[280] Fannie Mae and Freddie Mac are restricted to the market for conventional, conforming loans,[281] and essentially fund all net new loans meeting those criteria.[282] The FHLBs were created to provide short-term loans ("advances") to thrifts in order to stabilize mortgage lending in local markets. Today, FHLB membership is broad, including the largest commercial banks, and advances to members can be issued on a variety of collateral and used for any purpose.[283]

The GSEs are subject to capital requirements and regulatory oversight. The Office of Federal Housing Enterprise Oversight (OFHEO) regulates Fannie Mae and Freddie Mac.[284] Fannie Mae and Freddie Mac currently hold capital well in excess of the amounts required,[285] but recent accounting problems at Freddie Mac have undermined confidence that the GSEs, and their regulators, have an adequate grasp on their risk. HUD setsaffordable housing

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[276] DEPT. OF HOUSING & URBAN DEVELOPMENT, FISCAL YEAR 2004 BUDGET SUMMARY 13 (Feb. 3, 2003) *available at* http://www.hud.gov/about/budget/fy04/budgetsummaryu.pdf, [hereinafter "HUD BUDGET SUMMARY"].
[277] Dept. of Housing & Urban Development, About Housing, *at* www.hud.gov/offices/hsg/hsgabout.cfm (visited Aug. 6, 2004).
[278] HUD BUDGET SUMMARY, *supra* note 276, at 13. 36 percent were minority.
[279] Statement of CBO Director Dan L. Crippen before the Committee on Financial Services, May 23, 2001, *available at* ftp://ftp.cbo.gov/28xx/doc2839/GSE-Testimony.pdf, at 1. *See also*, Treasury Dept., "Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation," July 1996 [hereinafter "Treasury Study"].
[280] Treasury Study, *supra* note 279, at 1. Fannie Mae was a government corporation, but Congress divided its functions into two parts, and Fannie Mae became a GSE in 1968. Ginnie Mae, the part that remained government-owned, insures securities of FHA loans.
[281] *Id.* Conventional loans are those not backed by government insurance. Conforming loans are those that are under the dollar limit set annually for GSE purchases.
[282] CBO Study 2001, *supra* note, at 28.
[283] *Id.*; *see also* CBO Study 2001, supra note 242, at 4.
[284] Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501-4641 (2000); OFHEO, Press Release, OFHEO Issues Capital Classifications for Fannie Mae and Freddie Mac, June 30, 2003, *at* http://www.ofheo.gov/media/pdf/ofheocc063003.pdf ["OFHEO 2003 Capital Classifications"].
[285] *Id.*

goals for Fannie Mae and Freddie Mac. The Federal Housing Finance Board regulates the FHLBs.

B. CRA COMPARED WITH FAIR LENDING LAW

Critics of CRA contend that, if CRA is aimed at redressing racial discrimination, the government should simply enforce ECOA instead.[286] ECOA does seem to help increase lending to minorities. For example, the share of bank and thrift lending to low- and moderate-income borrowers and areas that went to minority borrowers increased from 21 to 28 percent from 1993 to 1999. Most of the increase occurred during a period of intense Justice Department focus on enforcing fair lending laws, from 1993 to 1995.[287]

Yet CRA may help uncover some practices with discriminatory effects that both disparate treatment analysis and disparate impact analysis as they are currently formulated have a hard time detecting or remedying. For example, ECOA's disparate treatment and impact tests cannot easily detect discriminatory overages, yield spread premiums, risk-based pricing, or segmented markets.[288] Moreover, relying on ECOA lawsuits alone to advance anti-discrimination norms has its own limitations. Few ECOA lawsuits have been brought. Developing proof of lending discrimination is costly and difficult. When credit scoring is not the sole basis for a lending decision, lenders have a high degree of discretion, particularly in the case of applicants who are neither highly qualified not unqualified. Even when credit scoring is the sole basis, disparate treatment might arise when creditors subjectively evaluate data before entering it into the credit system, when creditors provide different levels of assistance to borrowers in completing credit applications, or when creditors permit overrides of credit scoring in close cases. Given the complex and proprietary nature of credit scoring systems, and the difficulty of proving that any two applicants are similarly situated except for race, disparate treatment is hard to prove. Disparate impact analysis is often no easier. Creditors have essential information about their loan portfolio and proprietary credit evaluation systems and the weights placed on all the variables in their system. Plaintiffs do not have such information, and creditors resist revealing their methodology because of competitive concerns.[289]

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[286] Klausner, *supra* note 18, at 1563-64.

[287] LITAN ET AL., FINAL REPORT, *supra* note 142, at 27. The Justice Department cases resulted in important consent decrees. *See* Consent Agreement, United States v. Long Beach Mortgage Company, No. CV-96-6159 (C.D. Cal., Sept. 5, 1996); Consent Agreement, United States v. First National Bank of Vicksburg, No. 5-94-CV-6(B)(N) (S.D. Miss., Jan. 21, 1994); Consent Agreement, United States v. Shawmut National Corporation, No. 93-CV-2453 (D. Conn., Dec. 13, 1993); Consent Agreement, United States v. Decatur Federal Savings and Loan Association, No. 1-92-CV-2198-CAM (N.D. Ga., Sept 17, 1992).

[288] *See generally* ROSS & YINGER, *supra* note 77. *But see* Cason v. Nissan, No. 3-98-0223, (M.D.T.N. May 25, 2001) (ECOA suit based on discriminatory overages in automobile market leading to settlement order).

[289] *See generally* ROSS & YINGER, *supra* note 77

ECOA's weaknesses do not necessarily imply that CRA is the only, or even the best, answer to credit market discrimination. ECOA itself sets out important anti-discrimination norms, and should be strengthened. And building on the strength of HMDA, "cross-modal" strategies, such as a disclosure law requiring creditors to disclose the borrower's credit score and the creditor's rate sheet, could help address price discrimination. A new law on product regulation could bar the payment of yield spread premiums, which disproportionately fall on minority borrowers.

Still, CRA plays an important role in reinforcing the anti-discrimination principles underlying ECOA and in expanding access to credit for minority borrowers. Minority households are disproportionately represented among low- and moderate-income households and in low- and moderate-income communities. CRA has encouraged banks and thrifts to increase their lending in such communities significantly, and minority households now constitute a larger share of such lending than they did a decade ago. CRA's focus on low-income neighborhoods may address structural inequalities facing African Americans and other minorities more effectively than ECOA's disparate impact standard, which is hemmed in by equal protection jurisprudence and the business necessity defense.[290] Moreover, CRA goes beyond ECOA's focus on credit discrimination to address broader market failures affecting low-income borrowers and communities. While CRA helps to reinforce ECOA, fair lending laws are no substitute for CRA.

C. CRA Compared with Disclosure Law

Disclosure laws are perennial favorites in the legal literature.[291] I agree that disclosure can help to improve the home mortgage credit market. However, I take issue with disclosure advocates on three grounds. First, disclosure serves a broader set of purposes than usually posited. Second, I have a healthier dose of skepticism about the effectiveness of disclosure in helping households than legal scholars have recently espoused.[292] Third, I argue that disclosure is no substitute for CRA.

There are two basic types of disclosure: disclosures designed to improve market efficiency by making consumers better shoppers and disclosures designed to help regulators enforce other laws and push markets towards compliance with social norms. TILA represents the first type, requiring disclosures to individual consumers regarding the cost of loans that they

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[290] *See, e.g.,* Richard A. Primus, Equal Protection and Disparate Impact: Round Three, 117 HARV. L. REV. 493, 499 (2003) (lamenting "the growing tendency of equal protection jurisprudence to obscure the dynamics of group hierarchy and to truncate the memory of historical discrimination").

[291] *See*, *e.g*., Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

[292] *See* Camerer, et al., *supra* note 291 (arguing that HOEPA disclosures respond adequately to consumers' need for more information about high cost loans).

negotiate, calculated as an APR.[293] This type of disclosure seeks to remedy asymmetric information and improve market competition and efficiency.[294]

HMDA represents the second type of disclosure, requiring information not only for the consumer but also for regulators and the market generally. These broader disclosures reinforce positive social norms, promote market efficiency, and enhance the regulatory effectiveness of other laws.[295] The collection and public disclosure of information is the essential underpinning of CRA, ECOA, and HOEPA in expanding access to credit. Public debate over this performance likely contributed to increased lending to minorities in the 1990s.

Yet relying on HMDA alone to overcome market failures and discrimination could in theory lead to "over-enforcement" of anti-discrimination and community investment norms. HMDA information does not contain measures of creditworthiness, loan terms, or property characteristics that influence creditor decisions. Relying on HMDA data alone can lead to dramatic overstatements of lending discrimination. Similarly, HMDA data do not provide any context for understanding creditors' ability to lend in low-income communities, so banks and thrifts might face undue pressure to make unsound loans. Conversely, relying solely on public disclosure could lead to under-enforcement of equal protection and community investment norms. Without fair lending laws, HMDA's disclosure might convey less approbation. Without CRA, disclosure under HMDA that a bank did little lending in low-income communities would have little consequence.

Although HOEPA's disclosure requirements and TILA facilitate comparison shopping by consumers, in some cases too much information is provided for consumers to use, and in other cases too little,. Even outside of the subprime market, there is little reason to think that consumers understand most aspects of mortgage transactions.[296] Decision theory suggests a need for simplicity: individuals faced with complex problems simplify them to one or

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[293] 12 C.F.R. pr. 226.18(e), 226.4(a) [need year of code edition cited].

[294] *See* The Congressional Findings and Declaration of Purpose for TILA, 15 U.S.C. § 1601; Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1280-81 (2002); Schwartz & Wilde, *supra* note 267, at 635 ("Because more consumers will become informed if information acquisition costs are decreased, reducing these costs is thought to be the preferable response to the problem of imperfect information.") (footnote omitted).

[295] The Federal Reserve Board recently amended its HMDA regulations to require lenders to report certain price information about high-cost loans. HMDA reporting could be improved further by requiring information on interest rate and fees. *See* Treasury Comments on the Federal Reserve Board's proposed rules under Regulation B, C, and Z.

[296] *See* JOINT STUDY ON THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, *available at* http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf; *see also* Lauren E. Willis, Decisionmaking & the Limits of Disclosure: The Problem of Predatory Lending (draft Jan. 2004, on file with author).

two major decisions.[297] In addition, mortgage brokers can take advantage of borrowers, who trust mortgage brokers to provide them with full and accurate information and to provide them with the best loan product. Yet it is in the broker's interest to provide the borrower with the highest rate loan that the broker can convince the borrower to accept. Brokers can earn higher yield spread premiums for placing borrowers into more expensive loans than ones for which the borrower could qualify. Unlike retail consumer markets in which commodities are nearly impossible to price differentially (e.g., Cheerios in supermarkets), individual transactions for home mortgages present the possibility for price discrimination based on sophistication and willingness and ability to shop for better terms.[298] With credit scoring, creditors know whether borrowers qualify for a less expensive loan, while most borrowers do not.[299]

The efficacy of disclosures is diminished by inadequacies in the nature and timing of disclosures,[300] their limited effect on consumer behavior, and consumers' cognitive limitations. First, TILA disclosure typically occurs after a deal has been negotiated and the consumer has invested substantial lender-specific search and negotiation costs.[301] Second, TILA disclosure may not actually be noticed, read, or understood by consumers, who often have limited finance or English-language skills.[302] In one survey, 75 percent of respondents either agreed somewhat or agreed strongly that TILA statements are complicated.[303] Third, TILA disclosures may inundate the consumer with so much data that the most important aspects of the contract, such as the APR, are swallowed by the details.[304] The need for simplicity conflicts, however, with the goal of producing comprehensive disclosures that would permit consumers

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[297] *See*, *e.g.*, JONATHAN BARON, THINKING AND DECIDING (3d ed. 2000); ROBIN HOGARTH, JUDGMENT AND CHOICE (2d ed. 1987); SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING (1993).

[298] *See* JACKSON & BERRY, *supra* note 114, at 63. Ayres has documented similar price discrimination in automobile sales and other markets. *See* AYRES, *supra* note 109.

[299] FICO scores are now available to borrowers upon request. Empirical research is needed on whether this access has been used.

[300] William N. Eskridge, Jr., *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083, 1128-30 (1984); Jonathan M. Landers & Ralph J. Rohner, *A Functional Analysis of Truth in Lending*, 26 UCLA L. REV. 711, 715-16 (1979) (discussing the timing problem). Early disclosure is now required by Regulation Z, 226.19(b), 226.5a, 226.5b.

[301] *See* Eskridge, *supra* note 300, at 1129 (noting that home buyers tend to submit only one loan application because most lenders charge a nonrefundable application fee of several hundred dollars); Landers & Rohner, *supra* note 300, at 717-21; L.G. Tesler, *Searching for the Lowest Price*, 63 AM. ECON. REV. 40 (1973).

[302] Elizabeth Renuart, Comment, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in a Tale of Three Markets Point in the Right Direction*, 82 TEX. L. REV. 421, 432 (2003).

[303] Thomas A. Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FED. RES. BULL. 201, 208 tbl. 9. (2002).

[304] Eskridge, *supra* note 300, at 1133-35; Landers & Rohner, *supra* note 300, at 722-25.

to comparison shop based on the real price of loans. Fourth, this effect is exacerbated for low-income and minority buyers, for whom alternative credit options are more limited. Low-income buyers are the least likely to be aware of alternative credit options and the least likely to shop for alternate financing arrangements.[305] Each of these problems is exacerbated in the subprime market, making disclosure laws even less likely to be effective.[306]

Disclosures can and should undoubtedly be improved,[307] but the current structure of the home mortgage market in low-income communities suggests that disclosure will not significantly affect either consumer or creditor behavior. Financial education can play a role in helping consumers understand disclosures better. It is hard to find scholarly literature or policy advocates who do not end a discussion of disclosure with a call for consumer financial education. The problem is that financial education is notoriously hard to do well. And expenditures for it lead to strong positive externalities, so it is quite difficult to induce market participants to offer financial education to the borrowing public at anything like the scale it would take to matter.

These problems explain why disclosure laws are no substitute for CRA. CRA gives strong incentives on banks and thrifts, those most able to alter their behavior in response to the problem of information asymmetry and collective action.[308] CRA can enhance competition in fragmented markets where disclosures seem unlikely on their own to significantly affect market structure. CRA also enlists expert agencies to further its goals, rather than relying solely on the public to change creditor behavior either in response to HMDA data or one loan at a time through TILA disclosures.

D. CRA COMPARED WITH ABUSIVE PRACTICE PROHIBITIONS

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[305] *See, e,g.*, Jack Guttentag, DOES IT PAY TO SHOP FOR A MORTGAGE? (1998), available at http://www.mtgprofessor.com/tableofcontents.htm; Jeanne Hogarth & Jinkook Lee, *Consumer Information for Home Mortgages: Who, What, How Much, and What Else?,* 9 FIN. SERVICES REV. 277 (2000); Jeanne Hogarth & Jinkook Lee, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MARKETING, SPECIAL ISSUE ON PRICING AND PUBLIC POLICY 66 (1999).

[306] *See* Barry Zigas & Paul Weech, The Rise of Subprime Lending: Causes, Implications, and Proposals, Lending to Borrowers with Blemished Credit: Challenges and Opportunities 26 (Fannie Mae, Discussion Draft, Oct. 2001); *supra* Section III.C.

[307] *See, e.g.*, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134 (proposed July 29, 2002) (proposing significant simplification). *But see* Comments of the Staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission, Before the Department of Housing and Urban Development, in the Matter of Request for Comment on Proposed Amendments to the Regulations Implementing the Real Estate Settlement Procedures Act, Docket No. FR-4727-P-01 (Oct. 28, 2002) (arguing that HUD's proposal would not assist consumers).

[308] *Cf., e.g.*, GUIDO CALABRESI, THE COST OF ACCIDENTS (1970) (discussing the "cheapest cost avoider").

HOEPA's record has been decidedly mixed.[309] Given the characteristics of the lower-income consumer credit market—high demand from a population with imperfect or limited credit history, many lightly regulated players and little competition from mainstream lenders—the potential for abuses is ripe. A Treasury-HUD report that I co-directed proposed a four-part approach to curbing predatory lending: improve consumer literacy and disclosure, prohibit harmful sales practices, restrict abusive terms and conditions, and improve overall market structure.[310] None of the legislative changes have been enacted, but the Federal Reserve Board issued a rule addressing the harmful sales practices and abusive terms often associated with high-cost mortgages using its existing authority under HOEPA.[311] This rule takes significant steps towards limiting abusive practices, but congressional action would improve matters further,[312] The Board's requirement that creditors document and verify a borrower's ability to repay will help deter asset-based lending.[313] Rule changes made in December 2001,[314] under the Board's HMDA authority, complement its efforts on predatory lending by requiring disclosure of certain rate spreads and of whether a loan exceeds HOEPA triggers.[315] Many other improvements to abusive practice regulation are possible, as states are experimenting in this area and various cross-modal strategies have promise.

CRA could play an increasingly important role in reducing abuses. Banks and thrifts can, and should, play an important role in improving competition in the credit market for lower-income consumers. Low-income markets can be profitable for banks,[316] and recent census data confirm that minority and new

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[309] *See, e.g.*, U.S. Department of Treasury and U.S. Department of Housing and Urban Development, Curbing Predatory Home Mortgage Lending: A Joint Report (June 2000) (co-directed by the author) (gathering extensive evidence of predatory practices despite HOEPA).
[310] *See id.*; Barr, *supra* note 127.
[311] Final Rule, Federal Reserve System, 12 C.F.R. Part 226, Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001).
[312] Congress could bolster the Board's action in a number of ways, including: banning the financing at or before closing of single premium credit insurance, products often "packed" into subprime loans; requiring lenders to report the full credit histories of borrowers to the credit bureaus; requiring lenders to offer the borrower a choice of a loan without a prepayment penalty; and including "yield spread premiums" in the points-and-fees trigger for HOEPA. *See* U.S. Department of the Treasury Comment on Regulation Z (Truth in Lending Act; Home Ownership and Equity Protection Act) Proposed Rulemaking Docket No. R-1090. Yield spread premiums permit lenders to pass on the cost of a mortgage broker fee to the borrower in the form of a higher interest rate rather than in the form of a cash payment at closing.
[313] Stronger requirements might deter asset-based lending even more. *See* U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *supra* note 309 (suggesting documentation of ability to repay be signed by broker and acknowledged as received by borrower 3 days prior to closing).
[314] Federal Reserve System, Home Mortgage Disclosure; Final and Proposed Rule, 12 C.F.R. Pt. 203, 67 Fed. Reg. 7,221 (Feb. 15, 2002).
[315] The rule could be strengthened by requiring disclosure of all rate spreads, points, and fees, as well as other loan characteristics. *See* U.S. Department of the Treasury Comment on Regulation C (Home Mortgage Disclosure Act) Proposed Rulemaking Docket No. R.-1001.
[316] *See, e.g.*, Performance and Profitability, *supra* note 176.

immigrant communities will need to be a growing share of any bank's customer base. Banks can get ahead of the curve by moving more quickly and creatively to serve central city markets where these growth populations tend to live and work. Competition from banks and thrifts can help to drive out abusive practices and improve price transparency in these markets. Low-income borrowers may be ending up in a bank's subprime unit or affiliate when they could qualify for better terms. Banks and thrifts should have in place procedures to "upstream" these borrowers with good credit histories into their prime units. Regulators should give CRA consideration for "promoting" borrowers from the subprime to the prime market. In this way CRA can help thwart abuses in the subprime market without cutting off access to credit.

CRA has other advantages over HOEPA's product regulation approach. CRA covers all bank and thrift loans, not simply loans that are "high cost." CRA is designed to expand access to the full array of credit products, not simply to weed out bad actors or discourage predatory lending. In addition, HOEPA's product regulation approach is more prescriptive than CRA. CRA does not dictate that banks or thrifts provide or withdraw any particular loan product or service, but leaves decisions about business strategy and product design to the banks and thrifts. Lastly, unlike HOEPA, CRA attempts to bring low-income households into the financial services mainstream.

E. CRA COMPARED WITH SUBSIDIES

One alternative to CRA is to rely more on subsidies. In principle, subsidies should be used "to make marginal private costs equal to marginal social costs, and to make marginal benefits equal to marginal social benefits."[317] In practice, this is hard to do. Substantively, it is hard to get private market actors to respond to government subsidies unless the subsidies are robust. Politically, it is hard to prevent the subsidies from becoming too robust. Subsidies are pervasive in the home mortgage market.[318] In this section, I focus only on the GSEs and FHA as alternatives to CRA, while in Part VI I explore other, hypothetical subsidies that could be deployed. With respect to Fannie Mae, Freddie Mac, and the FHLBs, the subsidies are large in comparison to the benefits accruing to low-income, moderate-income, and minority borrowers.

The GSEs benefit from their relationships with the federal government in a variety of ways. They are exempt from state and local taxation,[319] are exempt from Securities and Exchange Commission (SEC) registration,[320] can

[317] STIGLITZ, *supra* note 23.

[318] *See*, *e.g.*, White, *supra* note 4, (arguing that it "is possibly only a slight exaggeration to claim that when it comes to housing and especially home ownership, the ethos of public policy has been (and continues to be) 'too much is never enough' ").

[319] CBO Study 2001, *supra* note 242.

[320] Fannie Mae and Freddie Mac agreed in 2002 to begin voluntarily to register their common stock with the SEC under section 12(g) the 1934 Act. Registration under the 1934 Act will subject Fannie Mae and Freddie Mac to SEC disclosure requirements. Once registered, Fannie and Freddie will remain subject to such requirements in the future. The FHLBs have not consented to SEC registration. The GSEs remain exempt from registering new issuances of

borrow from the Treasury,[321] and issue debt that banks and thrifts can hold under capital standards that favor the GSEs over private conduits.[322] Unlike privately issued securities,[323] GSE securities are exempt from SEC registration,[324] are treated as government securities under the Exchange Act,[325] and are exempt under the Trust Indenture Act of 1939 and the Investment Company Act of 1940.[326] Most importantly, the GSEs benefit from the credit enhancement of an implicit guarantee that the federal government will intervene in the event of financial collapse.[327] Despite the disclaimer by both the federal government and the GSEs that there is no federal guarantee, there is a general belief by the market to the contrary. That belief may arise because of the GSEs' congressional charters, the indicia of federal support, or the notion that they are "too big to fail." The implicit guarantee permits the GSEs to issue debt at a lower cost, and to hold less capital than similar private firms.[328]

Measuring the subsidy provided to the GSEs is the subject of intense debate. The Congressional Budget Office (CBO) found that the benefits accorded to the GSEs were worth $13.6 billion, of which Fannie Mae received $6.1 billion, Freddie Mac $4.6 billion, and the FHLBs $3.0 billion.[329] CBO estimated that a "little more than half ($7.0 billion) of that total subsidy in 2000 passed through" to mortgage borrowers through lower interest rates on conventional, conforming loans.[330] CBO estimated that Fannie Mae and Freddie Mac retained $3.9 billion (37 percent) of the subsidy for their

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mortgage-backed securities under the 1933 Act. *See* STAFF REPORT: ENHANCING DISCLOSURE IN THE MORTGAGE-BACKED SECURITIES MARKETS, A STAFF REPORT OF THE TASK FORCE ON MORTGAGE-BACKED SECURITIES DISCLOSURE (2003), *available at* http://www.treas.gov/press/releases/docs/disclosure.pdf (last visited Aug. 10, 2003) [hereinafter MBS DISCLOSURE REPORT].

[321] CBO Study 2001, *supra* note 242, at 13-14.

[322] Risk-Based Capital Guidelines, 12 C.F.R. Pt. 3, Appendix A, §3(a)(2)(vi)-(viii).

[323] Most privately issued MBS are sold in registered transactions. MBS DISCLOSURE REPORT, *supra* note 320, at 25.

[324] *See* 12 USC § 1723c (Fannie Mae) and 12 U.S.C. § 1455g (Freddie Mac). As government securities, Ginnie Mae's securities are also exempt. *See* section 3(a)(2) of the Securities Act, 15 U.S.C. § 77c(a)(2) (2000), and section 3(a)(12) of the Exchange Act, *id.*. § 78c(a)(12).

[325] 15 U.S.C. § 78c(a)(42)-(43) (2000).

[326] *Id.*. § 77aaa-bbbb; *id.* § 80a-1 to 80a-64. GSE securities are subject to anti-fraud provisions of the Securities Act and the Exchange Act. *See id.* § 77q(a); *id.* § 78j(b); 17 CFR § 240.10b-5.

[327] Congressional Budget Office, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac 10-11 (1996), at http://ftp.cbo.gov/0xx/doc13/Fanfred.pdf [hereinafter "CBO Study 1996"].

[328] *See* UNITED STATES DEPARTMENT OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION (July 11, 1996), at 3.

[329] CBO Study 2001, *supra* note 242.

[330] *Id.* at 1. CBO did not calculate the benefits of the affordable housing goals in determining the net GSE subsidy. The GSEs' public purposes go beyond access to credit for disadvantaged borrowers, so I first use estimates of the net subsidy to the GSEs after accounting for such broader purposes, and then discuss the affordable-housing mission of the GSEs.

shareholders or other stakeholders.[331] As for the FHLBs, CBO estimated that they passed on only $300 million of their $3 billion subsidy to mortgage borrowers, with 90 percent of the subsidy accruing to the benefit of the FHLB member banks or reducing interest rates on other types of loans borrowed from FHLB members.[332] These estimates are sensitive to assumptions about the funding advantages GSEs receive and about how to model the pass-through to borrowers.[333] For present purposes, the point estimates are not critical. I will assume that the amount of the subsidy is some nontrivial amount above zero.

The GSEs contribute to access to home mortgage credit for low- and moderate-income households. Fannie Mae and Freddie Mac's performance has surpassed HUD's affordable housing goals since they were first formally promulgated in 1997,[334] and HUD increased those goals for 2001-04,[335] and again for 2005-08.[336] However, the share of GSE purchases financing affordable housing under the goals lagged that of the primary market during the 1990s.[337] In the early 1990s, the GSEs held less of the credit risk associated with lending to low-income or minority borrowers and areas than did FHA and Ginnie Mae, as well as depository institutions, both as a share of the GSEs' own activities and as a share of the market.[338] In addition to the affordable housing goals, other factors contributed to this activity, such as the

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[331] CBO Study 2001, *supra* note 242, at 5.
[332] *Id*.
[333] *Compare id.* (finding that GSE securitization lowers interest rates on conventional, conforming mortgages) with Andrea Heuson, Wayne S. Passmore & Roger Sparks, CREDIT SCORING & MORTGAGE SECURITIZATION: DO THEY LOWER MORTGAGE RATES?, FEDERAL RESERVE BOARD, FINANCE & ECONOMICS DISCUSSION SERIES 2000-44 (2000) (arguing that lower interest rates lead to higher levels of securitization, not the reverse).
[334] In 1992, Congress enacted a new affordable housing requirement for Fannie Mae and Freddie Mac. HUD had set up the first affordable housing goals regulation for Fannie Mae in 1978. OVERVIEW OF THE GSE'S HOUSING GOAL PERFORMANCE, 1993-2001, *at* http://www.huduser.org/datasets/GSE/gse2001.pdf, (visited Aug. 10, 2003), n. 2. The GSE definition of low- and moderate-income households, 100 percent of area median income, includes households with higher incomes than as defined for CRA. Under CRA, low- and moderate-income households have incomes less than or equal to 80 percent of area median.
[335] *See* Dept. of Housing & Urban Dev., "Issue Brief," January 2001, at 3-4, *available at* http://www.huduser.org/publications/pdf/gse.pdf [hereinafter Issue Brief].
[336] *See* HUD, Proposed Housing Goal Rule – 2004, *at* http://www.hud.gov/offices/hsg/gse/summary.doc.
[337] Treasury Department, Office of Government Sponsored Enterprise Policy (Sept. 15, 2000) (on file with author); UNITED STATES DEPARTMENT OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 56-60 (July 11, 1996).
[338] *See* Glenn B. Canner & Wayne Passmore, *Credit Risk and the Provision of Mortgages to Lower-Income and Minoirty Homebuyers*, 8 FED. RESERVE BULL. 989, 1000 tbl. 3, 1004 tbl. 4 (1995). The authors surmised that primary market participants performed better because they had greater access to information about the creditworthiness of borrowers or the conditions of neighborhoods, and used greater flexibility in underwriting than did the GSEs.

GSEs' business strategies and the shift in the primary mortgage market towards greater levels of lending to low-income borrowers.[339]

Fannie Mae and Freddie Mac have also contributed to affordable housing in other ways. Both GSEs sponsor home counseling programs. The GSEs train loan originators and support community organizations to increase affordable lending. The GSEs have used more flexible underwriting criteria for loan purchases. Greater flexibility in the secondary market can help to spur greater flexibility in the primary market, but these innovations have also occurred among home mortgage originators themselves.

The FHLBs also provide modest subsidies for affordable housing and community development through the Affordable Housing Program and Community Investment Program. However, the bank members of the FHLBs enjoy extensive low-cost advances that essentially subsidize the full range of bank activities.[340] The FHLBs made $16.9 billion in net advances to members in 2002, with $490 billion outstanding at the end of that year.[341] In addition, the FHLBs have begun to experiment with untargeted secondary market operations in the hopes of competing with the other GSEs.

The GSEs pose risks and carry high costs. Fannie Mae and Freddie Mac shareholders and FHLB members retain a significant portion of the subsidy, and the portion passed on to consumers is spread diffusely through the market, reaching many home buyers who would purchase a home in any event. The FHLB subsidy is spread even more diffusely than that of Fannie Mae and Freddie Mac. The GSE duopoly hinders competition in the secondary market for conventional, conforming loans, although the jumbo and subprime secondary markets are thriving. Taxpayers would face a large, contingent liability in the unlikely event that the GSEs failed. The large role of GSEs in the debt market may raise the price of Treasury borrowing and squeeze credit in other markets. Moreover, the government faces the difficulty of managing risk from an implicit guarantee, rather than an explicit, budgeted one.[342]

FHA provides mortgage subsidies through insurance. FHA provided $157 billion in insurance on home mortgage loans to 1.3 million households in 2002. FHA's secondary market counterpart, Ginnie Mae, guaranteed $175 billion in mortgage-backed securities that year. FHA specializes in serving borrowers

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[339] The shares of CRA loans sold on the secondary market increased from 54 percent in 1993 to 67 percent in 1998.

[340] CBO Study, *supra* note 272.

[341] FEDERAL RESERVE BOARD, FEDERAL RESERVE STATISTICAL RELEASE Z.1, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS FIRST QUARTER 2003, *at* http://www.federalreserve.gov/Releases/Z1/Current/zlr-1.pdf (visited Aug. 10, 2003) at 33 tble. F. 124, Government-Sponsored Enterprises (Flows), 78, tble. L.124, Government-Sponsored Enterprises (Levels). Taxpayers may be an indirect beneficiary of advances because they reduce the interest rate exposure of FHLB member banks, and to the extent that this makes it less likely that banks will fail, deposit insurance funds benefit. CBO Study, supra note 272, at xii.

[342] *See* Treasury Study, *supra* note 279, at 77-81.

who make "low down payment[s], have high debt-to-income ratios, and/or have tarnished credit."[343] These borrowers tend to be first-time, minority, or low-income and tend to live in low-income or minority-concentrated neighborhoods.[344] A higher share of FHA lending goes to low-income and minority borrowers, and low-income areas, compared to the GSEs.[345] During the 1990s, the share of FHA lending going to low- and moderate-income minority borrowers grew more rapidly than did the share of conventional lending to those borrowers.[346] FHA also serves a role in regional markets with falling wages, increasing unemployment, and dropping house prices.[347] At times, FHA has competed with conventional lenders.[348] A dilemma for FHA is how to reach further into the market while managing risk.[349] As the conventional market serves the more credit-worthy portion of FHA's pool of borrowers,[350] adverse selection will leave FHA with higher risk. That problem is exacerbated because FHA lags the private sector in credit scoring and risk management.[351] The FHA portfolio is becoming riskier.[352]

In sum, government subsidies generate windfalls for the GSE shareholders and others. A large portion of those whose mortgages are purchased by the GSEs would likely have had access to the credit markets in any event, even if at a higher price. GSE subsidies are not transparent, making it difficult for the public to weigh its costs and benefits. FHA subsidies are more transparent because the cost of the subsidy appears as user fees and as an item in the federal budget.[353] The cost of transparency is, however, direct taxpayer liability for the FHA. FHA may not have the management capacity and technical expertise to manage risk as effectively as private market participants.

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[343] SARAH ROSEN WARTELL, SINGLE-FAMILY RISKSHARING: AN EVALUATION OF ITS POTENTIAL AS A TOOL FOR FHA 11 (Millennial Housing Commission, June 2002) [hereinafter ROSEN, FHA RISKSHARING].

[344] *Id.* FHA's success in serving first-time homebuyers may be overstated, since studies suggest that these households would become homeowners anyway at a later age. Pennington-Cross & Yezer, *supra* note 119, at 367.

[345] *Id. See also* Pennington-Cross & Yezer, *supra* note 119, at 362 (noting FHA role in serving minorities).

[346] *See* Treasury Study, *supra* note 279.

[347] Pennington-Cross & Yezer, *supra* note 119, at 362.

[348] In part, this may be a sign of success. FHA's innovative underwriting practices, when they work, can be replicated by the private market. *Id.* at 363-365.

[349] *See, e.g.*, HUD BUDGET SUMMARY, *supra* note, at 13

[350] *See* ROSEN. FHA RISKSHARING, *supra* note 343, at 17 (noting that PMIs increased the portion of high LTV loans insured to 10 percent of their insured loans and that Fannie Mae and Freddie Mac had increased the portion of high LTV loans purchased to 4-6 percent).

[351] *See id.* at 16; THOMAS H. STANTON, THE PRICEWATERHOUSECOOPERS ENDOWMENT FOR THE BUSINESS OF GOVERNMENT CREDIT SCORING AND LOAN SCORING: TOOLS FOR IMPROVED MANAGEMENT OF FEDERAL CREDIT PROGRAMS 4 (1999).

[352] *See* ROSEN, FHA RISKSHARING, *supra* note 343, at 21.

[353] GSE activity is noted in federal budget documents, even though the GSEs are not "on budget."

CRA has important advantages over existing subsidy approaches. Needless to say, CRA provides no windfall to banks and thrifts. CRA targets all its efforts at expanding access to credit and financial services for low- and moderate-income borrowers and communities, so there is no wasted effort on generalized policies subsidizing housing consumption. CRA is less risky than subsidies through GSEs or FHA. If CRA increased risk because of expanded lending to low-income borrowers, that risk would be diffused over the well diversified portfolios of thousands of depositories, all of which are comprehensively supervised for safety and soundness and required to hold adequate capital. Moreover, banks and thrifts have expertise in finding creditworthy borrowers and in using extensive risk-mitigation techniques that are more difficult for secondary market participants to operate. It is certainly possible to design subsidies far better than the ones we have, but our experience over the last 70 years should augur caution.

VI. CRA Compared with Other Alternatives

Critics have argued for a range of other policy alternatives to CRA. The previous Part compared CRA with existing legal regimes of negative prohibition (ECOA), disclosure (HMDA and TILA), product regulation (HOEPA), and subsidy (through the GSEs and FHA). This Part compares CRA with ideal types of alternative arrangements that have been suggested by critics, including income transfers or demand-side subsidies, supply-side subsidies, and rules as compared with CRA's standards. I contend that alternative institutional arrangements to CRA, including relying solely on the market, would likely produce inferior outcomes or be quite costly in transition.

A. CRA Compared with Income Transfers or Demand-Side Subsidies

Assume for the moment that the purpose of credit market regulation is to redistribute "something" to the poor so that afterwards their social welfare is higher. The public finance literature usually assumes that income is a good proxy for social welfare, and that the "something" being redistributed should thus be income. That income redistribution should be confined to the tax and transfer system and should not be a goal of legal rules is a familiar assertion in public finance, and with good reason. At least in principle, income transfer can usually be accomplished at lower cost than if redistribution were accomplished by changing legal rules. Kaplow and Shavell take the strong form of this argument, contending that legal rules should never take account of distributional consequences and should only aim for efficiency.[354]

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[354] *See* Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821 (2000); Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994); *see also* Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000). Kaplow and Shavell argue that legal rules should not be modified to favor the poor because "society can instead use the income tax system (here interpreted to

Macey and Miller argue that CRA could be characterized as a tax on banks and thrifts aimed at redistribution and thatincome transfers should be preferred in accomplishing this goal.[355] CRA is not, at least not explicitly, aimed at redistribution, but rather at correcting perceived market failures. Even if the goal of CRA were to be recast as income redistribution, it is not obvious that the tax-and-transfer system should be preferred over CRA. One may want to use legal rules in place of transfers because income taxation is itself distortionary,[356] and income transfers may have high administrative costs.[357]

If income is transferred as an in-kind subsidy the costs may be higher than through "cash" transfers—or even through legal rules.[358] First, in-kind subsidies are considered less efficient than cash subsidies because the recipient may only use the in-kind subsidy for specified purposes.[359] To the extent that the recipient undertakes the specified actions to the same degree as if given a cash grant, the in-kind subsidy costs more to administer. To the extent that the subsidy changes behavior, the subsidy does not increase the recipient's welfare to the same degree as if she had received a cash subsidy to pursue her own preferences. Second, in-kind plans are paternalistic in telling the heterogeneous recipients that they should derive utility from the provision of a particular service.[360] In-kind mechanisms may impose a higher value on a service than an individual may have given it. Third, in-kind programs are often more administratively costly than direct transfers.[361]

Nor is transferring income as "cash" without controversy. There is no consensus on the appropriate distribution of income. Moreover, even if one were to decide how much income to redistribute, the means are contentious. The inefficiencies associated with the welfare system are well known.[362] Similarly, the literature debating tax expenditures is voluminous.[363]

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include programs that transfer income to the poor) to redistribute income." Kaplow & Shavell, 29 J. Legal Stud., *supra*, at 822. *But see* Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157 (2003) (arguing that legal rules may optimally redistribute social welfare under some circumstances).

[355] Macey & Miller, *supra* note 18, at 296.

[356] STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, *supra* note 23.

[357] For example, government income transfers to the unbanked often require costly financial services transactions to convert a check into cash. *See* Barr, *supra* note 1.

[358] *See generally* STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, *supra* note 23

[359] *See, e.g.*, STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, *supra* note 23, at 254-65 (presenting arguments concerning the substitution versus income effect).

[360] *See generally* Edgar K. Browning, *A Theory of Paternalistic In-Kind Transfers*, 19 ECON. INQUIRY 579 (1981).

[361] *See, e.g.*, STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, *supra* note 23, at 349.

[362] *See, e.g.*, Committee on Ways & Means, U.S. House of Representatives, The 2000 Green Book: Background Materials & Data on Programs Within the Jurisdiction of the Comm. On Ways & Means, Appendix L, Monitoring the Effects of Pre- and Post-TANF Welfare Reform Initiatives (17th ed., Oct. 6, 2000).

[363] For the debate over tax expenditures, see, e.g., STANLEY S. SURREY, PATHWAYS TO TAX REFORM (1973); Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Tax Reform*, 80 HARV. L. REV. 925 (1967); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budget:*

Furthermore, the distinction between tax and transfer programs and regulations is not obviously meaningful conceptually and questions about program design, regulatory structure, and the appropriate incidence of the tax—whether on banks or other taxpayers— in relation to the tax structure generally, would all remain.[364] In addition, transition costs from laws that redistribute income to a tax and transfer program would diminish the benefits of such a change.

If the main goal of CRA were to redistribute income, as a *theoretical* matter it seems more desirable and efficient simply to eliminate CRA and other credit market regulation and subsidies and to shift to a much more progressive income tax. If regulations and subsidies are intrinsically inefficient and also distort the work-leisure tradeoff, and one assumes away transition costs and the political difficulty of the task, then income redistribution through significant expansion of the tax and transfer programs may be preferable.[365] But all these conditions seem unlikely to hold in the real world.

One could also think of credit market regulation as about redistributing not income, but access to credit.[366] Suppose that society seeks neither to correct market imperfections, nor to guard against discrimination, nor to redistribute income, but instead to redistribute access to credit to low- and moderate-income and minority households. Why would society have this goal? Redistribution of home mortgage credit might advance a goal of spreading the positive externalities associated with owning a home.[367] Redistribution of mortgage credit would also have "expressive" value,[368] by conveying that low-income and minority households are full members of our society because they can participate in the "American dream" of home ownership.

If this is the intended form of redistribution, then CRA may be more efficient than income redistribution. Income is, after all, only a proxy for social welfare. Directly redistributing the thing that society wishes to redistribute may be less costly than using income redistribution to achieve the same aim. Society may have to redistribute a large sum of income to underserved borrowers to induce the credit markets to leave them as well off as they are with current regulations and subsidies. Moreover, it would be hard to convey the same "expressive" effect regarding inclusion in the American

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A Critical View, 54 TAX NOTES 1661 (1992); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986).

[364] *See, e.g.*, David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 995 (2004).

[365] *See* Kaplow & Shavell, 23 J. LEGAL STUD., *supra* note 354.

[366] For a thoughtful discussion of the role of legal rules in distributing non-income goods, see Logue & Avraham, *supra* note 354.

[367] *See* GLAESER & SHAPIRO, *supra* note 273.

[368] On "expressive" benefits generally, see Elizabeth S. Anderson & Richard Pildes, *Expressive Theories of Law*, 148 U. PA. L. REV. 1503 (2000). *But see* Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000). I discuss this further in exploring the benefits of standards over rules, *infra*, this Part.

dream through income redistribution if some aspect of the difficulty these households have in accessing credit markets is not solely due to their income. For example, if racial discrimination, market failures, lack of wealth, poor credit history, or neighborhood racial or income characteristics are factors, then income redistribution alone would likely be inadequate to address them.

The broader point is that CRA is not primarily justified by redistributive goals, but by the need to address market failures and discrimination. It would be highly inefficient to attempt to redress these market failures by increasing the incomes of millions of individuals, regardless of whether they attempt to access the home mortgage market and regardless of whether they would experience barriers to credit from market failures or racial discrimination.

B. CRA COMPARED WITH SUPPLY-SIDE SUBSIDIES

At some level, subsidies can become substitutes for regulation. If the government pays private sector participants a sufficient amount, for example, they will take a second look for creditworthy borrowers in low-income, moderate-income, or minority communities in the same way that they would under a regulatory regime. Developing such a subsidy regime is not without difficulties. First, one would need to decide whether the particular market participants or taxpayers should bear the cost of addressing the market failure. Second, one would need to determine the amount of subsidy necessary to have the desired effect without generating undesirable windfalls to recipients.

With respect to the former issue, for example, if lenders practicing statistical discrimination are paid sufficiently, presumably they would be willing to stop engaging in that form of discrimination. The question is whether we as a society think that private market participants should be permitted to engage in "rational' discrimination. In that area, ECOA bars statistical discrimination. That is, we prohibit discrimination even if it is "rational" and we do not think taxpayers should have to pay to stop market participants from employing statistical discrimination on a prohibited basis. Presumably, society would have an even greater aversion to subsidizing institutions to get them to stop discriminating on the basis of racial animus.

With respect to the latter issue, subsidies to financial institutions for lending in low-income communities could be expanded, but previous experience, documented in Part V, suggests that windfalls would be difficult to control. In addition to subsidies to banks and thrifts more generally, targeted subsidies to specialized lenders can be an important means of expanding the reach of the private lenders.

For example, the Treasury Department's Community Development Financial Institutions (CDFI) Fund, established in 1994,[369] is designed to create a national network of financial institutions focused on low-income communities. The CDFI Fund has provided over $535 million to locally based, private sector CDFIs, as well as mainstream banks and thrifts. These

[369] Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, title I, Sec. 104, Sept. 23, 1994, 108 Stat. 2166, codified at 12 U.S.C. 4703.

local CDFIs have a strong track record of producing tangible results.[370] For example, Self-Help Credit Union of North Carolina has provided over $1 billion in financing to 16,000 home buyers, small businesses and non-profits in North Carolina. The Reinvestment Fund, serving the Philadelphia region, has made $200 million in loans, investments and grants and leveraged an additional $800 million in public and private capital for affordable housing and community development. The Reinvestment Fund has helped to build 6,000 units of affordable housing, to create 16,000 jobs, provide 6,000 new child care slots, and build numerous new community facilities.

CDFIs around the country are helping to transform low- and moderate-income neighborhoods. They are drawing in mainstream banks and thrifts to invest with them. CDFIs are often the market pioneers in their community, using their local market expertise and knowledge about the community to make loans and investments others had overlooked. The CDFI Fund has played a critical role in growing this industry. The Fund's investments have helped its awardees to increase their capitalization, develop stronger infrastructure and operations, and expand their reach.[371] The growth of CDFIs is critically important to expanding lending in low-income communities, and I worked hard at the Treasury Department to grow this field.

However, the small size and scale of these CDFIs suggests that it would be inefficient to switch from relying on the banking system to a system based solely on such specialized lenders.[372] Moreover, without the impetus of CRA, it is doubtful that banks and thrifts would have invested so heavily in CDFIs over the last decade. Eliminating CRA in favor of CDFIs would thus require an even greater infusion of governmental funds to continue CDFI growth, and CDFIs might also lose out on the technical expertise, business judgment, and advice that banks have brought to the table over the last decade. In addition, there would be enormous costs to shift to a system of targeted subsidy.

More serious objections could be made to switching to a system in which the government delivers the benefit directly, creating a need for a government loan distribution system parallel to the banking sector. Not only would the transition costs be enormous, but the government would probably do badly at providing financial services in this way. Even if the government were good at it, such services would unfairly compete with the private sector.

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[370] Details on CDFIs from CDFI Fund, at http://www.cdfifund.gov/awardees/index.asp.

[371] In 2001, the Fund's $74 million in CDFI awards leveraged $150 million in outside capital for CDFIs, and its $45 million in incentives to mainstream banks and thrifts brought $244 million in investments in CDFIs and another $1.1 billion in direct loans in low-income communities. The CDFI Fund found that its 106 awardees from fiscal years 1996, 1997, and 1998 had made $3.5 billion in community development loans and investments since receiving their award, or $31 in financing for each dollar received from the Fund. CDFI Fund, FY 1999 Annual Survey Preliminary Findings (May 8, 2001), at http://www.cdfifund.gov/news/pdf/1999_CORE_FY_Survey.pdf (visited Aug. 6, 2004).

[372] Compare, for example, the $535 million in CDFI Fund investments, 1993-2000, with the more than $1 trillion in CRA loans over same time period.

C. CRA's Standards Approach Compared to a Rules Approach

The CRA statute, and its implementing regulations, can be characterized as employing a legal standard, rather than a rule. Schlag defines rules as having an "empirical" trigger and a "determined" response while standards are defined as having an "evaluative" trigger and a "guided" response.[373] The CRA statute directs the banking agencies to "assess the institution's record of meeting the credit needs of its entire community…" and to "take such record into account" in evaluating applications for mergers, acquisitions, branch openings and closings.[374] The structure of the agencies' responsibilities under the statute is evaluative and guided rather than determined. Under the regulations, a bank's or thrift's "performance under the tests and standards in the rule is judged in the context of information about the institution, its community, its competitors, and its peers."[375] That is, bank regulators provide no fixed requirement for banks to undertake a certain level of activity, but rather make a judgment about the institution's performance in the context in which it is operating.

The debate over whether standards or rules should be preferred has a long pedigree.[376] Three basic approaches emerge in this debate. First, scholars have identified philosophical underpinning of rules and standards.[377] Second, other scholars have rejected the notion that formal distinctions between rules and standards have any meaning.[378] A third group of scholars have attempted to discern general principles for deciding when standards or rules are more appropriate.[379] Among the last group, law and economics scholars have used transaction cost economics to argue that the higher cost of articulating rules ex

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[373] Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 382-83 (1985).
[374] 12 U.S.C. § 2903(a) (2000).
[375] Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22156 (May 4, 1995).
[376] *See, e.g.*, FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM 72-73 (1944); MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES (1987); FREDERICK SCHAUER, PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISIONMAKING IN LAW AND IN LIFE 149-55 (1991); Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181 (1996); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1688 (1976); Eric A. Posner, *Standards, Rules, and Social Norms*, 21 HARV. J.L. & PUB. POL'Y 101 (1997); Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U. L. REV. 781 (1989); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985).
[377] *See, e.g.*, Kennedy, *supra* note 376, at 1688 (arguing that standards reflect altruism while rules reflect individualism); Rose, *supra* note 376, at 609 (contending that debate is over what our relationship with strangers should be).
[378] *See, e.g.*, Radin, *supra* note 376; Schlag *supra* note 376.
[379] See, e.g., Kennedy, *supra* note 376, at 1710 (listing qualities associated with rules and standards).

ante is worth it when large numbers of people engage in the activity being regulated, multiplying the transaction costs many times over.[380]

Critics of CRA have argued that its standards approach results in arbitrary and inefficient enforcement, permits rent-seeking by banking agencies and community groups, and violates basic notions of the rule of law.[381] CRA's critics tend to espouse rhetoric that would support the notion that deep philosophical differences underlie the distinction between rules and standards, but the anti-formalists are right that standards can be made to look like rules, and vice versa, undermining the importance of such a gulf. Legal directives can take forms arrayed on a continuum from those that are more standard-like to those that are more rule-like. Thus, for the purposes of analyzing CRA, I adopt a pragmatic approach, and ask whether something like the standards approach of CRA is preferable to a more rules-based approach in this area.

Translating transaction cost theory into application is difficult because it is hard to measure the costs and benefits of alternative rule and standards formulations. Kaplow argues that after promulgation, standards increase transaction costs relative to rules. The lack of certainty in standards for meeting community needs under CRA does have compliance costs. Lacking a numerical target imposed by regulators makes it more difficult for firms to know whether their CRA initiatives will result in the rating they seek. Firms may "overcomply" with CRA, particularly given the social norm of disapprobation that accompanies a low rating.[382] Each examiner may review bank performance using implicitly different standards, leading to inconsistent evaluations even by a single regulator. Examiners may vary in their standards across regulators and regions, magnifying the likelihood of inconsistency.

Nonetheless, there are strong reasons for preferring a standard to a rule for CRA. First, a standard is likely to be more efficient than a rule. Kaplow suggests that the cost of rulemaking will be higher ex ante than the cost of developing a standard. How much higher will depend in part on how detailed the rule must be to cover the array of factual situations in which it is supposed to apply. It would be quite costly to come up with a rule for CRA that was nuanced enough to fit the myriad contexts in which financial institutions lend. One would want to adjust for: local market conditions; competition; the structure of the local housing market; the presence or absence of community organizations helping with screening and educating potential borrowers; the strength of local homeowners and civic organizations; local, state and federal funds available for homeownership assistance; the particular characteristics of

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[380] *See, e.g.*, Kaplow, *supra* note 376. *But see* Posner, *supra* note 376, at 107 (arguing that the logic of economic optimization implied by Kaplow's approach leads to an infinite regress rather than a basis for decision-making); Rose, *supra* note 376, at 609 (criticizing law and economics approaches).

[381] *See infra*, Parts II & III.

[382] For a strong form of this argument, see Posner, *supra* note 376, at 113-116 (describing overcompliance with social norm against wearing western-made motorcycle helmets in Soviet Union).

the bank or thrift; and other factors. Delineating these factors in advance would be enormously costly, with a high chance of getting them wrong.

To lower costs ex ante, one could adopt a simple set of rules instead. One might imagine a system that involved levying fines on banks for failure to comply with numerical lending targets. Setting fines for violations of CRA would comport CRA enforcement more closely with other areas of bank regulation. In the 1990s regulatory reform process, the regulators considered including fines for banks achieving only a "needs to improve" rating on their examination, but dropped the idea, in part because the Department of Justice opined that such fines were not authorized by the statute.[383]

Yet CRA's contextual standard has significant advantages ex post over an approach with fines for violating rules. Clear, quantitative requirements on all firms would be inefficient. Different firms have different cost structures, scope and scale, and operate in markets with different demographics and competitive structures. Firms make loans at different times under different market conditions. Setting a single rate (or rates) of lending in advance would likely cause some firms to be unable to meet the standard despite their best efforts, cause others to make uneconomic loans, and cause still others to meet the rule without any serious effort to lend to low-income borrowers. By contrast, the CRA standards permit banks to respond to local needs based on their own institutional organization, market assessments, and business plans, without being judged on the basis of national norms. Rather, examiners look to local context and business strategy. Standards also diminish the extent to which regulators need fear that CRA would lead to "credit allocation," since the bank makes the judgment about whether, and to whom, to extend a loan.[384]

A second reason to prefer a CRA standard over a rule is that using standards permits banks and local communities to participate in the formation of the legal directive. Banks subject to CRA help to shape the content of the

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[383] See Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22156, 22158 (May 4, 1995).

[384] Although critics label CRA "credit allocation," regulators have avoided quotas or approaches involving the government in decisions about the precise level of lending or the proper parties to which to lend. *See, e.g.*, Fed. Res. Bd. Chairman Alan Greenspan, Economic development in low- and moderate-income communities, Remarks at a Community Forum on Community Reinvestment and Access to Credit: California's Challenge, Los Angeles, CA (Jan. 12, 1998), at http://www.federalreserve.gov/boarddocs/speeches/1998/19980112.htm; *see also* Performance and Profitability, *supra* note 176, at 96:

> The legislative history indicates that the Congress did not intend for the CRA to result in government-imposed credit allocation. The expectation, rather, was the banking institutions would be proactive in seeking out and serving viable lending opportunities in all sections of their communities. At the same time, it was expected that lending activities would be undertaken in a manner consistent with the safe and sound operation of banking institutions. The regulations that implement the CRA reflect those goals. They provide for flexibility and direct that performance be evaluated in the context of the specific circumstances faced by each institution.

standard, not merely through the notice and comment rulemaking process, but also in CRA's application to their local context. CRA enforcement through public disclosure, rating the institution's performance, and taking public input also permit greater citizen participation in the decision about application of the rule. This enhances local organizations that in turn improve the potential performance of loans made in their community. While public involvement adds to the transaction costs of CRA enforcement, these benefits of civic engagement should be weighed also. This kind of "bottom-up" form of law-making can have important advantages over clear rules.[385]

CRA may be characterized as a form of output regulation but without any numerical target. Compared with input regulation, for example, requiring certain kinds of underwriting, this type of output regulation provides for greater flexibility and enhances rather than stifles innovation. Output regulation, increasingly favored in the environmental protection context, can be more efficient than input regulation because it lets firms choose how to shape conduct to meet output requirements.[386] CRA lacks numerical requirements normally associated with output regulation. The lack of certainty can put enormous strain on regulatory discretion and add costs. Yet it has the advantage of letting banks, as well as their local communities, have a say in the manner in which bank performance will be judged. This increases the likelihood that the performance will be judged according to an appropriate standard for the institution and the local market context.

Third, some of the down sides generally associated with standards, such as arbitrary and unaccountable decision-making and agency rent -seeking, are mitigated in the case of CRA. The regulator's CRA review becomes public and so can be subjected to analysis. The review includes notice and comment proceedings, often with the opportunity for hearings, which enhances transparency and permits all affected parties to provide input. Regulators, community organizations, and banks and thrifts have repeated interactions over time on the same issues, unlike parties who appear before a judge only once. These factors increase accountability and minimize the opportunities for abuse.

Fourth, the form of a legal directive as a standard rather than a rule conveys social meaning and affects enforcement.[387] Examples from other credit market regulation may help to elucidate the point. ECOA's rule that statistical discrimination is prohibited, as opposed to a rule that subsidized creditors for deciding not to engage in such discrimination, is based on our deeply rooted sense that distinctions based on race, even if "rational" in the short run, are wrong. Thus the law prohibits the conduct rather than subsidizing adherence to the rule. Social meaning attaches to other forms of regulation even in areas that are less deeply felt. For example, ambivalence about the desirability of

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[385] *Cf., e.g.*, PETER H. SCHUCK, THE LIMITS OF LAW: ESSAYS ON DEMOCRATIC GOVERNANCE 452 (2000).
[386] *See generally* STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, *supra* note 23, at 276.
[387] *See generally* Anderson & Pildes, *supra* note 368.

high-cost lending can be conveyed by HOEPA's simultaneous requirement of additional disclosures and restrictions on loan terms without any usury cap or other stringent provisions that would effectively bar such lending.

The form of the legal directive also can enhance compliance because the law helps to create social norms and to reveal instances in which actors transgress those norms. For example, HMDA contains no substantive legal rule, but reveals information about the extent to which creditors may be falling short of meeting the credit needs of minorities or low- and moderate-income communities. Even if no enforcement action is taken under ECOA, and even if no mergers are denied under CRA, HMDA data can change creditor behavior. That may be so because the public cares, in general, about the social norm of equal access to credit, and because the creditors care about their reputation with the public. Of course, the social norm may push behavior beyond what is efficient or fall short of what was intended by the promulgators of the standard.

CRA's broad standards and "enforcement" mechanisms—public disclosure of examination results and consideration of the institution's CRA performance during merger applications—have long been derided by both proponents and detractors of CRA. Community advocates urge stricter rules and harsher consequences of failure. Bankers lament the lack of clear rules or safe harbors and the intrusive role of the public. Yet it is this interplay, this conversation, between banks and communities that is one of CRA's chief virtues. A rule setting forth lending requirements would cut off this dialogue. It would also send a message that banks are to disregard creditworthiness, business strategy, and local context, which is not the goal of CRA. In this respect, CRA's legal directive appropriately takes the form of a standard rather than a rule.

CRA's broad standard expresses the value of inclusion in lending. Because interpretation of CRA's standard requires community input, CRA expresses an inclusive ideal of participation in rule making that should be counted among the law's benefits. The expressive effects of law should be considered alongside the operational effects.[388] Even welfare economists acknowledge that expressive factors, like other non-consequentialist factors, may be included in concepts of utility or well-being that aggregate to social welfare.[389] Thus, under either an expressive or a utilitarian theory of value, to the extent that CRA's norms of inclusion resonate with low-income, moderate-income, and minority borrowers, such expression ought to be regarded as a benefit of CRA. CRA conveys that borrowers who have been left out of the economic mainstream ought to be treated with respect by lenders and regulators alike. This expressive function of CRA can bring real benefits, as attested to by members of these communities.

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[388] *Cf.* Anderson & Pildes, *supra* note 368. *But see* Adler, *supra* note 368.

[389] *Cf.* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1009 (2001) (asserting that "welfare economics takes into account any effect of a legal rule that is pertinent to anyone's well-being", while criticizing fairness-based theories of policy evaluation).

VII. POLICY REFORMS

The banking agencies issued an advance notice of proposed rulemaking (ANPR) in 2001 seeking input on what changes should be made to CRA.[390] After a long review, the proposed rule was issued in February 2004.[391] The agencies left the existing CRA regulations largely in place, but significantly expanded the scope of institutions defined as "small" under the rule and therefore subject to only a streamlined lending test, rather than a full-scope CRA review. The agencies also specified that CRA examinations would consider evidence of certain illegal or abusive credit practices. In July, 2004, the agencies abruptly withdrew the proposal,[392] when the Office of Thrift Supervision (OTS) announced that it would unilaterally raise the small bank threshold to $1 billion.[393] Indications are that the FDIC will quickly follow suit, while the Federal Reserve Board and the OCC have declined to do so.[394] Meanwhile, Congress is considering whether to reform CRA.[395]

In my view, the Board and the OCC were correct to be cautious about revising the CRA regulations at this time, and the OTS and FDIC were wrong to unilaterally raise the threshold. I first discuss the general reasons for maintaining CRA's basic framework, and explain why raising the small bank threshold is ill-conceived. I then turn to policy reforms that could deepen CRA's effectiveness while increasing flexibility for banks.

A. MAINTAIN CRA'S BASIC FRAMEWORK

1. General Considerations

First, despite problems with aspects of implementation, the regulations have worked exceedingly well in expanding access to credit—far more so than any involved in the 1995 revisions could have expected. As I have documented, CRA has significantly expanded access to credit. The Board's study suggests that this significant expansion of credit has come at a relatively modest cost, if any, in terms of performance and profitability.

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[390] Joint advance notice of proposed rulemaking, Community Reinvestment Act Regulations, 66 Fed. Reg. 37602 (July 19, 2001). The agencies had committed to undertake this review at the time of the issuance of revised regulations in 1995. *See* Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22156, 22177 (May 4, 1995).

[391] See Press Release, Federal Reserve Board, *Bank and Thrift Agencies Publish Proposed Rulemaking Regarding the Community Reinvestment Act*, Feb. 6, 2004, available at http://www.federalreserve.gov/boarddocs/press/bcreg/2004/0040206/default.htm.

[392] Press Release, Federal Reserve Board, *Board's Intention to Withdraw Proposed Amendments to Community Reinvestment Act regulations*, July 16, 2004, available at http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040716/default.htm.

[393] OTS, Press Release, OTS to Modify CRA Small Institutions Benchmark, July 16, 2004, available at http://www.ots.treas.gov/docs/7/77426.html.

[394] Heller, *supra* note 16.

[395] *Id*; *see also*, Heller, *supra* note 15.

Second, the costs to banks, and to the agencies, of changing the regulations could be high.[396] It has taken quite some time for banks and the agencies to work through complicated interpretive issues, operational and information system problems, and, perhaps most importantly, the training of bank employees and agency examination staff. Community-based organizations, state and local governments, and other bank partners have organized their community development activities in response, to some degree, to the current structure of CRA. New regulations might necessitate changes in those activities, with high transition costs. The start-up costs associated with changes in regulations account for a significant part of compliancecosts. [397]

Third, current economic uncertainties present complex problems for banks and serious hardships for the most vulnerable households. Now may not be the most opportune time to re-examine basic rules governing bank performance in serving the needs of low- and moderate-income households and communities.

2. Retain the Current Definition of Small Banks

The agencies proposed to increase the asset level at which institutions are considered "small" under CRA. Currently, banks and thrifts are small if they have assets of $250 million or less, and are independent or are part of a holding company with under $1 billion in bank and thrift assets. Under the proposal, banks and thrifts would be considered small if they have assets under $500 million, whether independent or affiliated with a holding company of any size. While the proposal would not have a major effect on the percentage of assets in institutions considered large, the proposal would have cut in half the number of institutions subject to the large retail institution test, reducing coverage of full-scope CRA review to about eleven percent of all banks and thrifts.

With respect to the threshold, the agencies presented little evidence that banks between $250 and $500 million faced special burdens from the full-scope review. If such particular burdens exist, it would be better to deal with them through modifications of the investment and services tests, rather than eliminate the tests for those firms entirely. Regulators have the authority to be flexible on the investment test.[398] As for the service test, small institutions often have a comparative advantage in providing retail services tailored to their local communities. These services are often vital to low- and moderate-income households, partly because such services are gateways to access to credit. Because there is little justification for not applying a service test to small banks it seems all the more ill-advised to expand the category of institutions not subject to the test. Lastly, smaller institutions often have a

[396] For a discussion of the compliance costs of changing regulation more generally, see Elliehausen, *supra* note 207.

[397] Elliehausen, *supra* note 207.

[398] *See infra* Part VII.E. See also, Ryan Trammell, Understanding the Relationship Between Investment Test Examination Criteria and Investment Test Ratings, Federal Reserve Board of San Francisco, Center for Community Development Investments (Aug. 2004), at http://www.frbsf.org/community/resources/QIfinal.pdf (visited Aug. 18, 2004) (finding that qualitative factors, not investment volumes, drive CRA investment test ratings).

comparative advantage in relationship lending to small businesses.[399] Thus, it makes little sense to avoid collecting small business data and evaluating institutions on their small-business-lending performance.

Even more problematic is the proposal to ignore the asset size of the holding company when determining whether to consider the bank "small." This is so for two main reasons. First, banks within holding companies that have less than $500 million in assets are less in need of regulatory "burden relief" than similarly sized independent institutions. Holding companies provide scale economies to their subsidiaries in complying with bank regulations.[400] Banks that are part of holding companies face lower regulatory burdens from the same regulation than their non-affiliated counterparts of similar size. Thus, affiliation should generally be weighed, not ignored, in determining tradeoffs between regulatory burdens and benefits.

Second, banks that are part of holding companies have available to them the range of expertise of the holding company, which is useful for developing programs to meet community needs under CRA. The holding company is part of the bank's performance context. Along with its subsidiaries, it can offer a range of services to the bank in helping the bank meet its CRA performance goals, such as innovative loan products, securitization, or expertise in investment and other matters. These affiliates *do* affect a bank's CRA performance, and the bank should therefore be assessed using the CRA test for large retail institutions which includes the investment and service tests and which takes account of the expertise and resources of the parent institution.

For these reasons, the agencies were correct to withdraw the joint rule increasing the small bank asset thresholds, and the FDIC and OTS were wrong to pursue even higher thresholds unilaterally. Under the FDIC and OTS plans, banks and thrifts with less than $1 billion in assets, regardless of holding company affiliation, would be considered "small" for purposes of CRA. The OTS plan would exempt over 800 thrifts—88 percent of all thrifts holding over $160 billion in assets, with 15 percent of total thrift assets—from the CRA large bank retail examinations.[401] The FDIC plan would exempt over 4,600 FDIC-supervised banks and thrifts—over 86 percent of FDIC-supervised institutions, with $640 billion in assets.[402]

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[399] *See, e.g.*, Robert B. Avery & Katherine A. Samolyk, *Bank Consolidation and Small Business Lending: The Role of Community Banks*, 25 J. FIN. SERVICES RES. 291 (2004) (finding that small banks gain market share from large banks during consolidations); David A. Carter, James E. McNulty, & James A. Verbrugge, *Do Small Banks have an Advantage in Lending? An Examination of Risk-Adjusted Yields on Business Loans at Large and Small Banks*, 25 J. FIN. SERVICES RES. 233 (2004) (finding that small banks have an informational advantage in evaluating small business loans); Jonathan A. Scott, *Small Business and the Value of Community Financial Institutions*, 25 J. FIN. SERVICES RES. 207 (2004) (discussing small bank informational advantages).

[400] Elliehausen, *supra* note 207.

[401] Heller, *supra* note 16; author's calculations based on Office of Thrift Supervision, 2003 Fact Book (May 2004), available at www.ots.treas.gov/docs/4/480149.pdf.

[402] *Id*.; author's calculations.

B. COMBAT PREDATORY LENDING

The ANPR had asked if agencies should consider whether loans made are harmful or abusive. The agencies began to address this issue in the interagency questions and answers issued in 2001.[403] Under that approach, examiners are directed to take account of certain unlawful loan practices. In addition, examiners are to take note of programs designed to transition borrowers from high cost loans to lower cost loans. Over the last decade, affiliations between insured depository institutions and non-bank subprime specialists have increased. Thus, the effectiveness of the agencies' approach will depend on adequate supervision of the relationship between the bank and its affiliates to assess whether borrowers with good credit history are "upstreamed" from subprime affiliates and offered prime products; whether borrowers with poor credit histories have an opportunity to demonstrate creditworthiness and move into prime products; and whether borrowers are inappropriately steered to higher-cost products or divisions. The principles set forth in the interagency questions and answers will need support from agency examinations extending beyond the bank or thrift itself.

The Proposed Rule was much narrower. The agencies would have only taken account of illegal credit practices in affiliates that the bank or thrift chose to include in its CRA record. Affiliates engaged in unlawful practices but not included by the bank or thrift in its CRA submission would not be considered in evaluating the bank's performance under CRA. Moreover, the proposal focused on only one particular form of abuse—"asset based lending"—to the exclusion of other predatory practices. Focusing solely on asset-based lending would have sent a message that other abuses would not affect an institution's CRA rating. Thus, the agencies were correct to withdraw this proposal.

The ANPR does not ask, but should, whether consumer loans should play a more central role in CRA examinations. Currently, such loans are only considered at the option of the bank, or in cases where consumer lending constitutes a core feature of the depository's lending activities. As evidenced by the rise of non-bank consumer lending in low-income communities, some low-income individuals have consumer credit needs that are not being met by banks. Greater competition in the consumer market might help drive out sharp practices. The agencies should consider ways of encouraging banks to assess how their consumer lending could contribute to meeting CRA obligations.

C. ENHANCE THE INVESTMENT AND SERVICE TESTS

The balance among the lending, service, and investment tests set forth in the preamble to the 1995 rule has worked well. Lending has rightly been the focus of a statute aimed at the "credit needs" of communities, but the investment and service tests play critical roles as well. Investments help expand access to credit by enhancing the capacity of specialized local lenders

[403] Federal Financial Institutions Examination Council, Community Reinvestment Act Regulations; Interagency Questions & Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,619, 36,622 (July 12, 2001).

such as CDFIs to provide credit, and by stabilizing a local community with direct investment, thereby enabling loans to be made in the community in a more safe and sound manner. The importance of services to the provision of credit has been less well understood in the past, but recent research shows that services also play a critical role in expanding access to credit.[404]

1. Investment Test

Investments help banks to meet the credit needs of low- and moderate-income communities. Investments help build local financial and community infrastructure and stabilize and grow the broader economic base of low- and moderate-income communities. The interagency questions and answers provide appropriate flexibility for examiners to consider investments made outside of an institution's assessment area if the needs of its community are adequately served. With such flexibility, participation in a broad range of investment options are available in today's marketplace even for reasonably small firms. Based on anecdotal evidence, examiners may not be fully using existing flexibilities, and institutions may not be taking advantage of the full range of investment options. Additional examiner guidance about investments should encourage examiners to provide greater weight to innovative investments (for example, investments in CDFIs) than to larger-volume, low-risk investments (for example, standard mortgage-backed securities).[405]

The ANPR asks what weight should be given to originated loans, purchased loans, and asset-backed securities of CRA-qualifying loans. The current regulation treats loans originated and purchased the same, and asset-backed securities as investments. In principle, one could measure, regardless of the structure, who bears the origination cost, the servicing cost, and the credit risk; quantify such factors as a percentage of the loan; and then assign a portion of each loan corresponding to each bank's share. In practice, the expense is highly unlikely to make the effort worthwhile. Banks should be able to provide examiners with information about their business strategy, and to allocate securities to the investment or lending test according to that strategy. Examiners could make qualitative judgments about the extent to which the firm is serving credit needs however the activity is categorized.

2. Service Test

The provision of financial services is critical to meeting the credit needs of low- and moderate-income communities. Low-income individuals with bank accounts have better access to, and pay less for, transaction services, short-term consumer loans, small business loans, and home mortgage loans. Access to an appropriate bank account, for most low-income "unbanked" individuals,

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[404] See Barr, *supra* note 1.

[405] A much better understanding of institutions' relative performance under the test could be had if the agencies compiled annual institutional and aggregate data on the dollar amount, location, and type of investment made. The lack of such information seriously impedes evaluations. Given the relatively small number of large-sized qualified investments, collecting and reporting such information should not pose a serious burden on banks or thrifts.

would mean lower transaction costs, greater consumer protection, more access to loans, and increased savings as a cushion against financial emergency.[406]

The 1995 regulations provide sufficient flexibility for analysis of an institution's performance, but agency examination procedures do not provide enough guidance as to how to measure an institution's activities in ways that matter to low-income consumers. The service test has received perfunctory attention from examiners,[407] with public evaluations containing little analysis of whether low-income consumers use bank services. Examinations under the service test could be vastly improved by taking three steps.

First, examiners should evaluate the extent to which institutions offer low-cost accounts designed to meet the needs of low-income individuals. Low-cost electronic accounts with direct deposit, little or no risk of overdraft, the opportunity for the accumulation of savings, and bill payment or electronic money order, may hold special promise in this regard. Examiners should make a qualitative judgment about the institutions' products, taking into account research into low-income consumer needs, the costs to institutions of providing accounts, and the requirements of sound banking practice.

Second, regulators should evaluate banks based on the number of low- and moderate-income account holders at their institution. Quantitative measures of usage should provide a portrait of an institution's performance under the service test, and data collection on the numbers of accounts provided should not in and of itself be burdensome.[408]

Third, and conversely, the agencies should give negative consideration to activities that undermine the provision of quality services to the poor. For example, participation by banks in arrangements with other parties that do not provide adequate consumer protection or raise compliance, operational, or other risks should receive negative consideration as part of the performance context under the service test. Agencies should ensure that banks are not

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[406] *See, e.g.*, Michael S. Barr, *Access to Financial Services in the 21st Century*, CAPITAL XCHANGE, June 2001, *at* http//www.brookings.edu/es/urban/capitalxchange/article4.htm; Jeanne Hogarth & Kevin O'Donnell, If *You Build It Will They Come? A Simulation of Financial Product Holdings Among Low- to Moderate-Income Households*, 23 J. CONSUMER POL'Y 409 (2000); Constance Dunham, *The Role of Banks and Non-Banks in Serving Low- and Moderate-Income Communities*, paper prepared for Federal Reserve System Conference on Changing Financial Markets & Community Development, April 5-6, 2001.

[407] MICHAEL STEGMAN ET AL., CREATING A SCORECARD FOR THE CRA SERVICE TEST (Kenan Institute, 2001).

[408] Requiring data collection on the income of account holders could be burdensome. The agencies might consider permitting institutions to use assumptions about customer income based on the accounts offered. For example, a holder of a specialized bank account with no checking privileges and limited ATM access might be presumed to be low-income for reporting purposes. Accounts opened at branches in (or held by individuals residing in) low- or moderate-income areas might be presumed to be held by low- or moderate-income individuals. A formula based on the percentage of low-income population in the census tract could be used. For institutions that already collect information on account holders' income for other purposes, such as cross-marketing, reporting of income might not be burdensome.

merely "renting" their charters to these firms, but are engaged in monitoring and supervision to ensure compliance with applicable law. This may require targeted, risk-based examination of these parties, as has been conducted by the OCC with respect to national bank relationships with payday lenders.

D. Rely More on Flexible Approaches

1. Provide Guidance on Qualitative Factors

The ANPR had asked whether the regulations strike the right balance between qualitative and quantitative factors, and among lending, investment and service tests. As Board stated in its Proposed Rule, in theory, the regulation itself is flexible on both counts. In practice, qualitative factors are more difficult to evaluate, which in examinations tends to diminish their importance. The regulations' focus on actual performance has largely worked in increasing lending to low- and moderate-income borrowers and areas. The challenge now is to preserve those gains in focusing on measurable results, while integrating quality concerns into examinations. Without changing the regulations, the agencies could provide examiners with more detailed guidance, which will tend to raise the quality of the qualitative analysis over time. For example, the current interagency questions and answers note that institutions would receive favorable consideration for instituting programs that graduate borrowers from the subprime to the prime market. It may be useful to provide examiners with tools to assess how the presence of such a program affects the ability of a bank or thrift to meet the credit needs of its community.

2. Develop the Strategic Plan Option

The strategic plan option represents, in principle, an important alternative method of evaluation, particularly for firms with non-traditional business plans and operations. In fact, the strategic plan option is likely to become more important over time, as firms use an increasingly wide variety of means—including the internet, ATMs and POS, interstate and global branches—to collect deposits, make loans and investments, and provide services. Firms are increasingly meeting the credit needs of communities through a variety of affiliates. The fact that so few firms have used the strategic plan option argues strongly for the need to make the option easier to exercise, in part by providing assistance in development, speeding up review, and providing greater certainty and speed in examination of firms that have adopted such plans.

3. Broaden the Performance Context

The flexibility provided by the performance context assessment is one of the most critical aspects of the CRA regulation. It permits the locally based decisionmaking contemplated by Congress in enacting CRA. The performance context permits financial institutions to respond to local needs based on their own institutional organization and business plan, without being judged on the basis of national norms. Examiners instead look to local context and the business strategy of the bank or thrift. The performance context also permits greater citizen participation in the formulation of the assessment, which may increase its accuracy and perceived legitimacy. The performance context also gives examiners the opportunity to evaluate the extent to which the bank's or thrift's relationships with affiliates or third parties enhances or diminishes the ability of the depository to meet the credit needs of its community. Based on a non-scientific review of a number of public evaluations from examinations of large banks, however, examiners could benefit from additional training and education in more clearly linking an understanding of performance context with an assessment of performance. Moreover, examiners should explicitly look to affiliates and subsidiaries in the holding company structure for an understanding of the bank's capacity to perform under CRA.

4. Allow More Flexibility in Assessment Area

Assessment areas, which are tied to geographies surrounding deposit-gathering facilities, provide a reasonable standard for most institutions. However, in an era in which banks collect deposits, raise funds, and make loans across states, national borders, and over the internet, "community" will need redefinition. A more tailored approach might permit institutions to define more broadly their own low- and moderate-income target markets or emphasize different product and geographic markets in different contexts, with strong anti-gerrymandering protections. For example, a bank might compete with non-bank lenders to make affordable loans to subprime borrowers in areas where it has no branches, rather than emphasizing prime loans in a tight market where it does have branches. Adopting a more flexible approach to assessment areas is more complicated for the agencies to administer, and in some ways riskier for banks and community organizations, than the current approach. Nonetheless, CRA will need to evolve with the marketplace to remain effective. A prudent course is for the agencies to experiment with a flexible approach to delineating assessment areas in the strategic plan option.

E. MONITOR AFFILIATE ACTIVITY

As financial institutions increasingly rely on a broad range of affiliations to carry on their businesses, it is both possible and desirable to take account of affiliate activity while respecting the fact that CRA applies only to insured depositories. Permitting banks, at their option, to include activities of affiliates in meeting the credit needs of their community, with current safeguards against gerrymandering, is consistent with this approach. It is also critical to an accurate measure of CRA performance. Some borrowers may be ending up in a bank's subprime unit, or subprime affiliate, when in fact they could qualify for a mortgage on better terms. Banks and thrifts should have in place procedures to "upstream" these borrowers with good credit histories into their prime mortgage units. The regulators should give CRA consideration for "promoting" borrowers from the subprime to the prime market.

Moreover, the other agencies should adopt the current approach of the OCC, which considers a bank's subsidiaries' assets in determining the performance context in which a bank operates. The assets and activities of all of the affiliates of a bank should also be considered in assessing the performance context within which a bank meets its obligations under CRA. After all, a bank's affiliates are hardly irrelevant to the bank's business decisions, including how to meet the credit needs of their communities. The Gramm–Leach–Bliley Act made a financial holding company's commencement of newly authorized activities, or its merger with newly authorized entities, contingent on satisfactory CRA performance by all of the affiliate banks or thrifts. A bank's affiliates have a strong interest in ensuring adequate CRA performance by all the insured depositories of the holding company. The agencies should include the assets and activities of affiliates in assessing performance context for CRA examinations of banks and thrifts.

Finally, CRA regulations already provide that evidence of illegal credit practices will affect an institution's CRA rating. The laws governing such credit practices are equally applicable to banks and thrifts and non-depository creditors. Illegal credit practices of an affiliate that has been included at the option of the depository institution for purposes of a CRA examination are relevant to its rating, but so too are the illegal credit practices of affiliates not so included. Regulators should not turn a blind eye to illegal practices. Given the high cost of examining all affiliates for such practices, enforcement of other credit laws should occur through risk based examinations of affiliates. The results of such compliance examinations should be taken into account in understanding the performance context of affiliates under CRA.

VIII. CONCLUSION

Enormous progress has been made over the last decade in expanding access to credit for low-income, moderate-income, and minority households. Contrary to the contentions of previous legal scholarship, I have argued that CRA effectively responds to important market failures and helps to address racial discrimination. Using recent empirical evidence, I have shown that CRA has helped to expand access to credit to low-income, moderate-income, and minority households over the last decade. I have also demonstrated that CRA's costs have been exaggerated. I have explained why a wide range of other critiques of CRA miss the mark. Furthermore, comparing different modes of credit market regulation and subsidy has helped to reveal some hidden strengths and weaknesses of CRA, and to rebut the contention of CRA's critics that CRA should be abandoned in favor of various existing and potential alternatives. In light of these assessments, I have suggested areas of reform that would help CRA continue to expand access to capital. My conclusions have been based on recent empirical studies, but I recognize that as credit markets develop, scholars and policy makers should reassess CRA.