

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

MICHAEL S. BARR*

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 in 1977 to help overcome barriers to credit that these groups faced. Scholars have long leveled numerous critiques against CRA as unnecessary, ineffectual, costly, and lawless. Many have argued that CRA should be eliminated. By contrast, I contend that market failures and discrimination justify governmental intervention and that CRA is a reasonable policy response to these problems. Using recent empirical evidence, I demonstrate that over the last decade CRA has enhanced access to credit for low-income, moderate-income, and minority borrowers at relatively low cost, consistent with the theory that CRA is helping to overcome market failures. I argue that the form of CRA's legal directive, more akin to a standard, is preferable to more rules-based approaches, on grounds of both efficiency and legitimacy. Comparing CRA to other credit market regulations and subsidies, I argue that CRA is a reasonably effective response to market failures and should not be abandoned. In sum, contrary to previous legal scholarship, I contend that CRA is justified, has resulted in progress, and should be retained.

INTRODUCTION 515

 I. THE COMMUNITY REINVESTMENT ACT: HISTORY AND
 PURPOSE 523

 II. CRITIQUES OF CRA 526

* Copyright © 2005 by Michael S. Barr. Assistant Professor of Law, University of Michigan Law School. B.A., Yale University, 1987; M.Phil, Magdalen College, Oxford, 1989; J.D., Yale Law School, 1992. I would like to thank Peter DiCola for research and editorial assistance, and Brian Greene and Kevin Smith for research assistance in Part VII. This Article was made possible through a generous grant from the Ford Foundation, for which I thank Frank DiGiovanni, and from the Cook Endowment of the University of Michigan Law School. I have benefited from assistance from the Brookings Institution, where I am a nonresident senior fellow. I would like to thank the participants at Harvard University's Joint Center for Housing Studies conference, "Building Assets, Building Credit," particularly Malcolm Bush, Edward Gramlich, Jeff Jaffee, Duncan Kennedy, and Richard Riese. For comments on earlier drafts, I thank Reuven Avi-Yonah, Omri Ben-Shahar, Steve Croley, Phoebe Ellsworth, Richard Friedman, Daniel Halberstam, Howell Jackson, Ellen Katz, Kyle Logue, Nina Mendelson, Geoffrey Miller, Sallyanne Payton, Daria Roithmayr, Dan Sokolov, Peter Swire, Mark West, Jim B. White, J.J. White, and participants in the University of Michigan's Legal Theory Workshop and Governance Workshop. Thanks also go, as ever, to Jim Krier. This Article builds on research on CRA that I directed while serving at the Treasury Department. For their contributions to that project, I thank Eric Belsky, Maureen Kennedy, Paul Leonard, Robert E. Litan, and Nicolas P. Retsinas.

A.	<i>No Market Failures or Discrimination Justifying CRA</i>	527
B.	<i>Little Benefit, High Costs</i>	527
C.	<i>Rules versus Standards</i>	530
D.	<i>Geographic and Institutional Scope Distorts Markets</i>	531
E.	<i>Other Alternatives</i>	532
III.	THEORETICAL FOUNDATIONS OF CRA	533
A.	<i>Market Failure</i>	534
B.	<i>Racial Discrimination</i>	544
C.	<i>Problems in the Subprime Sector</i>	555
D.	<i>Summary</i>	560
IV.	EMPIRICAL EVIDENCE THAT CRA IS EFFECTIVE	560
A.	<i>The Benefits of CRA Are Substantial</i>	561
B.	<i>The Costs of CRA Have Been Overstated</i>	580
1.	<i>Profitability and Risk</i>	580
2.	<i>Mergers and Acquisitions</i>	586
3.	<i>Rent-Seeking</i>	588
4.	<i>Compliance Costs</i>	591
V.	CRA'S STANDARDS APPROACH COMPARED TO A RULES APPROACH	596
A.	<i>CRA's Standard Compared to a Rule</i>	596
B.	<i>CRA's Standard Reasonably Addresses Market Failures and Does So Better than Tradeable Obligations</i>	604
C.	<i>The Standards Approach Compares Favorably with Safe Harbors</i>	608
VI.	THE SCOPE OF CRA	612
A.	<i>Geography</i>	612
1.	<i>CRA is Not Anachronistically "Localist" in Its Operation</i>	612
2.	<i>CRA Does Not Cause Banks to Avoid Low-Income Communities</i>	614
B.	<i>Applying CRA to Insured Depositories Is Justified</i> ..	616
1.	<i>Subsidies to Banks and Thrifts</i>	617
2.	<i>Role in Financial Markets</i>	620
3.	<i>Credit Unions</i>	621
4.	<i>Affiliates</i>	622
VII.	CRA COMPARED WITH OTHER CREDIT MARKET REGULATIONS	624
A.	<i>CRA Compared with Fair Lending Law</i>	625
B.	<i>CRA Compared with Disclosure Law</i>	628
1.	<i>Types of Disclosure Laws</i>	628

2. Problems with Disclosure Laws	630
3. Disclosure Reforms Compared with CRA	633
C. CRA Compared with Abusive Practice Prohibitions	634
D. CRA Compared with Subsidies	637
1. Supply-Side Subsidies Through the Government Sponsored Enterprises and the Federal Housing Administration	638
2. CRA Compared with Targeted Supply-Side Subsidies	643
3. CRA Compared with Income Transfers or Demand-Side Subsidies	645
CONCLUSION	648

INTRODUCTION

Financial markets in the United States are broad and deep.¹ Our capital markets are regarded as highly efficient in spurring business growth, and for most Americans, access to credit has become readily available for consumer purchases and home ownership. Our home mortgage markets are innovative and liquid, attracting investors from around the globe. Competition in the financial services sector is generally vibrant, and the removal of many geographic and product restrictions on banking has given rise to diversified financial services organizations with nationwide reach.

Yet the very success of our credit markets makes it easy to overlook those who may have been left behind historically—low- and moderate-income communities, as well as minority households.² Enormous progress has been made in expanding access to home mortgage lending for low- and moderate-income and minority households,³ but there is evidence that minority borrowers continue to face dis-

¹ See generally ROBERT E. LITAN & JONATHAN RAUCH, U.S. DEP'T. OF TREASURY, *AMERICAN FINANCE FOR THE 21ST CENTURY* (1997).

² This Article systematically explores themes I first worked on at the Treasury Department, and then wrote about in Michael S. Barr, *Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress*, 16 NOTRE DAME J.L. ETHICS & PUB. POL'Y 447 (2002) and Michael S. Barr et al., *The Community Reinvestment Act*, in *BANKING AND SOCIAL COHESION: ALTERNATIVE RESPONSES TO A GLOBAL MARKET* 214 (Christophe Guene & Edward Mayo eds., 2001).

³ In evaluating the Community Reinvestment Act (CRA), this Article largely relies on evidence regarding home mortgage lending because it 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 than 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).

crimination.⁴ In addition, community advocates have long argued that “redlining”—not lending to borrowers in neighborhoods with high concentrations of minority households—has, at least historically, limited the flow of capital for homeownership in minority communities.⁵ Moreover, the effects of race and economics are intertwined because of the high degree of racial segregation in housing and the concentration of minority households in low-income communities. Economic theories predict that low-income communities generally would 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, which prevent lenders from fully recapturing the costs of gathering information and developing expertise in lending to low-income borrowers, may have impeded the formation or full development of credit markets in low-income communities, which generally have had fewer home mortgage transactions than higher-income markets.⁶ More recently, “subprime”⁷ lenders have provided more capital in low-income areas. Consumer advocates have argued, however, 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.

Congress has enacted a wide range of federal laws and subsidy programs that affect the provision of credit.⁸ This Article focuses on perhaps the most controversial of these laws: the Community Reinvestment Act of 1977 (CRA).⁹ Passed in response to concerns

⁴ See *infra* Part III.B.

⁵ The federal government’s housing insurance program and private market participants in some cases literally drew red lines on maps around areas that were to be avoided, and more widespread racial discrimination in housing has been well documented. See NAT’L COMM’N ON URBAN PROBLEMS, *BUILDING THE AMERICAN CITY*, H.R. DOC. NO. 91-34, at 101 (1969); Amy E. Hillier, *Spatial Analysis of Historical Redlining: A Methodological Exploration*, 14 J. HOUSING RES. 137, 142–44 (citing examples of historical redlining).

⁶ See *infra* Part III.C.

⁷ 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.

⁸ See generally, e.g., Michael S. Barr, *Modes of Credit Market Regulation*, in BUILDING ASSETS, BUILDING CREDIT: CREATING WEALTH IN LOW-INCOME COMMUNITIES (Nicolas Retsinas & Eric Belsky eds., forthcoming 2005) (providing introduction to five types of credit market regulation and subsidy programs); Lawrence J. White, *Focusing on Fannie and Freddie: The Dilemmas of Reforming Housing Finance*, 23 J. FIN. SERVICES RES. 43 (2003) (discussing role of Fannie Mae and Freddie Mac in housing policy).

⁹ 12 U.S.C. §§ 2901–2908 (2000) (Community Reinvestment Chapter); see also *id.* § 1831u(b)(3) (CRA requirement for interstate mergers); *id.* § 1831y (CRA Sunshine Requirements); *id.* § 1843(l)(1)–(2) (CRA requirement on insured depositories must be

about redlining of minority and low-income areas,¹⁰ and market failures in low-income communities,¹¹ 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.¹² Federal banking agencies periodically examine and rate banks and thrifts on their CRA performance. Banks have an incentive to seek high ratings because regulators consider a bank's or thrift's CRA record in determining whether to approve that institution's application for a "deposit facility," which includes mergers with or acquisitions of other depository institutions. CRA also plays a role in the approval process for more mundane events, such as the opening or closing of a bank branch.¹³ Such applications also provide the public with an opportunity to comment, including by commenting on the CRA performance of the institution.¹⁴

CRA has been since its enactment, and remains today,¹⁵ the subject of extensive debate. The contentiousness of the policy is reflected in the uncharacteristic drama that accompanies proposed policy changes. 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 (OTS) made a unilateral announcement that the agency was going to curtail CRA examinations for nearly ninety percent of institutions that it regulates, those holding less than \$1 billion in assets, and the Federal Deposit Insurance Corporation (FDIC) proposed a similar rule.¹⁶ The Federal Reserve Board and the Office of

met for financial holding companies or financial subsidiaries to engage in expanded financial activities).

¹⁰ 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 on market failures rather than on discrimination per se, but as I discuss *infra* Parts III.A & III.B, market failures and discrimination are intertwined.

¹¹ For the theories underlying CRA, see *infra* Part III.

¹² 12 U.S.C. § 2901(b) (2000).

¹³ See 12 U.S.C. § 2902(3) (2000); see also *infra* notes 33–37 and accompanying text.

¹⁴ 12 C.F.R. § 25.29(c) (2004).

¹⁵ See, e.g., Michele 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 Michele Heller, *FDIC Seen Siding with OTS on CRA*, AM. BANKER, July 20, 2004, at 1. See also David W. Chen, *U.S. Set to Alter Rules for Banks Lending to Poor*, N.Y. TIMES, Oct. 20, 2004, at A1 (describing effects of proposals to raise small bank threshold and arguments about importance of CRA); Editorial, *Endangering Community Development*, N.Y. TIMES, Aug. 21, 2004, at A14 (arguing that regulators should reject proposal to raise threshold for small banks). The Office of Thrift Supervision finalized the rule on August 18, 2004. See Community Reinvestment Act Regulations, 69 Fed. Reg. 51,155 (Aug. 18, 2004) (codified at 12 C.F.R. § 563.12(t)). The FDIC proposed a similar rule, Community Reinvestment, 69 Fed. Reg. 51,611 (Aug. 20, 2004).

the Comptroller of the Currency (OCC) balked at this move.¹⁷ OTS then proposed to let any savings and loan institution, regardless of size, opt out of the investment and service tests under CRA.¹⁸ Then, the Board, the OCC, and the FDIC agreed to raise the small bank threshold to \$1 billion but to add a new “community development test” for institutions with between \$250 million and \$1 billion in assets.¹⁹ At bottom, debate over these kinds of changes revolves around competing views of the underlying purposes of CRA, the need for government intervention in credit markets, and the costs and benefits of such policies.²⁰

Legal scholars vigorously question the theoretical and empirical claims that motivated the enactment of CRA, and many of them advocate eliminating the policy.²¹ A large body of literature suggests

¹⁷ Heller, *supra* note 16.

¹⁸ Community Reinvestment Act—Community Development, Assigned Ratings, 69 Fed. Reg. 68,257, 68,262 (proposed Nov. 24, 2004).

¹⁹ See Joint Press Release, Federal Deposit Insurance Corporation & Office of the Comptroller of the Currency, Federal Banking Agencies Propose Revisions to Community Reinvestment Act Regulations (Feb. 22, 2005), at <http://www.fdic.gov/news/news/press/2005/pr1305.html> (last visited Mar. 8, 2005); Press Release, Federal Reserve Board, Request for Comments on Proposed Revisions to Regulations Implementing the Community Reinvestment Act, Regulation BB (Feb. 25, 2005) at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050225/default.htm> (last visited Mar. 8, 2005).

²⁰ See, e.g., Robert E. Rubin & Michael Rubinger, *Don't Let Banks Turn Their Backs on the Poor*, N.Y. TIMES, Dec. 4, 2004, at A19 (arguing that CRA has been successfully helping communities and that OTS and FDIC plans would place these gains at risk).

²¹ See generally Charles W. Calomiris et al., *Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 J. MONEY, CREDIT & BANKING 634 (1994) (arguing there is lack of evidence of bigotry in mortgage market); Jeffery W. Gunther, *Should CRA Stand for “Community Redundancy Act”?*, REG., vol. 23, iss. 3, at 56 (2000) (arguing CRA is costly and not necessary to ensure access to credit to minorities), available at <http://www.cato.org/pubs/regulation/regv23n3/gunther.pdf> (last visited Jan. 26, 2005); Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197 (2000) (maintaining that existing regulatory framework is partially responsible for credit market's failure to serve minorities); Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561 (1995) (finding CRA to be an inefficient solution to lending discrimination); Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993) (concluding that the CRA does more harm than good); Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533 (1995) (using regression analysis to argue creditworthiness, not redlining, is responsible for minorities being underserved by credit markets); Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993) [hereinafter Swire, *Safe Harbors*] (responding to Macey and Miller and offering safe harbor proposal for protection from CRA enforcement); Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 FORDHAM URB. L.J. 281 (1993) (faulting CRA as either redundant or dependent on cross-subsidy); Craig E. Marcus, Note, *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.

that competition in credit markets has driven (or will drive) out discriminatory²² or abusive practices and that the market failures are illusory.²³ Critics of CRA argue that it addresses 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 having little, if any, positive effect, and at a high cost. For example, in their seminal article a decade ago, Jonathan Macey and Geoffrey Miller attempted to demonstrate the weak foundations and high cost of CRA in the wake of the 1989 reforms to CRA, charging that CRA is theoretically unjustified, undermines the safety and soundness of the banking system and empowers community group rent-seeking at the expense of bank profitability.²⁴

Critics lodge five main arguments against CRA: First, they argue that the CRA is unwarranted in theory because market failures and discrimination are not significant problems in credit markets and CRA is ill-equipped to address them if they are. Second, CRA provides little benefit to low-income communities and is costly because it forces banks to make unprofitable, risky loans and compliance costs are high. Third, CRA's use of a legal standard rather than a rule is lawless, and contributes to its higher costs. Fourth, the scope of CRA harms banks and thrifts as well as the low-income communities it is intended to serve. Lastly, other alternatives are better able to overcome market failures and discrimination, and to help low-income and minority households.

This Article systematically analyzes these 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 failures and racial discrimination that justify CRA. I contend that a good deal of earlier legal scholarship on CRA wrongly discounted these market problems. Of course, at the most

L. REV. 710 (1996) (arguing CRA provides weak incentive to improve low- and moderate-income lending because it does not combat discrimination or require banks to make particular kinds of loans in specified areas). For a "community empowerment" critique, see generally Anthony D. Taibi, *Banking, Finance and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463 (1994). Criticisms of CRA are discussed in detail in Part II *infra*.

²² This view usually is derived from Kenneth J. Arrow, *The Theory of Discrimination*, in *DISCRIMINATION IN LABOR MARKETS* 3 (Orley Ashenfelter & Albert Rees eds., 1973) and GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION* (2d ed. 1971).

²³ See, e.g., Jeffrey M. Lacker, *Neighborhoods and Banking*, 81 ECON. Q. 13, 15–24 (1995) (arguing that empirical evidence does not demonstrate conclusively that discrimination or market failures exist in bank lending to low-income communities).

²⁴ See Macey & Miller, *supra* note 21, at 318–24, 333–37.

basic level, no market is perfect.²⁵ The real question is a relative one—whether CRA is preferable to other alternatives, including simply allowing those market failures to persist, or relying on market forces to overcome them. This Article explores why such market imperfections might be relatively greater in low-income communities, as well as more appropriate as targets of government intervention, given the social benefits of expanded access to capital.²⁶ The Article then argues that critics failed to explore fully how CRA could help to overcome market failures and discrimination. Thus the critics have missed the ways in which CRA could help in theory, and has helped in practice, to overcome these problems.

The Article deploys recent empirical analyses that cast doubt on many of the critics' claims about the costs and benefits of CRA. In part, earlier critics were wrong in their predictions about the high costs and low benefits of CRA, based largely on anecdotal evidence, and rooted in their belief that no meaningful market failures existed. In part, the 1995 reforms to CRA promulgated by the bank regulators responded to earlier criticisms in positive ways. Recent evidence shows that over the last decade CRA appears to have created far greater benefits than previous legal scholarship had predicted. Lending to low- and moderate-income and minority households increased dramatically during the 1990s. Through econometric controls, studies suggest that CRA has had an independent effect on increased lending to low- and moderate-income and minority communities. Earlier articles suggested that the costs of CRA were exceedingly high; this Article argues that such costs are relatively low, and that the 1995 reforms likely contributed to reducing the costs. The fact that CRA lending has provided real benefits to communities and has not proven to be unprofitable or overly risky provides indirect support for market failure and discrimination theories underlying CRA. That is, if market failures and discrimination were not significantly present, either CRA would not matter, or an effective CRA would wind up forcing banks and thrifts to make costly, risky loans. The empirical evidence instead is more consistent with the argument that CRA is theoretically justified.

²⁵ The existence of transaction costs, for example, implies that markets are not perfect. Cf. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (arguing it is unrealistic to assume there are "no costs involved in carrying out market transactions" and therefore market forces will not necessarily lead to efficient allocations of legal rights).

²⁶ For discussion of circumstances disfavoring government intervention to correct market failures, see, for example, JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 8–10 (3d ed. 2000).

In addition, this Article argues that some of the costs incurred under CRA—for example, those caused by the lack of bright line rules under the CRA standard—also represent benefits, previously ignored or dismissed, in the form of increased citizen participation and local, contextual “rulemaking.” In that regard, I contend that the “rules versus standards” literature has failed to give sufficient attention to both the “expressive benefits” of legal standards and to their potential to improve social welfare and enhance the accountability and legitimacy of the regulatory process when such standards are structured to encourage involvement in the process of regulatory interpretation by both citizens and the regulated entities themselves. Moreover, proponents of rules have focused on the ex post transaction costs involved in standards and have failed to give appropriate weight to the substantive benefits of flexibility that standards provide. In particular, standards may be preferable to rules when the conduct to be regulated varies significantly by the size, market context, organizational structure and business strategy of the regulated entity. These benefits explain in part why CRA’s current approach has significant advantages over rule-based proposals to set numerical targets or create safe harbors. In sum, I contend that CRA has a reasonable foundation,²⁷ and that it can be defended as socially efficient, in the sense that the benefits of CRA likely exceed the costs.²⁸

CRA’s opponents are also critical of the geographic and institutional scope of CRA. With respect to geographic scope, they argue that CRA is overly focused on communities around bank branches when there is no reason banks should lend near where they take deposits. With respect to institutional scope, they argue that CRA unfairly or inefficiently burdens banks and thrifts while leaving other market participants outside CRA’s scope. While there is some force to these arguments, I argue, on balance, that CRA’s geographic scope is broader and more flexible than critics allege, and that CRA’s institutional focus on banks and thrifts is reasonable, given governmental subsidies to these institutions and their specialized market roles.

Some critics argue that CRA should be eliminated because other regulatory steps have been taken, or could be, to overcome market failures and improve access to capital in low- and moderate-income

²⁷ See *infra* Parts III–V.

²⁸ I am making a claim here for Kaldor-Hicks efficiency. 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. See Nicholas 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).

areas or to minority borrowers.²⁹ These other alternatives are often mentioned in a cursory fashion rather than systematically explored. On closer examination, by contrast, I argue that CRA seems reasonably effective at reducing market failures and discrimination when compared with other types of credit market regulation, including disclosure, fair lending laws, product regulation, and subsidy. I also show that tax and transfer systems proposed by critics suffer from deficiencies that make them problematic as alternatives to CRA. I do not argue that CRA is preferable to all of these approaches, but rather that all of the approaches suffer from limitations that make it plausible to think that the tradeoffs involved in deploying CRA to overcome market failures and discrimination are reasonable ones, and that eliminating CRA would be ill-advised.

The approach that I will take in the Article to analyzing CRA is non-utopian. I do not ask, in an ideal world, what would be an ideal policy. Instead, my approach asks—is CRA a reasonable policy response to real world problems? Given that we have CRA, should we keep it, or abandon it, as critics suggest? I answer these questions by drawing on theory, empirical evidence, and comparative analysis. My short answer is: CRA is a reasonable policy response to market failures and discrimination, and we should keep it.

The Article proceeds as follows. Part I briefly describes CRA's history and structure. Part II recounts the scholarly critiques of CRA, and the remaining parts respond to these arguments. Part III defends CRA in theory as an appropriate response to market failure and discrimination. Part IV analyzes recent empirical evidence regarding the costs and benefits of CRA and argues that the empirical case for CRA's role in overcoming market failures and discrimination is strong. Part V shows that the structure of CRA, using an approach more akin to a standard, rather than a rule, contributes to the benefits CRA confers. I also explain why numerical targets and safe harbors, which are variants of a rule-based approach, would be inferior to current policy. Part VI explores the current scope of CRA. I argue that critics' arguments about the geographic and institutional scope of CRA have much less force than commonly asserted. Part VII analyzes CRA in the context of other alternatives, and contends that the tradeoffs involved in CRA are plausible ones, and that CRA should not be eliminated in favor of these other alternatives.

²⁹ See *infra* notes 97–103 and accompanying text.

I

THE COMMUNITY REINVESTMENT ACT: HISTORY
AND PURPOSE

The Community Reinvestment Act has a rich cultural, political, and economic history, but I only wish to sketch enough of the contours here to enable readers to engage with the arguments about the merits of the Act. CRA was enacted in the 1970s as part of a trio of laws—together with the Home Mortgage Disclosure Act³⁰ (HMDA) and the Equal Credit Opportunity Act³¹ (ECOA)—designed to address racial discrimination as well as lack of access to credit in low- and moderate-income communities. In enacting the Community Reinvestment Act in 1977, Congress found:

- (1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;
- (2) the convenience and needs of communities include the need for credit services as well as deposit services; and
- (3) regulated financial institutions have [a] continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.³²

Congress directed the appropriate federal regulatory agency with supervisory responsibility for each type of insured depository institution to “(1) assess the institution’s record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution; and (2) take such record into account in its evaluation of an application for a deposit facility by such institution.”³³ To meet the first directive, the regulatory agencies regularly examine each depository institution, write up an evaluation of the institution’s performance, and assign the institution a rating.³⁴ To meet the second directive, the agencies evaluate CRA performance in the context of applications for mergers and acquisitions, deposit insurance, branch openings, and other matters constituting “application for a deposit facility.”³⁵ The structure of CRA expanded on pre-existing requirements for the regulators to take into account the “convenience and

³⁰ 12 U.S.C. § 2801 (2000).

³¹ 15 U.S.C. § 1691 (2000).

³² 12 U.S.C. § 2901(a).

³³ *Id.* § 2903(a).

³⁴ *See id.* § 2906 (describing ratings of “[o]utstanding,” “[s]atisfactory,” “[n]eeds to improve,” or “[s]ubstantial noncompliance”).

³⁵ *Id.* § 2902.

needs” of the community in evaluating such applications,³⁶ and the pre-existing authority for the regulators to hold public hearings to consider such applications.³⁷

During the first decade or so following CRA’s enactment, regulators paid CRA scant attention, and the results of CRA were likely modest as well. Regulators used a series of twelve factors to evaluate banks and thrifts,³⁸ and most commentators found that the regulators and banks had focused on process-oriented evaluations, such as the time spent at Board meetings discussing community needs, rather than on results.³⁹ This began to change at the end of the 1980s. Over time, particularly during the 1990s, both legal and market developments strengthened CRA.⁴⁰ Legislative changes to CRA enacted in 1989 required regulators to publicly disclose the institution’s rating and performance evaluation,⁴¹ which harnessed the power of public relations to CRA’s goals. Also in 1989, a bank regulator for the first time denied an application for merger on CRA grounds.⁴² The merger denial demonstrated that there could be serious consequences for poor CRA performance.

Still, by the late 1980s and early 1990s, community organizations and banks tended to view CRA as both overly burdensome and underperforming. In 1993, the banking agencies, at the behest of President Clinton, began a process to revise the CRA regulations, and issued proposals in 1993 and 1994.

Final changes to the regulations implementing CRA issued in 1995⁴³ focused CRA evaluations on objective performance measures rather than the more subjective and process-oriented factors that regulators previously had used and that scholars, banks, and community organizations often had criticized. These new regulations required

³⁶ *Id.* § 2901(a)(1); *see also id.* § 1842(c)(1) (requiring Board to consider whether merger or acquisition meets “convenience and needs” of community).

³⁷ *See, e.g.*, 12 C.F.R. § 5.11 (2004) (describing OCC hearing procedures for applications).

³⁸ Community Reinvestment Act Regulations, Joint Final Rule, 60 Fed. Reg. 22,156, 22,157 (May 4, 1995).

³⁹ *Id.* at 22,156–57.

⁴⁰ *See, e.g.*, ERIC S. BELSKY ET AL., INSIGHTS INTO THE PRACTICE OF COMMUNITY REINVESTMENT ACT LENDING: A SYNTHESIS OF CRA DISCUSSION GROUPS 4–8 (2000) (presenting findings from discussions with lenders and community organizations), available at <http://www.jchs.harvard.edu/publications/governmentprograms/cra00-1.pdf>. I discuss these legal and market development and CRA’s effectiveness in further detail *infra* Part IV.

⁴¹ Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183, 527 (codified at 12 U.S.C. § 2906(b) (2000)).

⁴² *Continental Bank Corporation*, 75 FED. RESERVE BULL. 304, 305–06 (1989) (describing “important deficiencies” in CRA performance and denying application).

⁴³ Community Reinvestment (Regulation BB), 12 C.F.R. § 228.11 (2004).

banks and thrifts to disclose information about their small-business, small-farm, and community-development lending.⁴⁴ Under the 1995 regulations, large banks, small banks, and wholesale or limited-purpose institutions have tailored examinations that more closely align CRA examinations with business strategies of different types of banking institutions. Large banks are evaluated on a three-part test of their lending, investments, and services, while small banks undergo a streamlined review of lending.⁴⁵

For large banks, the lending test, which counts for fifty percent of the bank's CRA rating, evaluates the bank's performance in home mortgage, small-business, small-farm, and community-development lending, and under some circumstances, its consumer lending. The agency considers the number and amount of loans, the geographic distribution of loans, including to low- and moderate-income areas, and the income of borrowers.⁴⁶ The agency also considers "innovative or flexible lending practices."⁴⁷ Under the investment test, which counts for twenty-five percent of the bank's CRA grade, the agency evaluates the dollar amount of the bank's investments, its innovativeness, its responsiveness to community needs, and the extent to which the investment fills gaps that other investors do not "routinely" provide.⁴⁸ Under the service test, which counts for the remaining twenty-five percent of the bank's evaluation, the agency analyzes "the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services."⁴⁹ The agency assesses an institution's record under the tests in light of the "performance context" in which the institution is operating, including economic, demographic, credit and other market factors; the bank's own capacities, constraints, and business plans; and the bank's "past performance and the performance of similarly situated lenders."⁵⁰

Lending has rightly been the focus of a statute aimed at the "credit needs" of communities, but investment and services play critical roles as well in meeting the credit needs of low- and moderate-income communities and are thus appropriately evaluated under CRA. Investments help build local financial and community infrastructure and stabilize and broaden the economic base of low- and

⁴⁴ 12 C.F.R. § 25.42 (2004).

⁴⁵ See *id.* §§ 25.21–25.26, 228.21–228.26.

⁴⁶ *Id.* § 25.22.

⁴⁷ *Id.* § 25.22(b)(5).

⁴⁸ *Id.* § 25.23.

⁴⁹ *Id.* § 25.24.

⁵⁰ *Id.* § 25.21(b).

moderate-income communities. Investments help expand access to credit by enhancing the capacity of specialized local lenders such as Community Development Financial Institutions (CDFIs) to provide credit. By stabilizing a local community with direct investment, banks also enable 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.⁵¹ Access to an appropriate bank account for most low-income “unbanked” individuals could mean the opportunity for lower transaction costs, greater consumer protection, more access to loans, and increased savings as a cushion against financial emergency and as a predicate for borrowing.⁵²

These legislative and regulatory changes occurred during a time of increasingly intense consolidation in the banking industry, which provided 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 1999,⁵³ some aspects of CRA were again strengthened. Under the Act, banks and thrifts must have a satisfactory CRA record if they, or their holding companies, are to engage in newly authorized financial activities, such as certain insurance and securities functions.⁵⁴ At the same time, the Act generally increased the time period between regular CRA examinations for small banks with satisfactory or outstanding ratings on their last examination.⁵⁵

II

CRITIQUES OF CRA

The Community Reinvestment Act has been widely criticized by leading scholars.⁵⁶ This Part summarizes the five key arguments against CRA.

⁵¹ See Barr, *supra* note 3, at 138 (describing how it is more difficult to establish credit or qualify for loan without bank account).

⁵² See *id.* at 134–41.

⁵³ Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

⁵⁴ 12 U.S.C. § 2903(c) (2000); *id.* § 1843(l)(2).

⁵⁵ *Id.* § 2908.

⁵⁶ See, e.g., *supra* note 21.

A. No Market Failures or Discrimination Justifying CRA

One group of critics argues that CRA is not necessary because there are theoretical reasons to believe that credit markets are efficient and will drive out discriminatory practices, and in their view the evidence establishing the existence of discrimination in credit markets is weak.⁵⁷ Others have focused on market failures, and argued that these market failures, if they exist, are no worse in low-income areas than in high-income areas and can be easily overcome by market forces.⁵⁸ If there were profits to be had in these communities, markets would find them without any regulatory intervention, they argue.

Critics also argue that even if market failures and discrimination exist in low-income communities, CRA is ill-designed to address these problems. They charge that the CRA is vague, blunt, and contradictory. The Act does not make explicit whether it is targeted at discrimination,⁵⁹ and fails to explain whether low-income communities or individuals are to be helped. In the critics' view, 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), but these goals are contradictory and muddled.⁶⁰ According to this view, there is a poor fit between antidiscrimination principles and CRA,⁶¹ and the structure of CRA would exacerbate, rather than ameliorate, market failures.⁶² In sum, critics argue that CRA is not justified in theory.

B. Little Benefit, High Costs

Critics contend that CRA has provided little benefit at a very high cost because it is the wrong answer to a nonexistent problem.⁶³ The benefits are insignificant, they argue, because economic growth, bank deregulation, technological innovation, and competition would

⁵⁷ See, e.g., Lacker, *supra* note 23, at 17 (describing as "inconclusive" Home Mortgage Disclosure Act data on discrimination against minority loan applicants). I discuss the critique further, and respond to it, in Part III.

⁵⁸ See, e.g., Gunther, *supra* note 21, at 60 (raising questions about degree to which CRA is needed to ensure fair access to credit by all segments of economy).

⁵⁹ See Calomiris et al., *supra* note 21, at 637 (indicating that CRA never mentions minorities explicitly).

⁶⁰ See Klausner, *supra* note 21, at 1561–64 (describing ambiguity of CRA goals); Swire, *Safe Harbors*, *supra* note 21, at 360, 366–67 (mentioning difficult tradeoffs between different CRA goals).

⁶¹ See Macey & Miller, *supra* note 21, at 295 (indicating that using CRA for "affirmative action" is distortion of original purpose of CRA).

⁶² See Klausner, *supra* note 21, at 1565–80.

⁶³ I respond to this critique in Part IV *infra*.

have driven banks to lend in low-income areas even without CRA.⁶⁴ Loan commitments that make headlines are a public relations boon but simply represent what the banks would do anyway.⁶⁵ Others contend that city renewal policies and community development financial institutions were responsible for increased lending.⁶⁶ 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.⁶⁷

At the same time, critics have argued that CRA imposes high costs in a number of ways,⁶⁸ and recent scholarship has suggested that the 1995 regulatory reform did not reduce compliance costs or enhance shareholder value.⁶⁹ First, critics argue that CRA conflicts with bank safety and soundness regulation. CRA expects banks not only to expand credit to households to whom they would not otherwise lend but also to maintain safety and soundness. Critics deride these aims as mutually inconsistent.⁷⁰ Because, in their view, market failures and discrimination are not significant factors justifying CRA, they argue that CRA forces banks to engage in unprofitable, risky lending.⁷¹ To the extent that CRA forces banks to lend to less creditworthy borrowers, CRA increases the bank's risk and reduces its profitability. To the extent that CRA forces banks to lend locally,

⁶⁴ See Gunther, *supra* note 21, at 56 (suggesting that recent growth in lending in low-income neighborhoods is due to effectiveness of market forces in breaking down financial barriers to such lending); Hylton, *supra* note 21, at 204–05 (describing factors other than CRA that may have contributed to improvement of lending markets for urban poor).

⁶⁵ See *infra* note 81 and accompanying text.

⁶⁶ See Hylton, *supra* note 21, at 205 (pointing to improved management policies of big-city mayors, as well as to Community Development Financial Institutions Act of 1994).

⁶⁷ See Gunther, *supra* note 21, at 58 (indicating that lenders not covered by CRA devoted growing proportion of home purchase loans to low-income communities).

⁶⁸ See Calomiris et al., *supra* note 21, at 641 (describing how CRA requires banks to expend great deal of effort and considerable resources focusing on low-income concerns); Klausner, *supra* note 21, at 1590–91 (describing how tradeable obligations would be less costly than current CRA regime); Macey & Miller, *supra* note 21, at 295 (indicating that CRA imposes significant compliance costs on institutions).

⁶⁹ 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*, 23 J. FIN. SERVICES RES., 59, 75 (2003) (indicating that expected benefits of reforms are approximately equal to expected costs).

⁷⁰ See Gunther, *supra* note 21, at 59; Hylton, *supra* note 21, at 197.

⁷¹ See Calomiris et al., *supra* note 21, at 654 (indicating that CRA compliance may involve making unprofitable loans); Macey & Miller, *supra* note 21, at 295 (suggesting that CRA requires banks to make unprofitable and risky investment- and product-line decisions); White, *supra* note 21, at 282 (claiming that CRA either encourages making of unprofitable loans or is redundant because it encourages banks to make profitable loans they would have made anyway).

CRA undermines the ability of banks to diversify their lending geographically, thereby undermining the soundness of their portfolio.⁷² Moreover, critics charge that during economic downturns, when banks must necessarily reduce their risk profiles, CRA examiners would give banks bad ratings for what are in fact only prudent reductions in risk.⁷³

Second, CRA, in their view, deters efficiency-enhancing mergers and cost reductions through closures of low-return bank branches.⁷⁴ By requiring CRA review during merger applications, CRA adds costs to all mergers and may impede marginal ones from proceeding, if this view is correct. Whatever efficiency losses accrue from deterring such mergers, or from the transaction costs of CRA during merger applications, outweigh the benefits of CRA, if any, in their view.

Third, enforcement of CRA's broad standard has been described as arbitrary and inconsistent.⁷⁵ Critics allege that regulatory outcomes depend on the strength of local community groups, competitive factors in the financial sector, the decisions of banks to merge, and the whims of regulators. There is reportedly wide variation in the strictness of regulators, both among agencies, and within agencies by geographic region.⁷⁶ In the critics view, CRA's standard is effectively lawless.

Fourth, critics argue that the CRA standard gives regulators unfettered discretion that they wrongly use to benefit interest groups. For example, Macey and Miller decry the manner in which public participation in reviewing the CRA performance of banks and thrifts 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.⁷⁷ Others charge that inner-city developers gain advantage from the regulation.⁷⁸ One scholar contends that large banks benefit from CRA relative to small banks and impede any changes to CRA that would benefit smaller institutions.⁷⁹ Critics fur-

⁷² See Macey & Miller, *supra* note 21, at 324.

⁷³ See Gunther, *supra* note 21, at 60.

⁷⁴ See Macey & Miller, *supra* note 21, at 322-23.

⁷⁵ See Calomiris et al., *supra* note 21, at 637-38 (describing how vagueness of CRA has led to arbitrary enforcement); Hylton, *supra* note 21, at 203 (same); Macey & Miller, *supra* note 21, at 295 (same); Swire, *Safe Harbors*, *supra* note 21, at 361-62 (describing CRA's high compliance costs and agencies' overbroad discretion).

⁷⁶ See KENNETH H. THOMAS, *THE CRA HANDBOOK* 547 (1998).

⁷⁷ See Macey & Miller, *supra* note 21, at 333-37 (describing how CRA has increased power of activist groups dedicated to various causes related to community development).

⁷⁸ See Hylton, *supra* note 21, at 237.

⁷⁹ See *id.* at 234-37 (arguing that large banks benefit overall from CRA and thus block reforms).

ther posit that the banking regulators 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.⁸⁰ According to this view, the power of rent-seeking interest groups and regulators under CRA leads banks to engage in CRA compliance in a way that benefits rent-seeking pressure groups but 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,⁸¹ and spend inordinate hours and dollars on compliance, generation of data reporting, and other wasteful paperwork, according to this view.⁸²

C. *Rules versus Standards*

At bottom, many of the criticisms regarding whether CRA is a reasonable response to market failures find their expression as an argument that CRA's standards-based regulation is lawless and inefficient.⁸³ Even those who take as a given the existence of CRA argue that the standards-based approach of CRA should give way to more rules-based regimes. Some scholars call for tradeable CRA obligations akin to those used in environmental regimes,⁸⁴ while others call for safe harbors under CRA for the top bank performers.⁸⁵ These proposals stem from the view that CRA is an inefficient means to overcome market failures and discrimination.

CRA's requirement that banks lend wherever they take deposits is a poor design choice to overcome market failures, 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.⁸⁶ CRA thwarts innovation because it requires a high level of

⁸⁰ See Macey & Miller, *supra* note 21, at 342.

⁸¹ See *id.* at 295, 330–33 (suggesting that compliance with CRA often requires successful public relations plan); see also Calomiris et al., *supra* note 21, at 638 (describing how banks feel obliged to waste resources in order to demonstrate their good faith).

⁸² See Swire, *Safe Harbors*, *supra* note 21, at 361; White, *supra* note 21, at 283.

⁸³ See, e.g., Calomiris et al., *supra* note 21, at 637–38 (citing views that CRA is “arbitrary,” “vague[],” and “waste[s] resources”); Macey & Miller, *supra* note 21, at 295 (arguing that CRA standard is “vague” and “arbitrary”). I respond to this critique in Part V.

⁸⁴ See Calomiris et al., *supra* note 21, at 652; Klausner, *supra* note 21, at 1580.

⁸⁵ See Swire, *Safe Harbors*, *supra* note 21, at 353–69.

⁸⁶ See Calomiris et al., *supra* note 21, at 655; Klausner, *supra* note 21, at 1574–75; Swire, *Safe Harbors*, *supra* note 21, at 354–55.

lending once an initial investment in branches in a poor area is made. CRA undermines the ability of banks to benefit from scale economies⁸⁷ and precludes banks from internalizing the positive externalities of their lending because CRA requires many institutions to lend in the community.⁸⁸

In the view of CRA's critics, rules-based regimes would be more efficient than a standard at addressing these problems. Thus, both Michael Klausner and Peter Swire have called for reforms that in their view would enhance CRA's effectiveness at lower cost. Klausner has called for tradeable CRA obligations, akin to tradeable environmental requirements, to take advantage of bank specialization, innovation and scale economies. In another effort to reform CRA, Swire has proposed safe harbors for strong CRA performers. Under a safe harbor, a bank would not face CRA scrutiny during merger applications if the bank had achieved a given level of lending as of its last CRA examination. A safe harbor, it is argued, would provide a measure of certainty to the best banks and thrifts and would thereby lower the costs of CRA, at least the costs due to relying on a "vague" standard rather than a rule.

D. Geographic and Institutional Scope Distorts Markets

Critics contend that the scope of CRA distorts the markets in two ways.⁸⁹ First, CRA distorts banks' location decisions in a way that actually hurts low-income communities. Second, because regulatory burdens and incentives are targeted to some, but not all, financial intermediaries, CRA may simply shift the composition of lending and not expand it or change its terms, and place an unfair and inefficient burden on banks and thrifts.⁹⁰

Scholars 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 com-

⁸⁷ See Calomiris et al., *supra* note 21, at 652, 655.

⁸⁸ Klausner, *supra* note 21, at 1577 (arguing that coordination offers means of internalizing externalities, but CRA makes coordination difficult); Cf. White, *supra* note 21, at 285 (arguing that "[i]f banks could coordinate their lending decisions, they might find that their joint lending could arrest the community's decline and make their loans jointly profitable; in essence, each bank would benefit from the lending decisions of other banks").

⁸⁹ I respond to this critique in Part VI.

⁹⁰ JONATHAN ZINMAN, THE EFFICACY AND EFFICIENCY OF CREDIT MARKET INTERVENTIONS: EVIDENCE FROM THE COMMUNITY REINVESTMENT ACT 2 (Harvard Univ. Joint Ctr. for Hous. Studies, Working Paper CRA02-2, 2002), at http://www.jchs.harvard.edu/publications/governmentprograms/cra02-2_zinman.pdf (last visited April 5, 2005).

munities.⁹¹ Defining communities by the geographical “accident” of deposit facilities, they argue, is itself a difficult process with perverse effects on bank locational decisions.⁹² They argue that CRA creates incentives for banks to avoid opening branches in poor neighborhoods in the first place, in order to avoid having to comply with CRA by lending in those communities.⁹³

Critics lament the additional burden CRA places on banks and thrifts while no similar burden affects other participants in the financial markets. They 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 doubt⁹⁴), critics say the appropriate response would be to eliminate the distortion directly, not enact CRA.⁹⁵ 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.⁹⁶ 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, to packagers of frozen peas.

E. Other Alternatives

Finally, critics argue that if one wants to achieve CRA’s goals, superior regulatory alternatives exist.⁹⁷ They argue that if CRA is rooted in distributional goals, these can better be met through the tax and transfer system, rather than through legal rules.⁹⁸ Still others

⁹¹ See Macey & Miller, *supra* note 21, at 296, 340 (describing how CRA drives capital away from poor neighborhoods by imposing tax on depository institutions “foolhardy” enough to do business in such communities); White, *supra* note 21, at 287 (indicating that banks and thrifts will avoid areas where CRA obligations are onerous).

⁹² See Klausner, *supra* note 21, at 1584 (suggesting some problems with tying CRA obligations to bank’s area of operation).

⁹³ See Macey & Miller, *supra* note 21, at 296.

⁹⁴ See, e.g., Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, 12 FDIC BANKING REV. 1, 15 (1999) (suggesting that if banks receive any net subsidy at all from federal safety net, it is small).

⁹⁵ See, e.g., Macey & Miller, *supra* note 21, at 296 (suggesting that goal of subsidizing poor or disadvantaged citizens can be better accomplished by direct subsidy programs).

⁹⁶ See Calomiris et al., *supra* note 21, at 655; Macey & Miller, *supra* note 21, at 312–13; White, *supra* note 21, at 287–90 (describing frequently proffered reasons for why CRA treats banks differently from other lending institutions).

⁹⁷ I respond to this critique in Part VII *infra*.

⁹⁸ See generally Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994) (arguing that tax and transfer system is always superior to legal rules in redistributing income). But see

argue for in-kind demand-side subsidies, supply-side subsidies, or tax incentives.⁹⁹ Others urge enforcement of existing antidiscrimination law.¹⁰⁰ Some contend that the market solution—in particular, the growth of the subprime mortgage market—answers any concerns about underserved low-income communities.¹⁰¹ Other scholars call for an increased focus on community development banks and peer-lending based on ethnic communities.¹⁰²

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.”¹⁰³ Moreover, it is unclear whether banks and thrifts would respond to incentives in desired ways, and the costs of CRA in overcoming these market failures and discrimination ought to be considered in determining whether it is an efficient means to overcome these problems. This debate cannot be decided in the abstract, nor on the basis of anecdotal evidence. Furthermore, the literature on standards versus rules would lend support, if correct, to the views of CRA’s critics. In addition, there is room for reasonable debate about the scope of CRA. Lastly, other alternatives do exist that influence the provision of credit to minorities and low- and moderate-income communities. The remainder of the article takes up these five points in turn.

III

THEORETICAL FOUNDATIONS OF CRA

In this Part, I will discuss how the theoretical support for CRA derives from three bases. First, CRA addresses market failures caused by 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. Contrary to the views of CRA’s critics, I will argue that the market failures are significant, and that CRA is an appro-

Swire, *Safe Harbors*, *supra* note 21, at 368 (criticizing arguments that relying on tax and transfer system is preferable alternative to CRA).

⁹⁹ See, e.g., Klausner, *supra* note 21, at 1592 (suggesting “tax benefits or other transfers”); Swire, *Safe Harbors*, *supra* note 21, at 367–68 (describing direct expenditures in low- and moderate-income neighborhoods as alternative to CRA); White, *supra* note 21, at 291 (arguing for “direct government subsidies” if there is public purpose in increasing lending).

¹⁰⁰ See White, *supra* note 21, at 283–84.

¹⁰¹ See Gunther, *supra* note 21, at 57.

¹⁰² See Calomiris et al., *supra* note 21, at 654–57; Swire, *Safe Harbors*, *supra* note 21, at 354–55 (describing how safe harbor policy might support investment in community development banks).

¹⁰³ ZINMAN, *supra* note 90, at 1.

prate response to them. Second, I will argue that CRA helps to reduce discrimination against minority borrowers and communities. CRA was not designed to address racial discrimination against individual borrowers directly, but it was aimed, in part, at addressing "redlining" discrimination and its legacy in segregated, low-income neighborhoods. Moreover, 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 contexts, this leverage is greater than that of fair lending laws.¹⁰⁴ Thus, I will explain why CRA is an important part of a broader regulatory strategy to overcome the legacy of discrimination in order to expand access to credit to minority households. Third, I will contend that CRA has largely not done enough to break down inefficient barriers between the bifurcated prime and subprime credit markets. CRA could do more to enhance competition between prime and subprime lenders in low- and moderate-income neighborhoods. Over time, along with market changes, CRA can help make the subprime and prime markets more efficient by completing the market. In addition, CRA could play a strong role in reducing discrimination that results from, and occurs in, bifurcated credit markets.

A. Market Failure

Credit market imperfections could impede lending in low- and moderate-income communities in several ways. First, information externalities and asymmetries may lead banks to overlook creditworthy borrowers and profitable loans.¹⁰⁵ Information externalities exist when creditors cannot fully recoup the costs of gathering information about creditworthy borrowers because other lenders can use the information generated to lend. Information externalities can produce credit constraints because the efficiency of bank lending is in part a function of "market thickness."¹⁰⁶ Information asymmetries, in which lenders cannot fully distinguish creditworthy from uncreditworthy borrowers, are reduced the more information that lenders have about prospective borrowers. CRA helps to reduce

¹⁰⁴ See *infra* Part VII.A (comparing CRA to fair lending laws).

¹⁰⁵ See Janusz Ordover & Andrew Weiss, *Information and the Law: Evaluating Legal Restrictions on Competitive Contracts*, 71 AM. ECON. REV. PAPERS & PROC. 399, 401 (1981).

¹⁰⁶ William W. Lang & Leonard I. Nakamura, *A Model of Redlining*, 33 J. URB. ECON. 223, 229-33 (1993) (explaining how information externalities can lead to inefficient credit rationing in low-volume markets). Market thickness refers to the amount of economic activity, as measured by the number of participants, or the number or total value of transactions, over some time period. *Id.* at 229-31.

information externalities and asymmetries by increasing market thickness. Second, collective action problems exacerbate information externalities and inhibit entry into these communities.¹⁰⁷ CRA could help to mitigate these credit constraints by providing “an effective commitment device to coordinate lending.”¹⁰⁸ Third, agency costs make it difficult to align corporate interest in profitable lending with the behavior of loan agents. CRA can help to address agency costs by providing additional incentives to reform corporate structures to align with these goals. Lastly, neighborhood externalities provide grounds for governmental intervention to reduce credit constraints and increase homeownership.¹⁰⁹ I take up these points in turn.

Information externalities contribute to lower rates of lending in low-income communities than would be socially optimal.¹¹⁰ 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, markets with a relatively lower level of economic activity.¹¹¹ The smaller number of transactions in a low-income community makes appraisals more difficult. Any one financial institution will not be willing to participate in a market with uncertain collateral values. The resulting reduction in market participants will decrease further the amount of information available about property values and reduce the liquidity of other loans to that neighborhood. Lenders will not want to lend in areas with low

¹⁰⁷ If monopolies were licensed for low-income areas, there would be no collective action problem, but we generally believe that monopolies are inefficient because the price, quantity, and quality of goods will be inferior to those offered in a competitive market. For empirical support of the existence of credit constraints because creditors cannot fully capture information externalities in competitive markets, see, for example, Mitchell A. Petersen & Raghuram G. Rajan, *The Effect of Credit Market Competition on Lending Relationships*, 110 Q.J. ECON. 407, 433 (1995) (finding that young firms are more credit constrained in competitive markets than in concentrated ones).

¹⁰⁸ ZINMAN, *supra* note 103, at 34 n.33.

¹⁰⁹ See, e.g., JACK M. GUTTENTAG & SUSAN M. WACHTER, REDLINING AND PUBLIC POLICY 39 (1980).

¹¹⁰ See STEPHEN ROSS & JOHN YINGER, THE COLOR OF CREDIT: MORTGAGE DISCRIMINATION, RESEARCH METHODOLOGY, AND FAIR-LENDING ENFORCEMENT 180–81 (2002) (analyzing Lang & Nakamura, *supra* note 106); David M. Harrison, *The Importance of Lender Heterogeneity in Mortgage Lending*, 49 J. URB. ECON. 285, 294 (2001); Klausner, *supra* note 21, at 1569–70; David C. Ling & Susan M. Wachter, *Information Externalities and Home Mortgage Underwriting*, 44 J. URB. ECON. 317, 318 (1998). But see Paul S. Calem, *Mortgage Credit Availability in Low- and Moderate-Income Minority Neighborhoods: Are Information Externalities Critical?*, 13 J. REAL EST. FIN. & ECON. 71, 105 (1996) (finding that information externalities result in higher loan denial rate overall, but that this relationship does not hold in minority neighborhoods).

¹¹¹ For empirical evidence on market thinness, and improvements during the 1990s, see *infra* text accompanying notes 230–238.

levels of liquidity. Property values will decline as the market becomes less liquid, reinforcing the downward trend in lending.

The information and expertise required to offset this trend are costly. In low-income communities, such information externalities are likely to be even more costly to overcome—and the benefits of overcoming them are likely to be smaller—than in high-income neighborhoods.¹¹² Creditors will face the up-front costs of developing expertise in neighborhoods that they have not served previously 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.¹¹³ Creditors will have to train their personnel to search for creditworthy borrowers and sound residential neighborhoods in locations where lenders have not conducted a large number of transactions previously. 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.¹¹⁴ Thus, the lender that invested in the additional information will not be fully compensated for its investment.

Given high search costs, lenders will use the average risk of the pool and miss good risks. Even if search and credit-analysis costs are reduced, there is likely to be insufficient volume and liquidity to support a relatively complete market.¹¹⁵ The friction from information

¹¹² See Klausner, *supra* note 21, at 1569–70.

¹¹³ See *id.*

¹¹⁴ Lenders report credit histories of borrowers under voluntary arrangements with credit bureaus. Lenders may then access the credit histories of borrowers or potential borrowers in order to make lending decisions. See generally Robert B. Avery et al., *An Overview of Consumer Data and Credit Reporting*, 89 FED. RES. BULL. 47 (2003).

¹¹⁵ In a complete market, equilibrium is always efficient. See generally, Kenneth J. Arrow & Gerard Debreu, *Existence of Equilibrium for a Competitive Economy*, 22 *ECONOMETRICA* 265 (1954). In an incomplete market, equilibrium may be inefficient, or may not be reached at all. See generally, John Geanakoplos, *An Introduction to General Equilibrium with Incomplete Asset Markets*, 19 *J. MATHEMATICAL ECON.* 1 (1990) (explaining theory of general equilibrium with incomplete markets); Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 *Q.J. ECON.* 629 (1976) (explaining how imperfect information can prevent equilibria from forming); Pradeep Dubey et al., *Default in a General Equilibrium Model with Incomplete Markets* 17 (n.d., unpublished manuscript) (explaining how imperfect information, such as “unreasonable pessimism[,] prevents many real world markets from opening”), at <http://cowles.econ.yale.edu/P/cd/d12a/d1247.pdf> (last visited April 7, 2005). Incomplete markets occur because of the presence of transaction costs (including information and evaluation costs), adverse selection, moral hazard, asymmetric information and information externalities, and insufficient volume and liquidity. See FRANKLIN ALLEN & DOUGLAS GALE, *COMPARING FINANCIAL SYSTEMS* 147 (2001).

externalities likely makes it costlier to serve low-income borrowers living in these neighborhoods whether they purchase a home in a low-income community or seek better options in high-income ones.

In addition, many lenders—in this context, banks and thrifts making prime loans—will worry that adverse selection and moral hazard will increase if the lenders charge more to cover their risks from market thinness and the uncertainty regarding distinguishing good risks from bad ones. Adverse selection increases with loan price because good-risk borrowers will avoid the higher cost loan if they have access to other alternatives. Moral hazard increases with loan price because the borrower faces a greater incentive to default when the costs of continuing to pay are higher.¹¹⁶ Lenders that do enter the market—in this context, mostly “subprime lenders”—will charge higher prices to offset these risks. 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 thinner, riskier market. Furthermore, lenders may seek to internalize more of the benefits of customer information by not reporting credit histories to the credit bureaus.¹¹⁷ 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.

In addition to information externalities that lower the returns to lending to low-income borrowers and in low-income neighborhoods, asymmetries in information between lenders and borrowers that are costly to overcome also can lead to credit rationing. “Credit rationing” describes situations where a lender decides not to make a loan to a given borrower or class of borrowers rather than making the

¹¹⁶ See generally, Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

¹¹⁷ See, e.g., Advisory Letter from the Federal Financial Institutions Examination Council, to Chief Financial Officers (Jan. 18, 2000) (noting motivation for lack of reporting is “intense competition among lenders for customers”), available at <http://www.occ.treas.gov/ftp/bulletin/2000-3a.txt>. Creditors may be more inclined to fail to report in thin markets than in thick ones because the information externalities, and thus the gains derived from not reporting, are higher in thin markets than in thick ones. That is, the gains from withholding information about good borrowers are smaller in a market full of good borrowers, than in a market with fewer good borrowers. Credit bureaus are now well established in the United States and work well for the majority of borrowers, but these bureaus took a long time and required high levels of market volume to develop. See Michael E. Staten & Fred H. Cate, Does the Fair Credit Reporting Act Promote Accurate Credit Reporting? 4–5 (2004) (unpublished working paper), available at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-14.pdf. Moreover, even in the well developed credit reporting market in the United States generally, subprime lenders tend not to report to the bureaus, and other lenders incompletely report.

loan and charging a higher price to cover higher cost or risk. 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.¹¹⁸ 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 because of adverse selection and moral hazard. 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. Moral hazard is a function of interest rates because the gains from failing to pay increase with interest owed, while losses cannot exceed the amount owed.¹¹⁹ Moreover, higher-priced loans simply will be more difficult for low-income borrowers to repay, and thus higher prices yield higher default rates. Higher prices are an independent source of default, in addition to moral hazard, because low-income borrowers face a relatively hard budget constraint with little room to adjust expenditures, dip into savings, or access other credit in order to meet debt service requirements. Both moral hazard and this price effect increase the likelihood that low-income borrowers will default even if they did not present a similar risk of defaulting on a lower-cost loan.

Calomiris is correct that the problem of adverse selection is likely worse for small businesses than for home mortgage applicants because information asymmetries are lower in the home mortgage market.¹²⁰ Yet such asymmetries are not fully eliminated even with the advent of credit scoring, and there are several reasons why it is costly to overcome information asymmetries regarding low-income borrowers. These borrowers often lack credit histories, and many do not even have a bank account,¹²¹ so determining their creditworthiness is 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, or sending remittances regularly to family members, as immigrants often do, but banks are not accustomed to relying on such information. There is not yet a clearing-house or standardized method of determining creditworthiness on the

¹¹⁸ Stiglitz & Weiss, *supra* note 116, at 408.

¹¹⁹ See *id.* at 393.

¹²⁰ See Calomiris, *supra* note 21, at 644 (arguing that only source for asymmetric information is "likely" to be "idiosyncratic attachment to the house" and that such asymmetry would not lead to credit rationing).

¹²¹ See Barr, *supra* note 3, at 123 (showing that 22% of low-income households lack bank accounts).

basis of these factors,¹²² making these measures more uncertain than the standard credit scores produced by the credit bureaus. Moreover, although credit scores are good predictors of repayment, there is variance around a given score. Additionally, low-income households often have lower levels of educational attainment and thus may require more assistance in completing loan applications.¹²³ Creditors rationally might choose not to spend the additional sums necessary to lend to creditworthy low-income borrowers absent regulatory or other interventions that alter these economics. These high costs of overcoming information asymmetries would plague low-income borrowers seeking a loan regardless of whether the borrower wanted to live in a low-income neighborhood or sought access to better economic opportunities in a higher-income neighborhood where lenders already operate.

Creditors considering whether to enter a low-income market also face collective action problems.¹²⁴ Lenders may delay entry into an otherwise profitable market because their lending would lead to benefits that they cannot fully capture in the form of information, market volume, and liquidity because other lenders can free ride. This delay in entry further diminishes the economic prospects of the area and reinforces other lenders' decisions not to lend. Even if there are creditworthy borrowers and sufficient collateral values, a lender rationally might avoid the risk of lending in an uncertain market because other lenders are not lending there. That would be the case even if all lenders would be better off if they all chose to lend in the community. One can characterize this delayed entry as a collective action problem.¹²⁵ By contrast, if lenders know that others will participate because they are required to do so under CRA, then their collateral is more likely to have knowable values, their collateral and

¹²² For innovative pilots in this regard, see, for example, a new organization, "Pay Rent, Build Credit," which seeks to develop credit histories for low-income households based on consistent payment of rent. See Pay Rent, Build Credit Homepage, at <http://www.payrentbuildcredit.com> (last visited Mar. 30, 2005).

¹²³ See Klausner, *supra* note 21, at 1568.

¹²⁴ See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (2d ed. 1971) (explaining why collective action problems can lead to inefficient outcomes, including in development of public policy). Collective action problems are a type of market failure that can occur when rational market participants do not produce efficient outcomes because the market involves a public good. In its pure form, a public good is nonrival and nonexcludable, but externalities that do not meet these formal tests still can result in collective action problems.

¹²⁵ Contrary to previous scholarship, see for example Klausner, *supra* note 21, at 1577 ("The CRA does little to promote coordination."), I argue that CRA is an effective response to collective action problems because it helps banks and thrifts coordinate their lending. See *infra* text accompanying notes 128–132.

loans are more likely to be liquid, loan volume might rise to the level sufficient to support a complete market, and property values may be able to rise more quickly, all other things being equal.

Other institutions that might mitigate these market failures are weaker or altogether absent in low-income communities. 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 generally are weaker or unavailable in low-income communities, and their absence exacerbates market failures.

Neighborhood externalities that result from credit market failures also undergird CRA.¹²⁶ 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.¹²⁷ Adjacent property owners may decide not to invest in maintenance or to move out of the neighborhood.¹²⁸ Poorly kept and vacant homes further depress property values, and reduce the volume and liquidity of credit markets.

Critics of CRA might argue that market failures, if they exist in low-income communities, do not apply to low-income borrowers purchasing homes outside low-income areas. In their view, CRA's inclusion of lending to low-income borrowers outside low-income areas would thus be unjustified. While critics are correct that market failures operate in more intense ways in low-income neighborhoods, such factors still come into play when low-income borrowers seek to move out of such neighborhoods. For low-income households seeking to purchase a home in a better neighborhood, rather than in a low-income one, nearly all of these market failures would still apply. Information externalities with respect to borrower creditworthiness are costly to overcome because of the low volume of low-income bor-

¹²⁶ See GUTTENTAG & WACHTER, *supra* note 109, at 7-9, 39 (describing neighborhood externality caused by coordination problems among rational lenders and asserting CRA's capacity to mitigate that externality); Klausner, *supra* note 21, at 1570-71 (discussing neighborhood externalities caused by physical deterioration and bank lending decisions).

¹²⁷ See, e.g., Klausner, *supra* note 21, at 1571 (stating that "owners who want to rehabilitate their properties may be unable to do so because they cannot borrow the money needed," and thus "a lack of credit in a neighborhood can actually precipitate its decline").

¹²⁸ See GEORGE C. GALSTER, HOMEOWNERS AND NEIGHBORHOOD REINVESTMENT 144-224 (1987) (discussing factors contributing to homeowner mobility and upkeep behavior).

rowers, particularly from low-income neighborhoods, and the cost of developing expertise in finding creditworthy borrowers in these thin markets. Information asymmetries are costly to overcome regardless of the location of the purchased home because low-income households have lower levels of assets available for downpayments or to demonstrate creditworthiness and many lack standard indicia used by creditors to evaluate risk. Collective action problems delay entry in serving low-income borrowers in similar ways to entering a low-income neighborhood. Moreover, low-income borrowers likely lack familiarity with or access to many of the institutional supports, such as a knowledgeable real estate broker, on which higher income borrowers rely.

CRA is a reasonable, though by no means the only possible, policy response to these market failures affecting low-income borrowers and neighborhoods. By providing incentives to banks and thrifts to lend in their entire community, CRA promotes market thickness. CRA solves the problem of underproduction from externalities by encouraging the banks and thrifts to lend anyway. Under CRA, free riders cannot exploit collective action problems because each bank is, in effect, required to participate in the market. Thus, CRA is a form of pre-commitment device that overcomes the coordination problem inherent when positive externalities are sufficiently large to act in ways similar to public goods.¹²⁹ Banks know that there will be liquidity and volume because other lenders will be looking for lending opportunities in these markets because of their CRA obligations. Moreover, once a sufficient volume of loans of similar characteristics to similar borrowers is reached, these loans can then be packaged and sold on secondary markets, which provides capital and liquidity for continued lending.

Over time, the thicker the market, the less each incremental loan will produce significant information externalities. With lower information externalities, lenders face less of a disincentive to lend in low-income communities because they can capture a larger share of the benefits from lending there. Furthermore, as lenders obtain information about creditworthy low-income borrowers and develop expertise in lending to these borrowers, the transaction costs associated with

¹²⁹ A pure public good is nonrival and nonexcludable. That is, the cost of additional consumption of the good is zero and anyone can use the good at no cost. No one person has an incentive to produce such a good because everyone else will be able to free ride on the production. In the real world, pure public goods are rare, but many phenomena with large externalities exhibit similar traits to public goods, in which collective action problems prevent coordination to internalize the externality. See HARVEY S. ROSEN, *PUBLIC FINANCE* 61–62, 92 (4th ed. 1995).

overcoming information asymmetries also decrease. It becomes easier both to obtain information about creditworthy borrowers and property values, and to evaluate such information. With lower information asymmetries, loan prices can be reduced so that they become commensurate with measurable risk, and thus adverse selection and moral hazard pose less of a problem to reaching further into the market of potential borrowers in low-income communities.

In addition, CRA both directly and indirectly bolsters community-based organizations in low-income communities that have been critical to the development of home mortgage markets in ways that are similar to the development of lending in wealthier communities. CRA encourages banks to support community organizations directly by giving banks CRA consideration for loans, investments, and services to community development organizations that strengthen and revitalize local communities.¹³⁰ CRA also indirectly supports these institutions because banks need such strong institutions in these communities in order to reduce the risk and increase the effectiveness of their lending operations. These stronger institutions, in turn, reinforce the effectiveness of CRA in overcoming market failures. Community-based organizations play roles analogous to real estate brokers, developers and neighborhood associations by stabilizing and improving housing stock, revitalizing local business districts, providing home ownership and other financial counseling to low-income borrowers, and helping to match creditworthy borrowers with willing banks and thrifts.

Finally, CRA helps to address neighborhood externalities by increasing the volume and liquidity of credit markets. These better functioning credit markets increase access to homeownership for low-income borrowers. CRA thus can work like other policies that are designed to increase access to credit and homeownership and can help to turn neighborhoods around, increasing property values for adjacent properties and neighborhoods.¹³¹ Government policies designed to

¹³⁰ See 12 C.F.R. § 25.22(b)(4) (2004) (including community development lending as part of lending test), § 25.23(e)(3) (including community development as part of investment test), § 25.24(e) (including community development lending as part of service test).

¹³¹ See, e.g., Ingrid Gould Ellen et al., *Building Homes, Reviving Neighborhoods: Spillovers from Subsidized Construction of Owner-Occupied Housing in New York City*, 12 J. HOUSING RES. 185, 211 (2001) (finding that two affordable homeownership projects in New York City had positive effect on property values in immediate neighborhood); Michael H. Schill et al., *Revitalizing Inner-City Neighborhoods: New York City's Ten-Year Plan*, 13 HOUSING POL'Y DEBATE 529, 562–63 (2002) (finding that New York City's Ten-Year Plan investments in housing production in city's poorest neighborhoods had positive impact on those neighborhoods).

increase homeownership thus can have positive externalities in communities not directly affected by the government programs.¹³²

If CRA succeeds in overcoming these market failures, one could ask how long CRA would continue to be necessary. Critics would argue that enough time has passed under CRA for banks to “get it.” Either I am right, and there were market failures present but now banks have overcome them by lending to these communities, or I am wrong, and there were never any market failures to overcome. The answer to that question involves both an empirical and a theoretical enquiry, and uncharted terrain. No market is perfect. Market failures can exist in reasonably well-functioning markets without causing significant problems. Progress has undoubtedly been made. The question becomes at what point any market failures become relatively inconsequential so that the costs of governmental regulation to overcome them become unlikely to be worth incurring.

My intuition, based on conversations over the years with senior management from banks and thrifts, is that this point has not yet been reached, although this is an area in which continued empirical research is essential. In theoretical terms, low-income markets are likely to stay relatively thinner than high-income markets for some time, even with the advances in low-income lending that this Article describes.¹³³ Low-income households will remain relatively more opaque to banks than higher-income ones, and less able to signal creditworthiness through sizeable down payments, given their low levels of asset holding and diverse sources of income. Thus, bank incentives to avoid household adverse selection and moral hazard, given information asymmetries, are likely to remain important considerations in decisions about the appropriate cutoffs for credit rationing and risk-based pricing with respect to such households. At the neighborhood level, home ownership, the number of home sales, the price of homes, and loan sizes, are likely to remain at lower levels than in higher-income neighborhoods, and real estate agents and appraisers are still likely to have lower volumes of activity in such neighborhoods than in the more affluent areas they serve. These factors suggest that information externalities will continue to be an important factor limiting lending. Thus, the volume of lending and liquidity required for a fully functioning market will likely continue to be difficult to sustain without at least some of the government policies discussed in this Article. For banks and thrifts where institutional structures and incen-

¹³² Ellen et al., *supra* note 131, at 211; Schill et al., *supra* note 131, at 562–63.

¹³³ For a discussion of the empirical evidence, see *infra* text accompanying notes 231230–238.

tives have not been altered to make lending to low-income households a core mission of the institution, the difficulty of focusing employee time and attention on serving this market will likely exacerbate the problem.

The imperfect competition that results from these transaction costs—including the cost of information, thinking creatively about the information, and information externalities; adverse selection and moral hazard; asymmetric information; agency costs in keeping the institution engaged in low-income lending; and the difficulty of creating and sustaining volume and liquidity to support the market—means that low-income households are likely to remain perennially at risk from being excluded from the pool of households that banks and thrifts will find it most profitable to serve. Thus, CRA and other policies are likely to be an important factor in lending to these communities for some time to come.

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).¹³⁴ Yet CRA had its origins in claims that banks were “redlining,” that is, refusing to lend to potential borrowers living in low-income, minority communities. One cannot fully understand the rationale for CRA unless one sees it as part of the federal government’s response to the long history of private sector and official discrimination in housing and credit markets. In this Section, I explore the theory and evidence regarding credit market discrimination as a basis for CRA.¹³⁵ Contrary to the claims of CRA’s critics, I argue that racial discrimination, and the effects of such discrimination, likely persists in home mortgage markets, and that the legacy of discrimination provides further theoretical justification for CRA. Moreover, I will argue that CRA in fact plays an important role, alongside ECOA, in overcoming such discrimination.

The dominant view, derived from the work of Gary Becker, is that in the long run, in a perfect market, discrimination will disap-

¹³⁴ 15 U.S.C. § 1691–1691f (2000). The Federal Reserve Board implements the Equal Credit Opportunity Act (ECOA) under Regulation B, 12 C.F.R. pt. 202 (2004).

¹³⁵ See A. Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431, 1453 (1995) (arguing that CRA should be understood as response to racial discrimination). But see Klausner, *supra* note 21, 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 VII.A *infra* (comparing CRA to ECOA).

pear.¹³⁶ Competition helps to drive away discrimination based on racial animus because market participants who practice it will lose out on hiring the best human capital and will leave profits from good customers on the table that other, nondiscriminatory actors will scoop up. Long-run equilibrium probably will occur sooner in credit markets than in, say, labor markets, because credit markets are more efficient.¹³⁷ I agree that competition likely diminishes discrimination. Nonetheless, the force of competition acting on discrimination depends on market structure, and for those who are discriminated against, waiting around for competition to work may be ill comfort. Government intervention can speed up the process of ending discrimination both by directly prohibiting it, and by overcoming market failures that exacerbate it.

Market failures can exacerbate discrimination in a variety of ways. At a given point in time, one would need to specify the parameters of Becker's model to test his hypothesis,¹³⁸ and competing theories suggest that the model is too limited.¹³⁹ As I will explain more fully below, credit-rationing theory can explain the persistence of lending discrimination. In addition, Becker's model assumes that only racial animus is illegal, and it is this form of discrimination that Becker demonstrates would disappear in a perfect market. Statistical discrimination—in which lenders use factors correlated with race as proxies for creditworthiness—violates ECOA, but such discrimination is rational under Becker's model.¹⁴⁰ Lastly, price discrimination, whether based on animus or statistical models, can persist in seg-

¹³⁶ Becker himself is somewhat softer on this point. See BECKER, *supra* note 22, at 159 ("Employer discrimination should, on average, be less in competitive industries than in monopolistic ones."). But see JOHN J. DONOHUE III, FOUNDATIONS OF EMPLOYMENT DISCRIMINATION LAW 189 (2d ed. 2003) (arguing that laws barring discrimination in employment are efficient because such laws speed up long-term effects of competitive markets in reducing discrimination).

¹³⁷ See John J. Donohue III, *Employment Discrimination Law in Perspective: Three Concepts of Equality*, 92 MICH. L. REV. 2583, 2595–97 (1994) (explaining why labor markets are less efficient than equity markets, with result that competition in labor markets will take longer than competition in equity markets to reduce discrimination).

¹³⁸ Becker himself acknowledged as much. See Gary S. Becker, *Nobel Lecture: The Economic Way of Looking at Behavior*, 101 J. OF POL. ECON. 385, 388 (1993) (noting that his model "depends not only on the distribution of tastes for discrimination among potential employers, but critically also on the nature of firm production functions").

¹³⁹ DONOHUE, *supra* note 136, at 205.

¹⁴⁰ Compare ROSS & YINGER, *supra* note 110, at 32–33, 41–42 (explaining that statistical discrimination violates fair lending law); FED. FIN. INST. EXAMINATION COUNCIL, INTER-AGENCY FAIR LENDING EXAMINATION PROCEDURES, at iv (1999) (same), available at <http://www.ffiec.gov/pdf/fairlend.pdf>, with BECKER, *supra* note 22, at 14 (defining discrimination as individual foregoing profits to satisfy irrational "taste" for discrimination); see also *infra* Part VII.A (comparing CRA to fair lending laws).

mented credit markets even if there is competition within each market. Such price discrimination appears to be an important factor in a portion of today's credit markets.¹⁴¹

Credit rationing enables discrimination, whether based on animus or statistics, to persist even in competitive markets. As Stiglitz and Weiss show, credit rationing can occur because of asymmetric information, adverse selection, and moral hazard.¹⁴² 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. This single-price model generally describes the prime credit market dominated by banks and thrifts,¹⁴³ 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, in theory they could discriminate on the basis of race within this class of loan applicants without losing profits (absent legal liability under antidiscrimination laws) because it would not matter which group, within the group of marginal borrowers, banks chose to ration. Moreover, tests of lending discrimination based on profitability would not identify lending discrimination because lenders who discriminated would be just as profitable as lenders who did not.¹⁴⁴ Within the group of marginal

¹⁴¹ See *infra* note 162.

¹⁴² See *supra* note 118 and accompanying text; see also David Besanko & Anjan V. Thakor, *Collateral and Rationing: Sorting Equilibria in Monopolist and Competitive Credit Markets*, 28 INT'L ECON. REV. 671, 672 (1987) (showing credit rationing when low-risk borrowers lack downpayments to distinguish as low-risk); Paul Calem & Michael Stutzer, *The Simple Analytics of Observed Discrimination in Credit Markets*, 4 J. FIN. INTERMEDIATION 189, 194-95 (1995) (discussing how creditors use high denial rates to separate low-risk from high-risk borrowers). 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 J. OF REAL EST. FIN. & ECON. 23, 24 (2000). Such portfolio effects might arise, they argue, from either 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 (U. of Cincinnati, Working Paper, 1997). Greater heterogeneity of loan pools, which would result from using more expansive underwriting criteria is itself a source of higher securitization costs, see TASK FORCE ON MORTGAGE-BACKED SECURITIES DISCLOSURE, STAFF REPORT: ENHANCING DISCLOSURE IN THE MORTGAGE-BACKED SECURITIES MARKETS 30 n.78 (2003) [hereinafter MBS DISCLOSURE REPORT], available at <http://www.treas.gov/press/releases/docs/disclosure.pdf> (last visited Mar. 8, 2005), and thus could be an example of such portfolio effects.

¹⁴³ For discussion of the subprime market, see *infra*, Part III.C.

¹⁴⁴ See ROSS & YINGER, *supra* note 110, at 272 (noting that studies seeking to determine whether creditors apply higher standards to minority applicants, as measured by lower default rates for minorities, cannot prove absence of both statistical- and animus-based discrimination).

borrowers, the rationed borrowers will not differ significantly in performance from the borrowers who get a loan.¹⁴⁵

Moreover, putting credit rationing aside, 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. Lenders could use such averages to ration credit, or use differential pricing. Competitive markets will not drive out statistical discrimination in the short term¹⁴⁶ precisely because such discrimination is rational, in the absence of legal liability for improperly relying on such stereotypes. 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, although that might be quite a while.¹⁴⁷

Turning from theory to evidence, the terrain becomes even more contested. Critics are right that the evidence on discrimination in credit markets is hotly debated.¹⁴⁸ 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

¹⁴⁵ Suppose, for example, at a given price of capital, that a lender chose to lend to all applicants with a credit score of 680 and above (since all of these loans will be sold on the secondary market) and to make 100 loans at scores of 620–679, and only 50 loans at scores of 580–619. It does not matter which borrowers with the same scores are rationed within these second and third groups, so lenders could, in theory, ration only black borrowers, or ration only borrowers with certain characteristics that the lender believes are indicative of creditworthiness but that are highly correlated with race.

¹⁴⁶ 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*, 539 U.S. 306, 343 (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. Alan B. Krueger, *Economic Scene: The Supreme Court Finds the 'Mushball Middle' on Affirmative Action*, N.Y. TIMES, July 24, 2003, at C2.

¹⁴⁷ See Stuart I. Greenbaum, *Twenty-Five Years of Banking Research*, 25 FIN. MGMT., Summer 1996, at 86, 91 (arguing that reduced information costs should reduce discrimination). But see Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787, 791 (1995) (arguing that discrimination reduces returns to investing in creditworthiness for minorities which would perpetuate discrimination); Stanley D. Longhofer & Stephen R. Peters, *Self-Selection and Discrimination in Credit Markets* 4, 11–17 (2004) (unpublished manuscript, on file with the *New York University Law Review*) (describing equilibria in which borrowers sort themselves among discriminatory and non-discriminatory lenders based on their creditworthiness and discrimination persists).

¹⁴⁸ See ROSS & YINGER, *supra* note 110, at 95–106 (surveying literature on mortgage lending discrimination).

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 1992.¹⁴⁹ The 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.¹⁵⁰ The study has come under a barrage of attacks,¹⁵¹ but rebuttals have affirmed its central findings.¹⁵² On balance, the evidence suggests that disparities between African American and white borrowers persist even after taking into account a wide variety of factors that legitimately could influence a creditor's underwriting practices.¹⁵³ These significant disparities suggest that minorities are subject to either disparate treatment discrimination, or disparate impact discrimination based on facially neutral, but unnecessary, market practices.¹⁵⁴ Matched-pair testing also has found differential treatment by creditors similar to that found in the home sales market.¹⁵⁵ 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."¹⁵⁶ Skeptics are correct, however, in viewing this evidence as subject to challenge, and further research remains warranted in understanding the role of discrimination.

¹⁴⁹ See Alicia H. Munnell et al., *Mortgage Lending in Boston: Interpreting HMDA Data*, 86 AM. ECON. REV. 25 (1996) (final publication with additional controls and responses to critics of initial publication, ALICIA H. MUNNELL ET AL., MORTGAGE LENDING IN BOSTON: INTERPRETING THE HMDA DATA (Fed. Res. Bank of Boston, Working Paper 92-97, 1992)).

¹⁵⁰ *Id.* at 26 (finding that probability of loan denial is 1.8 times higher for blacks and Hispanics than for whites).

¹⁵¹ See, e.g., ROSS & YINGER, *supra* note 110, at 107-69 (analyzing these studies).

¹⁵² See, e.g., *id.* at 163-65 (analyzing these studies and concluding that although "a limitation in the Boston Fed Study [relating to variability in lender underwriting standards] could potentially lead to a serious overstatement of discrimination[,] . . . the Boston Fed Study provides strong, but not irrefutable, evidence that in 1990 lenders in Boston engaged in either disparate-treatment discrimination or disparate-impact discrimination, or both").

¹⁵³ *Id.*; see also McKinley Blackburn & Todd Vermilyea, A Comparison of Unexplained Racial Disparities in Bank Level and Market Level Models of Mortgage Lending (Jan. 2005) (unpublished manuscript, on file with *New York University Law Review*) (finding evidence of discrimination when combining data across banks).

¹⁵⁴ ROSS & YINGER, *supra* note 110, at 211.

¹⁵⁵ See, e.g., Robin Smith & Michelle DeLair, *New Evidence From Lender Testing: Discrimination at the Pre-Application Stage*, in MORTGAGE LENDING DISCRIMINATION: A REVIEW OF EXISTING EVIDENCE 23-24 (Margery Austin Turner & Felicity Skidmore eds., 1999) (concluding, based on paired testing, that "race-based differential treatment is occurring in some cities"), available at http://www.urban.org/UploadedPDF/mortgage_lending.pdf.

¹⁵⁶ ROSS & YINGER, *supra* note 110, at 367.

Studies of redlining on the basis of neighborhood composition also 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.¹⁵⁷ The redlining studies generally provide only weak empirical support for the theoretical propositions regarding discrimination.

In addition to discrimination in loan denials, price discrimination also can occur because of market fragmentation.¹⁵⁸ In fragmented or incomplete markets, markets do not clear at a single equilibrium price.¹⁵⁹ Prime lenders generally offer a single price to borrowers who meet their criteria for a given type of loan and property and ration credit among the others. Subprime lenders, in contrast, 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,¹⁶⁰ differentiated pricing also may 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 risk, but also on factors other than risk, including a borrower's willingness to pay. Differential pricing can facilitate market clearing by permitting a wider range of creditors and borrowers to reach agreement on a loan contract tailored to their mutual needs, but in practice, these pricing techniques lead to systematically different prices for minorities than for whites.

¹⁵⁷ See *id.* at 229–30 (citing Stephen L. Ross & Geoffrey M.B. Tootell, Redlining, the Community Reinvestment Act, and Private Mortgage Insurance (1998) (unpublished manuscript, on file with *New York University Law Review*)) (finding evidence that lenders practice redlining against low-income census tracts); *id.* at 232 (citing study that shows largely black tracts receive significantly smaller supply of mortgages than other tracts, controlling for other characteristics); see also Consent Decree, *United States v. Chevy Chase Fed. Savings Bank*, No. 94-1824 (JG) (D.D.C. Aug. 22, 1994), reprinted in NAT'L CONSUMER LAW CTR., CREDIT DISCRIMINATION 401 (2d. ed. 1998) (settlement resulting from allegations of redlining in mortgage financing in African American neighborhoods). Income redlining does not violate ECOA, although it would affect an institution's performance under CRA. See, e.g., 12 C.F.R. § 25.41(e)(3) (bank's assessment area may "not arbitrarily exclude low- or moderate-income geographies").

¹⁵⁸ See, e.g., IAN AYRES, PERVERSIVE PREJUDICE? UNCONVENTIONAL EVIDENCE OF RACE AND GENDER DISCRIMINATION 31 (2001) (finding evidence of price discrimination in retail car sales, where vehicles do not have fixed sales price).

¹⁵⁹ See ALLEN & GALE, *supra* note 115, at 147 (arguing that in imperfect markets, contracts do not trade as "homogeneous commodity at a single market-clearing price").

¹⁶⁰ See *infra* Part III.C (discussing growth of subprime market).

Despite the fact that price discrimination is illegal under ECOA,¹⁶¹ price discrimination occurs in a range of credit markets.¹⁶² Because comprehensive loan pricing data are not available for home mortgages,¹⁶³ researchers have focused on case studies regarding “overages,” the amount by which negotiated loan rates exceed the lender’s minimum rates set forth on “rate sheets” for loan officers.¹⁶⁴ Some studies have found that mortgages obtained by African Americans more often contain overages, and higher ones, than mortgages obtained by others.¹⁶⁵ African Americans also fare worse than whites in negotiations with mortgage brokers and loan officers.¹⁶⁶

¹⁶¹ See, e.g., CREDIT DISCRIMINATION, *supra* note 157, at 229 & n.78 (citing Consent Agreement, United States v. First Nat’l Bank of Vicksburg, No. 5-94-CV-6(b)(n) (S.D. Miss. Jan. 21, 1994) (case brought by Department of Justice for bank’s price discrimination in loan products)).

¹⁶² See, e.g., Ian Ayres, Expert Report, Cason v. Nissan (No. 3-98-0223) (M.D. Tenn. May 25, 2001) at 1, available in NAT’L CONSUMER LAW CTR., CREDIT DISCRIMINATION (3d ed. 2002 & Supp. 2004) (CD-ROM) (finding evidence of disparate racial impact in car financing practices); AYRES, *supra* note 158, at 20–21; ROSS & YINGER, *supra* note 110, at 12 (“[S]everal studies suggest that . . . discrimination in the setting of mortgage rates appears to occur in some circumstances.”); Richard W. Lang, *The Conference on Business Access to Capital and Credit*, in FED. RESERVE SYS. RESEARCH CONFERENCE, SUMMARY: BUSINESS ACCESS TO CAPITAL AND CREDIT 7 (1999) (reporting that “all three papers found that African American-owned small businesses were less likely than White-owned businesses to receive loans, despite holding constant many factors likely to help account for differences in creditworthiness”), at http://www.chicagofed.org/cedric/files/business_access_capital_summary.pdf (last visited Mar. 30, 2005); Ian Ayres & Peter Siegelman, *Race and Gender Discrimination in Bargaining for a New Car*, 85 AM. ECON. REV. 304, 304 (1995) (finding “large and statistically significant differences in prices quoted to test buyers of different races and genders”).

¹⁶³ 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. 7221, 7222 (Feb. 15, 2002) (to be codified at 12 C.F.R. pt. 203). This data will be available for the first time in summer 2005.

¹⁶⁴ 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 generally Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* (2003) (unpublished manuscript on file with *New York University Law Review*) (discussing payment of yield spread premiums in residential mortgage originations).

¹⁶⁵ See *id.* at 9 (finding that blacks and Hispanics more often paid overages and paid higher overages than whites); ROSS & YINGER, *supra* note 110, at 225–26 (citing studies that find blacks pay about two-point overage, as compared to whites’ one point, and that blacks and Hispanics are more likely to be charged overages than whites). *But see id.* at 225–26 (citing study that reports more frequent overages for blacks and Hispanics, but that overages for blacks and Hispanics are slightly, but significantly, lower than for whites when paid).

¹⁶⁶ ROSS & YINGER, *supra* note 110, at 222–27 (surveying three recent findings of discrimination in loan terms); see also Harold A. Black et al., *Is There Discrimination in Mortgage Pricing? The Case of Overages*, 27 J. BANKING & FIN. 1139, 1159 (2003) (finding that “minorities are significantly more likely to pay an overage than similarly situated whites, and when they do, they tend to pay higher overages”); Blackburn & Vermilyea, *supra* note

Another potential source of racial discrimination is automated underwriting systems, now widely used by creditors to determine creditworthiness. Automated underwriting systems can help to reduce discrimination to the extent that they are based on objective factors that best measure creditworthiness, and limit loan officer or broker discretion to base their decisions on the race of the borrower. Yet they can have a disparate impact on minorities if the factors used are correlated with race,¹⁶⁷ and can allow disparate treatment if brokers treat borderline cases differently. As to the former, for example, lenders might place too much weight on the household's assets, and not enough weight on the loan-to-value ratios,¹⁶⁸ in a manner that disproportionately affects minority households, who hold less wealth than whites at every income level. Asset holdings are predictive of creditworthiness, but so too are loan-to-value ratios. Depending on the weight placed on these factors, a creditor might get equal predictive value from relying more on loan-to-value ratios, but with less of an adverse effect on minorities. As to the latter problem of disparate treatment, for example, brokers and loan officers have been found to help white borderline applicants more readily or extensively than black borderline applicants.¹⁶⁹

Other factors may reinforce credit market discrimination. Firms adopt reward structures for loan officers that favor larger loans, which are easier to make in high-income areas that typically have higher concentrations of white borrowers. In addition, loan officers or brokers may discriminate, but their practices might go undetected by creditors because of agency problems.¹⁷⁰ Furthermore, banks may underinvest (from a social perspective) in branches or in training loan officers in how to make loans in underserved, minority neighborhoods. Moreover, credit discrimination might lead minorities to

153, at 3 (finding evidence of racial discrimination using "regulatory model"). Possible explanations for worse negotiating outcomes include borrower anxiety based on experience with past discrimination, greater risk aversion with respect to loan denials, higher levels of information asymmetry in which the borrower underestimates her own creditworthiness or profitability to the lender, or discrimination by the loan officer or broker in negotiating the loan price.

¹⁶⁷ See ROSS & YINGER, *supra* note 110, at 277-91.

¹⁶⁸ For a general discussion of the problem of weighting of factors, see ROSS & YINGER, *supra* note 110, at 277-87.

¹⁶⁹ See, e.g., Margery Austin Turner & Felicity Skidmore, *Introduction, Summary, and Recommendations*, in *MORTGAGE LENDING DISCRIMINATION: A REVIEW OF EXISTING EVIDENCE* 8 (Margery Austin Turner & Felicity Skidmore eds., 1999) (citing evidence that "whites were more likely to be 'coached' on how best to handle potentially problematic aspects of their credit profile").

¹⁷⁰ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 8-15 (1991) (discussing agency costs).

underinvest in creditworthiness, diminishing their prospects for a loan and further entrenching racial disparities.¹⁷¹

Additionally, credit markets are affected by discrimination that may occur elsewhere in society. Discrimination in the housing market¹⁷² or the labor market¹⁷³ are transmitted to credit markets in the sense that minority individuals are lower-income and have lower wealth than they would absent discrimination. The long history of private and publicly sanctioned discrimination in the United States has contributed to lower incomes and lower wealth for African Americans and other minorities. Minority households thus are more likely to live in low-income neighborhoods, have low levels of assets, own homes with lower collateral values, and demonstrate overall less creditworthiness. Lastly, fears of racial integration in housing could have depressed housing prices, leading to lower sales, fewer loans, and thus higher interest rates in minority neighborhoods.

Segregation and wealth disparities are, in part, legacies of discrimination. Black households are significantly more likely to live in low-income neighborhoods, and neighborhoods are highly segregated by race.¹⁷⁴ Black families are more than twice as likely as their white counterparts to have low incomes: 37.4% of black families earned under \$25,000 in 2002, while 18.5% of white families earned under that amount.¹⁷⁵ Black families are nearly three times as likely to have incomes below the poverty level as white families: 20.7% of black families had incomes below the poverty level in 2002 while only 7.4% of white families did.¹⁷⁶ Median income for black families was 62% that of white families.¹⁷⁷

¹⁷¹ See Swire, *supra* note 147, at 791 (arguing that discrimination reduces returns to investing in creditworthiness for minorities).

¹⁷² For the history of discrimination in government housing policy and in real estate markets, see generally MARGERY AUSTIN TURNER ET AL., *DISCRIMINATION IN METROPOLITAN HOUSING MARKETS: NATIONAL RESULTS FROM PHASE 1 HDS 2000 i-viii* (2002) (describing history of paired testing "as a tool for fair housing enforcement, detecting and documenting individual instances of discrimination"), http://www.huduser.org/Publications/pdf/Phase1_Report.pdf; Anthony Pennington-Cross & Anthony M. Yezer, *The Federal Housing Administration in the New Millennium*, 11 J. HOUSING RES. 357, 357-61 (2000); ROSS & YINGER, *supra* note 110, at 1-10.

¹⁷³ For discussion of causes and effects of labor market discrimination, see generally DONOHUE, *supra* note 136.

¹⁷⁴ See, e.g., DOUGLAS S. MASSEY & NANCY A. DENTON, *AMERICAN APARTHEID: SEGREGATION AND THE MAKING OF THE UNDERCLASS 1-2* (1993) (describing extent of racial segregation by neighborhood); TURNER ET AL., *supra* note 172, at iii-v (describing discrimination in housing sales and rental markets).

¹⁷⁵ U.S. CENSUS BUREAU, DEP'T OF COMMERCE, *STATISTICAL ABSTRACT OF THE UNITED STATES: 2003*, at 43, <http://www.census.gov/prod/www/statistical-abstract-04.html>.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

The median black household holds about six to seven times less wealth than the median white household: \$19,000 for black households compared with \$120,900 for white households.¹⁷⁸ “The net worth of black and Hispanic *college* graduates is similar to the net worth of white *high school* graduates, and the net worth of black and Hispanic high school graduates is similar to the net worth of white high school dropouts.”¹⁷⁹ For most households, their home is a critical asset.¹⁸⁰ Yet despite gains in the 1990s, the homeownership rate for non-white or Hispanic families is only 47% compared to 73% for white families.¹⁸¹ Lower wealth (or put another way, asset poverty) can contribute to other social disadvantages, including less access to credit, less ability to accumulate other assets (both financial and homeownership), lower standards of living in worse neighborhoods, lower levels of opportunity for children, and worse educational, labor force, marital and health outcomes.¹⁸²

While critics are correct that antidiscrimination legislation is a more direct method of addressing discrimination in credit markets and other contexts, evidence suggests that antidiscrimination laws have not completely eradicated discrimination from our society.¹⁸³ CRA can play an important role in overcoming credit market, non-credit market discrimination, and the legacy of such discrimination.¹⁸⁴ Any

¹⁷⁸ Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence From the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RES. BULL. 1, 7–8 (2003). For further discussion of the income gap between black and white households, see generally DALTON CONLEY, *BEING BLACK, LIVING IN THE RED* (1999); MELVIN L. OLIVER & THOMAS M. SHAPIRO, *BLACK WEALTH/WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY* (1995).

¹⁷⁹ JOHN KARL SCHOLZ & KARA LEVINE, *U.S. BLACK-WHITE WEALTH INEQUALITY: A SURVEY 4* (2003), at http://www.ssc.wisc.edu/~scholz/Research/Wealth_survey_v5.pdf (last visited Mar. 3, 2005).

¹⁸⁰ See Aizcorbe, *supra* note 178, at 9 tbl.4, 16 & tbl.7 (showing that in 2001, primary residences made up 46.8% of families' nonfinancial assets, that nonfinancial assets made up 58% of total assets, and that this was the largest single asset category).

¹⁸¹ U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES: 2004–2005*, at 457 (2001 statistics), <http://www.census.gov/prod/www/statistical-abstract-04.html>.

¹⁸² See CONLEY, *supra* note 178, at 1–7 (discussing social impact of wealth gap between blacks and whites); ROBERT HAVEMAN & BARBARA WOLFE, *SUCCESSING GENERATIONS: ON THE EFFECTS OF INVESTMENTS IN CHILDREN 3* (1994) (summarizing effects of poverty on children); SARA McLANAHAN & GARY SANDEFUR, *GROWING UP WITH A SINGLE PARENT: WHAT HURTS, WHAT HELPS 79–94* (1994) (discussing how lower income associated with single parenthood impacts children's achievement); OLIVER & SHAPIRO, *supra* note 178, at 1–15 (same).

¹⁸³ See, e.g., DONOHUE, *supra* note 136, at 297 (“The passage of antidiscrimination legislation and the growing social disapproval of overtly discriminatory behavior have eliminated such proclamations far more thoroughly than they have eliminated discriminatory conduct on the part of employers.”).

¹⁸⁴ In this Part, I discuss the reasons for the importance of CRA in overcoming discrimination. In Part IV, I discuss the empirical evidence that CRA has helped to do so. In Part

serious attempt to address our long history of racial discrimination and its legacy needs to take account of racial segregation and the vast wealth gap in the United States. CRA is by no means the only or primary way to do so. But CRA is well-positioned to contribute to reducing discrimination and its effects by engaging federally insured depository institutions in helping to overcome the market failures that I described in Section A.

CRA encourages banks and thrifts to learn about low- and moderate-income communities in which minority households are disproportionately represented. To the extent that statistical and animus-based discrimination are rooted in lack of familiarity with minority communities, CRA can help foster greater understanding. To the extent that CRA succeeds in overcoming market failures, CRA can also help to reduce discrimination by harnessing competitive forces, increasing homeownership rates, improving credit opportunities in low-income neighborhoods and for low-income borrowers, and helping to connect low-income households to mainstream credit markets. Overcoming market failures in credit markets will inure to the benefit of all low-income borrowers and communities. Given the high correlation between being black and having a low income, living in a low-income neighborhood, and having little wealth, overcoming these market failures will help minority households gain access to new economic opportunities and diminish the space for discrimination.

In addition to addressing discrimination by helping to overcome market failures that affect minority households, CRA helps to reinforce ECOA's antidiscrimination norms directly. Under the 1995 regulations, "[e]vidence of discriminatory or other illegal credit practices adversely affects" the bank's CRA performance rating,¹⁸⁵ including evidence regarding violations of ECOA and the Fair Housing Act.¹⁸⁶ The basic principle is that engaging in such illegal credit practices would be "inconsistent with helping to meet community credit needs."¹⁸⁷ To the extent that CRA is underenforced in non-CRA supervisory contexts, or to the extent that the difficulty of proving an ECOA case, or ECOA's penalties once discrimination is proved, under-deter discriminatory practices, this provision of CRA would help to reinforce ECOA.¹⁸⁸

VII, I explain why CRA has important advantages over existing antidiscrimination laws in some contexts.

¹⁸⁵ 12 C.F.R. § 25.28(c) (2004).

¹⁸⁶ Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,640 (July 12, 2001).

¹⁸⁷ *Id.*

¹⁸⁸ For further analysis of ECOA, see *infra* Part VII.

C. Problems in the Subprime Sector

The expansion of lending by subprime specialists to a broader range of borrowers is generally a positive development, reflecting in part a reduction in informational barriers in low-income communities as well as advances in financial innovation. In many ways, however, problems in the subprime sector illustrate the overlapping and mutually reinforcing problems of market failure and racial discrimination. Thus, while the subprime sector exhibits its own pathologies warranting separate treatment in this section, analysis of this sector can help to reveal the ways in which market failures exacerbate discrimination, and how overcoming such failures can reduce discrimination and improve the efficiency of the home mortgage market as a whole. As I explain in Part IV, banks and thrifts have increased their lending to low- and moderate-income borrowers in ways that suggest that CRA is working. But subprime lending—a sector largely outside CRA's purview because such lending has been undertaken largely by financial services companies other than banks and thrifts¹⁸⁹—has grown dramatically at the same time.¹⁹⁰ Subprime lenders specialize in making loans to borrowers with impaired or limited credit history. Most subprime loans are refinance loans.¹⁹¹ Although refinancing may be used to obtain better rates, subprime refinance loans usually are used for home improvement or consumer purchases, to pay for education expenses, or to consolidate other consumer debt.¹⁹² With new and lower-cost sources of funding available from the secondary market through securitization, and with advances in information and risk management, subprime lending has grown sevenfold from a relatively small base in 1994 to reach \$241 billion, or 9% of the market, by

¹⁸⁹ As I explain below, affiliate loans can be counted at the bank's option and although such affiliate loans are not usually included, if they are included, and if the affiliate is a subprime lender, such subprime affiliate loans could be included in a bank's CRA performance rating. In the late 1990s, a number of banks and bank holding companies purchased affiliates that, among other things, make subprime loans. Moreover, some loan pools purchased by banks and thrifts could include subprime loans, and subprime loans currently are not distinguished from other types of loans in HMDA data.

¹⁹⁰ 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.A.

¹⁹¹ U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 31 (2000) [hereinafter HUD-TREASURY REPORT] (co-directed by the author), available at <http://www.hud.gov.80/pressrel/treasrpt.pdf>.

¹⁹² See *id.* at 30–31.

2002.¹⁹³ In 2002, there were just over 200 subprime and manufactured home lenders.¹⁹⁴

The subprime market is plagued by serious problems that are a blend of the market failures and racial discrimination discussed in the previous two Sections. Some subprime borrowers who could have qualified for loans from prime lenders end up in the subprime market, paying higher rates: Preliminary research suggests that between 10% and 35% of subprime borrowers could qualify for prime mortgage loans.¹⁹⁵ Some minority borrowers may have been improperly “steered” to higher cost lenders by brokers or real estate professionals.¹⁹⁶ Even after accounting for neighborhood and borrower characteristics that influence lending decisions, there is “a strong geographic concentration of subprime lending in those neighborhoods where there is a large population of African American homeowners” and “African-American borrowers, regardless of the neighborhood where they are located, have relatively high likelihood of obtaining a subprime compared to a prime loan.”¹⁹⁷ Moreover, studies have documented abusive practices in the subprime sector.¹⁹⁸ 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

¹⁹³ Governor Edward M. Gramlich, Remarks at the Texas Association of Bank Counsel 27th Annual Convention (Oct. 9, 2003), at <http://www.federalreserve.gov/boarddocs/speeches/2003/20031009/default.htm> (last visited Mar. 30, 2005).

¹⁹⁴ U.S. DEP’T OF HOUS. & URBAN DEV., HUD SUBPRIME AND MANUFACTURED HOME LENDER LIST, at <http://www.huduser.org/datasets/manu.html> (last visited Jan. 16, 2005). Manufactured home is the term for a home that is factory-built and usually sold at retail outlets. Manufactured homes include what are commonly referred to as “mobile homes,” as well as factory-built homes that resemble traditional site-built ones.

¹⁹⁵ FREDDIE MAC, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA’S FAMILIES Chap. 5 (Sept. 1996), <http://www.freddiemac.com/corporate/reports/moseley/mosehome.htm>.

¹⁹⁶ It is difficult to find direct evidence of credit steering, as opposed to evidence of steering by real estate professionals regarding home location. Minorities disproportionately use subprime lenders, but in addition to steering, minorities may misperceive their own creditworthiness, believe that prime lenders would deny their loans, or make bad choices. Moreover, subprime lenders market heavily in these communities, and prime lenders may not market sufficiently in minority communities for them to be perceived as real options by community members.

¹⁹⁷ Paul S. Calem et al., *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. REAL EST. FIN. & ECON. 393, 407 (2004).

¹⁹⁸ For a full discussion of such practices, see generally HUD-TREASURY REPORT, *supra* note 191 (detailing predatory lending abuses and evaluating reform proposals). I co-directed this report while at Treasury. See also Michael S. Barr, *Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress*, 16 NOTRE DAME J.L. ETHICS & PUB. POL’Y 447, 455–62 (2002) (describing problems in and opportunities for reform of subprime mortgage market).

additional products (such as credit life insurance) without the borrower understanding that the products were optional or unsuitable.¹⁹⁹ Loans have included fees unrelated to risk or servicing, and which are structured to disguise the loans' true costs.²⁰⁰ Some brokers have made home mortgage loans without regard to the borrower's ability to repay.²⁰¹ These so-called "asset based" loans often were made by brokers who earned high fees and were less concerned about their reputations among lenders.²⁰² In other cases borrowers have testified that "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."²⁰³

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."²⁰⁴ For example, borrowers who are older, Hispanic, or search less for interest rates are more likely to end up in the subprime market.²⁰⁵ Having a subprime loan is an important determinant of refinancing with a subprime loan even after controlling for relevant factors related to risk and creditworthiness: Some 60% of subprime borrowers who refinanced did so with subprime loans rather than prime ones,²⁰⁶ indicating that many subprime borrowers get stuck in the subprime market.

The higher 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 used widely.²⁰⁷ In loans with yield spread premiums, unlike other loans, there is wide dispersion in prices paid to mortgage brokers. Within

¹⁹⁹ See HUD-TREASURY REPORT, *supra* note 191, at 2.

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.* at 76-77.

²⁰³ *Id.* at 2.

²⁰⁴ Marsha J. Courchane et al., *Subprime Borrowers: Mortgage Transitions and Outcomes*, 29 J. REAL EST. FIN. & ECON. 365, 373 (2004).

²⁰⁵ *Id.* at 371-72.

²⁰⁶ *Id.* at 375, tbl.1.

²⁰⁷ See Jackson & Berry, *supra* note 164, at 127. While in principle yield spread premiums could permit lenders legitimately to pass on the cost of a mortgage broker fee to a cash strapped borrower in the form of a higher interest rate rather than in the form of a cash payment, the evidence suggests that yield spread premiums are in fact used to compensate brokers for getting borrowers to accept higher interest rates.

the group of borrowers paying yield spread premiums, African Americans paid \$474 more for their loans, and Hispanics \$590 more, than white borrowers; thus, even if minority and white borrowers could qualify for the same rate, in practice minority borrowers are likely to pay much more.²⁰⁸ Minority borrowers and white borrowers tend to go to different lenders, with minority borrowers more likely to use subprime lenders, "some [of which] use particularly aggressive rate-setting rules with minority customers."²⁰⁹ Moreover, borrowers in the subprime market form a pool whose risk characteristics are worse and more widely dispersed than borrowers in the prime market.²¹⁰ 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 because creditors price loans based on pooling risk by observable characteristics. Regulation of the subprime sector is in part a response to the problem of incomplete contracts.²¹¹ Borrowers cannot contract with one another to allocate the costs of the negative externality of default. Moreover, these externalities are more likely to be concentrated in low-income communities. Concentrated defaults make it less likely that creditors will be willing to lend to households living in neighborhoods with high default rates, both because the defaults will have undermined the stability of property values in the neighborhood, and because living in a neighborhood with high defaults will signal lower creditworthiness. Moreover, foreclosures concentrated in low-income neighborhoods cause negative externalities to neighboring property owners in terms of lower property values, reduced levels of investment in maintenance, and an increase in vandalism and crime on abandoned properties.²¹²

Some critics believe that the subprime market's growth obviates the need for CRA. After all, if subprime lending has increased

²⁰⁸ *Id.* at 125 (describing differences in "total mortgage broker compensation," which includes both yield spread premiums and their functional equivalents, broker "discount fees"); see also JACK GUTTENTAG, ANOTHER VIEW OF PREDATORY LENDING 8 (Wharton Fin. Inst. Ctr., Working Paper No. 01-23-B, 2000) ("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."), available at <http://fic.wharton.upenn.edu/fic/papers/01/0123.pdf>.

²⁰⁹ ROSS & YINGER, *supra* note 110, at 344.

²¹⁰ Anthony Pennington-Cross, *Credit History and the Performance of Prime and Non-prime Mortgages*, 27 J. REAL EST. FIN. & ECON. 279, 299 (2003).

²¹¹ On the problem of incomplete contracts, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 88-89 (1989) (distinguishing between paternalism and externalities as bases for immutable rules to fill gaps in incomplete contracts); Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115 (1999) (explaining theory of incomplete contracts based on inability of parties to contract at reasonable cost for all contingent states).

²¹² See, e.g., Pennington-Cross & Yezer, *supra* note 172, at 369.

without impetus from CRA, why not simply rely on subprime lenders in low-income communities? Critics like Gunther argue that market forces have solved the alleged market failures that I described. I think the empirical evidence is more complicated than that, as I discuss more fully in the next Part. 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.²¹³ Because they specialize in refinance loans, subprime lenders free-ride on the information generated by firms engaged in home purchase lending, predominately banks and thrifts covered by CRA. Second, many subprime lenders have failed to report credit scores for sound borrowers in order to capture the informational benefits from their investment.²¹⁴ As a result, the positive externalities from increased lending in low-income areas are not always realized. Third, borrowing from a subprime lender may signal to prime lenders that a borrower is more likely to be a bad credit risk. While in one study, 40% of subprime borrowers were able to obtain prime refinance mortgages, 60% were not.²¹⁵ For these borrowers, rather than increasing access to prime lending, subprime borrowing helped to keep them in the subprime market, where borrowers pay more for credit. As this study found, "previous mortgage segment is an important determinant of current market segment even after controlling for risk-related underwriting and demographic effects."²¹⁶ Thus, the growth of subprime lending does not obviate the need for prime lending to creditworthy borrowers in low-income communities. Lastly, the empirical evidence I explore in Part IV is more consistent with the view that CRA has had an independent role in expanding access to credit in low-income communities than with the view of CRA's critics.

CRA has not yet done enough to integrate the prime and subprime markets, as evidenced by these problems.²¹⁷ CRA is uniquely

²¹³ See HUD-TREASURY REPORT, *supra* note 191, at 31.

²¹⁴ See *supra* note 117.

²¹⁵ Courchane et al., *supra* note 204, at 374.

²¹⁶ *Id.* at 375.

²¹⁷ See, e.g., Bd. of Governors of the Fed. Res. Sys., *In re Citigroup Inc. & Citifinancial Credit Co., Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent*, May 27, 2004 (alleging subprime affiliate engaging in asset-based lending in violation of HOEPA, requiring co-signators to sell more credit insurance in violation of Regulation B, misleading examiners, and assessing civil money penalties of \$70 million and securing agreement to pay restitution to borrowers), available at <http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20040527/attachment.pdf> (last visited Mar. 30, 2005). But see OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION: CITIBANK, N.A. 7, 11–12 (June 9, 2003) [hereinafter CRA PERFORMANCE EVALUATION: CITIBANK] (rating Citibank outstanding after evaluating performance of bank and its mortgage affiliates, including

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. An integrated market would reduce the scope for price discrimination among similarly situated borrowers. As I explain in Part VII, CRA can help bolster ECOA in reducing some forms of discrimination, especially those involving disparate impact that results from bifurcated markets in which minority and white borrowers tend to go to different lenders, and market fragmentation, which increases the opportunity for differential pricing that disadvantages minorities. CRA can also help reinforce the Home Owners Equity Protection Act (HOEPA), as I explain in Part VII, to overcome problems in the subprime market by helping to enhance competition from banks and thrifts in serving these households.

D. Summary

Market failures in low-income communities, racial discrimination, and bifurcated credit markets warrant governmental action. I have argued that, in principle, CRA is a reasonable policy response to these problems. CRA helps to overcome information externalities and collective action problems by helping to coordinate bank lending. CRA responds to the continuing effects of 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. With modest regulatory changes, CRA could offer an even stronger response to the market failures and discrimination that have arisen in the subprime market. In the next Part, I use recent empirical evidence to explain how CRA already is helping to overcome many of these barriers, even though problems remain.

IV

EMPIRICAL EVIDENCE THAT CRA IS EFFECTIVE

Part III identified specific market failures and discrimination that are the theoretical foundations for CRA and explained how CRA could help to overcome such problems. The debate over CRA, however, cannot be decided based on abstractions or anecdotes. This Part explores recent empirical evidence showing that CRA, on balance,

Citifinancial, and noting that fair lending concerns at another affiliate "did not significantly impact our CRA assessment of Citibank" because affiliate did not constitute significant percentage of institution's low- and moderate-income mortgage lending), at <http://www.occ.treas.gov/ftp/craeval/may04/1461.pdf> (last visited Mar. 30, 2005).

constitutes a defensible policy response to market failures and discrimination. The first Section relies on empirical evidence, some of which was published in a study that 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.²¹⁸ This evidence effectively rebuts the arguments of critics that CRA provides little benefit, or is actually harmful, to low-income communities, and is consistent with a theory that CRA is helping to overcome market failures and discrimination.

Section B analyzes the critics' claims that CRA is overly costly, and explains how the costs of CRA generally are overstated. In particular, the claim that CRA induces banks and thrifts to make dangerously unprofitable loans is not substantiated by the data. Instead, the data is again more consistent with a theory that CRA is helping to improve market efficiency by overcoming market failures and discrimination. Similarly, I present evidence to rebut claims of rampant rent seeking, high compliance costs, heavy burdens on efficient mergers, and other costs predicted by CRA's critics. Even a rough sense of the costs and benefits of CRA adduced thus far suggests that it is on net socially beneficial, and reasonable legal response to market failures and the legacy of discrimination.

A. The Benefits of CRA Are Substantial

The experience under CRA over the last decade suggests that CRA has been effective in helping to overcome market failures in low-income communities. In this Section, I first describe innovative initiatives that CRA has spurred by banking organizations in order to serve low- and moderate-income communities. I then evaluate recent empirical evidence that attempts to measure the effects of CRA on home mortgage lending, which constitutes the bulk of CRA-eligible lending and as to which data is most readily available. I also discuss evidence regarding small business and community development lending as well as community development investments.

Initiatives by financial institutions over the last decade suggest that CRA—in combination with other factors that I assess more fully below—is helping banks and thrifts to eliminate or reduce barriers to credit. These activities are consistent with the view that CRA is

²¹⁸ It should be re-emphasized in this Part, as in the discussion of market imperfections, that empirical studies in an area as complicated as credit markets cannot prove any contention with certainty. Technological and economic change exacerbates this difficulty, as do the multiplicity of regulations and the pervasiveness of subsidies.

encouraging banks and thrifts to undertake steps to overcome market failures in order to meet the “credit needs of their entire community.”²¹⁹ For example, lenders have formed multi-bank Community Development Corporations (CDCs) and loan consortia, and partnered with third parties to reduce risk, overcome collective action problems, and share the costs and benefits of developing information about low-income markets.²²⁰ Banks have invested in locally based Community Development Financial Institutions (CDFI) to develop specialized market knowledge, share risk, and explore new market opportunities.²²¹ They have engaged in special marketing programs to targeted communities, and have experimented with more flexible underwriting and specialized servicing techniques to determine if a broader range of applications could be approved without undue risk.²²² Banks also have funded credit counseling to improve the creditworthiness of potential borrowers.²²³ Many larger institutions have developed specialized units within their organizations that focus on the needs of low- and moderate-income communities.²²⁴ These units help overcome agency costs by keeping the organization focused on expanding its low-income and minority lending, and by sharing expertise as to how to do so. 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

²¹⁹ 12 U.S.C. § 2903(a) (2000).

²²⁰ See, e.g., BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE PERFORMANCE AND PROFITABILITY OF CRA-RELATED LENDING, 86–87 (2000) [hereinafter PERFORMANCE AND PROFITABILITY] (noting that banks limit “potential exposure to losses by sharing risks with third parties, including local or state public authorities or private revolving loan funds”), available at <http://www.federalreserve.gov/boarddocs/surveys/craloansurvey/cratext.pdf>; *infra* note 222 and accompanying text. Third parties are involved in three quarters of CRA special lending programs. *Id.* Third parties include financial consortia, nonprofit organizations, and public entities at all levels of government. *Id.* at tbl.12, available at <http://www.federalreserve.gov/boarddocs/surveys/crloansurvey/cratables.pdf>; see also Robert B. Avery et al., *CRA Special Lending Programs*, FED. RES. BULL. 711 (2000) (reporting on results of survey); *How an Innovative Bank Launched a CDC*, COMMUNITY DEV. OFFICE OF THE COMPTROLLER OF CURRENCY (Winter 2004–05) (describing successful housing project funded through national bank CDC that provided revenues sufficient to cover CDC loan costs), at http://www.occ.treas.gov/cdd/ezine/winter04/how_a_inn.html (last visited Mar. 30, 2005).

²²¹ See, e.g., COMMUNITY DEV. NEWSL. 2002 (Office of the Comptroller of the Currency, Washington, D.C.) (describing variety of strategies for bank partnerships with CDFIs), available at <http://www.occ.treas.gov/cdd/E-zineText.pdf> (last visited Mar. 30, 2005).

²²² See, e.g., PERFORMANCE AND PROFITABILITY, *supra* note 220, 86, tbl.13 (describing characteristics of “affordable mortgage lending programs”).

²²³ *Id.* at 86–87.

²²⁴ See, e.g., *id.* at 65 (“About 63 percent of the [CRA special lending] programs are operated by a distinct unit or department.”).

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.²²⁵

Home mortgage data show increased lending to minority and low-income borrowers.²²⁶ From 1993 to 1999, the number of home purchase loans made to Hispanics increased 121.4%; to Native Americans, 118.9%; to African Americans, 91.0%; to Asians, 70.1%; and to whites, 33.5%.²²⁷ Over that period, the number of home purchase loans extended to applicants with incomes less than 80% of the median increased 86.2%, a much higher rate of growth than any other income group experienced.²²⁸ In 1999, conventional home purchase loans extended in neighborhoods that are predominantly minority were up 17% over the previous year, compared with 6% growth in other neighborhoods.²²⁹

Consistent with the theoretical analysis presented earlier, empirical evidence suggests that markets were relatively thin, and thus prone to relatively higher information externalities, at the beginning of the 1990s, and that market thickness improved during the decade.²³⁰ One measure of market thickness for home purchase loans is the volume of potential transactions as measured by the level of home ownership in low- and moderate-income communities as compared with high-income communities. In 1990, there were 19.6 million homeowners in low- and moderate-income communities, 49.6% the

²²⁵ See *id.*; see also *infra* Part IV.B.1 (discussing results of study in greater detail).

²²⁶ See, e.g., JOINT CTR. FOR Hous. STUDIES, HARVARD UNIV., THE 25TH ANNIVERSARY OF THE COMMUNITY REINVESTMENT ACT: ACCESS TO CAPITAL IN AN EVOLVING FINANCIAL SERVICES SYSTEM 3 (2002) [hereinafter 2002 JOINT CENTER CRA REPORT], available at <http://www.jchs.harvard.edu/publications/governmentprograms/cra02-1.pdf>.

²²⁷ Author's calculations based on HMDA data as reported by the Federal Financial Institutions Examination Council. See HMDA data, tbl. 7, at <http://www.ffiec.gov/hmcpr/hmda03.pdf> (last visited Mar. 30, 2005). As Peter Swire was kind enough to point out to me, critics might contend that this overstates progress in lending to minority households because Hispanic household growth was much higher than white household growth. Over this time period, the number of white households grew by 6.2%, black households by 12.4%, and Hispanic households by 36.7%. See U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, HOUSEHOLDS BY RACE AND HISPANIC ORIGIN: 1970 TO PRESENT, tbl. HH-2 (2004), <http://www.census.gov/population/socdemo/hh-fam/tabHH-2.pdf>. Adjusting for growth in the number of households, however, still shows progress for minorities. The growth in loans to whites was 3.58 times its household growth rate; for Hispanics, 3.31 times; for blacks 7.34 times.

²²⁸ See *supra* note 227.

²²⁹ Author's calculation based on HMDA data, *supra* note 227, at tbl.5.

²³⁰ I would like to thank Geoffrey Miller for suggesting that I examine the empirical evidence for the "market thinness" proposition using turnover rates and Rachel Drew for generating the tables of Census data that support this analysis.

number of homeowners in high-income areas.²³¹ By 2000, the ratio had improved, so that the 24.8 million homeowners in low- and moderate-income communities were 55% of the number in high-income areas.²³² The number of homeowners in low- and moderate-income communities grew by 26.6% over the decade, while the number of homeowners in high-income areas grew by only 14%.²³³ Another measure of market thickness is liquidity in home sales, as measured by the turnover rate—the percentage of homeowners who move in a given time. In the five years preceding 1990, 28.7% of homeowners in low- and moderate-income areas moved, as compared with 36.8% in high-income census tracts, a difference of 8 percentage points.²³⁴ By 2000, the percentage of homeowners who had moved in the prior five years was 32.3% for homeowners in low- and moderate-income tracts and 36.9% for high-income tracts, a difference that had diminished to 4.5 percentage points.²³⁵ A third way of thinking about market thickness is to look at the number of low- and moderate-income area homeowners who moved, generating a home sale, compared to the number of high income homeowners who moved. In the five years preceding 1990, about 5.6 million homeowners living in low- and moderate-income tracts had moved, about 38% of the number of homeowners who had moved in high-income areas.²³⁶ By 2000, the gap had narrowed: The number of homeowners who had moved in the prior five years in low- and moderate-income areas increased to 8 million, about 48% of the comparable figure for homeowners in high-income areas.²³⁷ The basic trend lines are the same for low- and moderate-income census tracts in which at least half of the households are minority, but the absolute levels of homeownership and home sales are much lower than in non-minority low- and moderate-income tracts, turnover rates are somewhat lower in minority tracts than in non-minority tracts, and the trends in improvement less pronounced in minority tracts than in non-minority tracts.²³⁸

²³¹ Author's calculations based on table, Homeownership and Turnover Rates, 1990, 2000 (on file with *New York University Law Review*) generated using microdata from U.S. Census 1990 & 2000. See generally U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, www.census.gov. Individual census tracts borders may have shifted between 1990 and 2000, but it is not possible to obtain the same micro files for 1990 data using 2000 census tract definitions, and these shifts are unlikely to affect the data in a meaningful way.

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ In minority tracts, there were 4.6 million homeowners in 1990 and 5.1 million homeowners in 2000. There were 1.1 million homeowners who had moved in the previous 5

Examples of innovative lending structures, growth in lending to these communities, and higher levels of home ownership and sales are indicative of progress, but careful econometric studies are essential to understanding the role of CRA itself in overcoming market failures and discrimination. Such studies have found evidence that CRA improved access to home mortgage credit for low-income borrowers during the 1990s, when CRA regulations were amended to focus on performance, regulatory agencies stepped up the seriousness of their CRA reviews, and bank merger activity increased. One study found that the share of loans to individuals targeted by CRA and fair lending regulations originated by banks, thrifts, and their affiliates in the 1990s increased; it also found evidence of gains to minorities and low-income areas from all lenders, which the authors attribute in part to increased fair lending enforcement.²³⁹ 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 lower-income and minority borrowers and neighborhoods.”²⁴⁰ Lending to low- and moderate-income borrowers grew much faster than lending to other groups in the 1990s, which may be attributable both to CRA and to other factors.²⁴¹ A case study found that one lender had extended loans to low-income and minority borrowers with lower credit scores than it normally required, and had essentially doubled its lending to low- and moderate-income borrowers, because of CRA.²⁴² These studies generally found much higher levels of activity during the 1990s than during the 1980s, when CRA was thought generally to be ineffective because of inadequate regulatory attention.

Many of the studies described above, however, had difficulties discerning the effect of CRA apart from other policy and market

years in 1990 and 1.4 million in 2000. Turnover rates were 24% in 1990 and 27.6% in 2000. *Id.*

²³⁹ Douglas D. Evanoff & Lewis M. Siegal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, 20 J. ECON. PERSP. 19, 28–38 (1996).

²⁴⁰ Robert B. Avery et al., *Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act*, 85 FED. RES. BULL. 81, 82 (1999).

²⁴¹ Robert B. Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 638–39 (1996).

²⁴² 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 14, 21 (May 4, 1998) (Conference paper presented at the Midyear Meeting of the American Real Estate and Urban Economics Association, Washington, D.C., unpublished manuscript, on file with the *New York University Law Review*) (noting that in study of loans from one mortgage lender, “only about half of all loans extended to the low-to-moderate income segment would not have qualified anyway under traditional scoring standards”).

changes. As a result, researchers attempted to isolate the effects of CRA with greater precision. I directed a two-part study at the Treasury Department, undertaken by researchers from the Brookings Institution and the Joint Center for Housing Studies at Harvard University, which constituted one such attempt. The baseline study found that, in absolute terms, between 1993 and 1998, depository institutions covered by the CRA and their affiliates made nearly \$620 billion in home mortgage, small business, and community development loans to low- and moderate-income borrowers and communities.²⁴³ Although fully comparable data are not available for the 1980s, available evidence suggests that stepped up regulatory attention under CRA, as well as other developments that I discuss below, resulted in much higher levels of lending to these borrowers.²⁴⁴ One way to measure CRA's effectiveness during the 1990s is to compare CRA lending by each bank or thrift to the same institution's non-CRA-eligible lending. CRA-eligible home mortgage lending increased relative to other home mortgage lending by banks and thrifts and their affiliates. The number of CRA-eligible mortgage loans increased by thirty-nine percent between 1993 and 1998, while other mortgage loans increased

²⁴³ Author's calculations based on ROBERT E. LITAN ET AL., U.S. DEP'T OF THE TREASURY, THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT ES-5 (\$467 billion in home mortgage lending including \$135 billion in 1998 alone), ES-14 (\$99 billion in small business lending), ES-16 (\$53 billion in community development lending) (Apr. 2000) [hereinafter LITAN ET AL., BASELINE REPORT], available at <http://www.treas.gov/press/releases/docs/crareport.pdf> (last visited Jan. 26, 2005); see also ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A FINAL REPORT 26 (Jan. 2001) (noting continued growth rate in 1999 in home mortgage lending from 1998 levels) [hereinafter LITAN ET AL., FINAL REPORT], available at <http://www.treas.gov/press/releases/reports/finalrpt.pdf> (last visited Jan. 26, 2005). Updating the total figures through 1999 would yield over \$800 billion in flows. Author's calculations based on LITAN ET AL., BASELINE REPORT, *supra*, (\$619 billion); LITAN ET AL., FINAL REPORT, *supra* (based on conservative assumption of additional \$135 billion in home mortgage lending); Fed. Fin. Inst. Examination Council, CRA National Aggregate Table 2-2, 1999 (\$35.4 billion in small business loans in low- and moderate-income areas), available at <http://www.ffiec.gov/webcraad/cranaag.htm> (last visited Mar. 30, 2005); Fed. Fin. Inst. Examination Council, CRA National Aggregate Table 3, 1999 (\$17 billion in community development lending), available at <http://www.ffiec.gov/webcraad/cranaag.htm> (last visited Mar. 30, 2005). For further analysis based on the data from the Treasury reports, see Eric S. Belsky et al., The Effects of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending (Harvard Univ. Joint Ctr. for Hous. Studies, Working Paper CRA01-1, 2001) (confirming results of LITAN ET AL., *supra*), available at http://www.jchs.harvard.edu/publications/governmentprograms/belschillyezer_cra01-1.pdf. Mortgage loans made between 1993 and 1998 constituted \$467 billion of that total. See LITAN ET AL., BASELINE REPORT, *supra*, at ES-5, 36 tbl.2. In 1998 alone, CRA-covered institutions and their affiliates made \$135 billion in mortgage loans to these borrowers, an eighty percent increase over their lending in 1993. See *id.* at ES-3 tbl., ES-1, ES-5.

²⁴⁴ BELSKY ET AL., *supra* note 243, at 5-6; LITAN ET AL., BASELINE REPORT, *supra* note 243, at 61-69; LITAN ET AL., FINAL REPORT, *supra* note 243, at 3.

by only seventeen percent.²⁴⁵ Excluding all affiliates (which are included in CRA assessments only at the lender's discretion²⁴⁶) banks and thrifts themselves increased their home mortgage lending to CRA-eligible low- and moderate-income borrowers and areas by ten percent; in contrast, mortgage lending in more affluent markets by these lenders did not change.²⁴⁷ The faster growth in CRA lending compared to other mortgage lending is reflected in the larger shares of bank and thrift portfolios devoted to CRA-eligible loans. Over this period, the portfolio share of CRA-covered lender and affiliate mortgage loans going to these low- and moderate-income borrowers and areas increased from 25% to 28%. That is, over the relevant period, these CRA-covered institutions and their affiliates increasingly focused on underserved markets.²⁴⁸

Critics argue that the growth of lending by independent mortgage and finance companies in the subprime market shows that CRA is irrelevant.²⁴⁹ In their view, since non-CRA lenders are serving low-income markets, CRA must be unnecessary. I do not believe that to be the case. To begin with, subprime lenders provide a different product from prime lenders. The dramatic expansion of non-covered lenders in the subprime refinance market, albeit from a low base, means that banks and thrifts lost market share overall in low- and moderate-income communities. Yet fully 85% of non-covered institutions' growth is attributable to lending by specialists in subprime and manufactured home lending.²⁵⁰ More than 77% of this subprime lending growth is attributable to refinancing rather than home purchase loans.²⁵¹ As a result of the growth in subprime refinance lending, if one includes both prime and subprime markets, non-covered institutions increased their overall market share of lending to low- and moderate-income borrowers and areas from 35% in 1993 to 37% in 1998.²⁵² By contrast, lenders covered by CRA primarily specialize in prime lending. In the prime market, banks and thrifts covered by CRA and their affiliates increased their market share of lending to low- and moderate-income borrowers and areas from 66% in 1993 to 71% in 1998.²⁵³ Thus, banks and thrifts subject to CRA increased their market share in home purchase lending, while finance

²⁴⁵ See LITAN ET AL., BASELINE REPORT, *supra* note 243, at ES-6.

²⁴⁶ *Id.* at 111.

²⁴⁷ See *id.* at 79.

²⁴⁸ See *id.* at ES-6-7 & ES-2.

²⁴⁹ See, e.g., Gunther, *supra* note 21, at 57, 60.

²⁵⁰ LITAN ET AL., BASELINE REPORT, *supra* note 243, at 39.

²⁵¹ See *id.* at ES-9.

²⁵² See *id.*

²⁵³ See *id.* at ES-10.

and mortgage companies focused on subprime refinance loans. That is, to the extent that CRA is designed to overcome market failures that diminish the opportunities for low-income borrowers to purchase a home, such home purchase lending by CRA-covered lenders increased more rapidly than similar lending by other lenders.

Without more evidence, however, the critics are correct that 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 and gains for low-income households.²⁵⁴ Real interest rates for mortgages were at low levels during much of this period.²⁵⁵ Second, financial and technological innovation helped drive down the costs of assessing creditworthiness, offering mortgage products, effectuating transactions, and funding loans through securitization.²⁵⁶ Third, extensive consolidation in the financial services sector in the wake of the removal of important geographic restrictions on banking heightened the potential to magnify the adverse consequences to banks and thrifts of poor performance under CRA when they undertook major transactions.²⁵⁷ At the same time, consolidation also likely enhanced competition for the delivery of credit in many markets, including both mature markets in high-income areas and newly found opportunities in low-income communities.²⁵⁸ 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 and perhaps differing ways on different mortgage market participants during this period.²⁵⁹

Controlling for the effects of these factors, however, a follow-up Treasury report that I again directed, undertaken by researchers from Brookings and the Joint Center for Housing Studies, found that CRA

²⁵⁴ LITAN ET AL., FINAL REPORT, *supra* note 243, at 24; Ana M. Aizcorbe et al., *Recent Changes in US Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 4 FED. RES. BULL. 4-5 (Jan. 2003) (showing income growth between 1992 and 2001 among nonwhite or Hispanic families and among bottom twentieth percentile of income).

²⁵⁵ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 1; LITAN ET AL., BASELINE REPORT, *supra* note 243, at ES-11.

²⁵⁶ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 15.

²⁵⁷ *Id.* at 14, 24.

²⁵⁸ For a thoughtful analysis of how consolidation can increase bank competition and benefit consumers, see Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992) (arguing in favor of deregulation of geographic restrictions on bank mergers and acquisitions).

²⁵⁹ See *infra* Part VII.

provides important benefits. For example, evidence benchmarking banks and thrifts against non-CRA lenders facing similar market 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 prime lending faster than those not regulated by CRA from 1993 to 1999.²⁶⁰ If the growth rates in CRA-eligible home purchase lending by banks and thrifts and their affiliates had been as slow as the growth rates for non-CRA lenders, CRA-eligible lending by CRA-lenders would have been 20% lower over that period.²⁶¹

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.²⁶² The report controlled for median household income, unemployment rate, housing affordability, home ownership levels, demographic composition, the role of the secondary market and government loan programs. It then assessed the role of CRA, as measured by the relationship between the share of loans to low- and moderate-income borrowers and areas and the share of loans within the bank's assessment area that are CRA-eligible, and the presence of CRA lending agreements with community groups. Although the measures are problematic in some ways,²⁶³ the report did find a correlation between CRA and higher shares of loans to low-income neighborhoods and borrowers.²⁶⁴ Case studies of lenders and community organizations in four metropolitan areas also support this view.²⁶⁵ Lenders and community organizations believe that CRA "drove" market changes in lending.²⁶⁶ On these measures, CRA appears to make a difference, although the report acknowledged that further econometric modeling would be required to provide more definitive results.²⁶⁷ Additional

²⁶⁰ See LITAN ET AL., FINAL REPORT, *supra* note 243, at ES-4.

²⁶¹ *Id.* at 35.

²⁶² *Id.* at 36.

²⁶³ See *id.* at 36-46 (describing measurement, variable and other errors including spatial aggregation bias and possible presence of heteroskedasticity).

²⁶⁴ *Id.* at 46.

²⁶⁵ *Id.* at 62.

²⁶⁶ *Id.* at 47.

²⁶⁷ See *id.*, at ES-3-4. This research stands in contrast to the approach taken by Gunther, *supra* note 21, at 60 (concluding that CRA is ineffective). Gunther examines data from 1993 and 1997, years that are not comparable because of differences in refinancings. 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

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—confirmed 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.”²⁶⁸

The Joint Center for Housing Studies 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.²⁶⁹ The study controlled for economic, demographic, and housing market variables as to metropolitan areas, tracts, loans, and borrowers, across the more than 300 metropolitan areas studied.²⁷⁰ This research again found that CRA has had positive effects consistent with the theory that CRA is helping to overcome market failures and discrimination. For example, if CRA were helping to overcome information externalities, one would expect to see higher rates of home sales—thicker markets—in CRA-eligible areas. In fact, the report found somewhat higher turnover rates in low- and moderate-income neighborhoods within banks’ assessment areas than in low- and moderate-income neighborhoods outside assessment areas.²⁷¹

Measuring the precise effects of CRA is difficult given other regulatory and market changes. The models used in the Joint Center report do not “reveal[] with precision the exact magnitude of the impact of CRA,”²⁷² and should be interpreted cautiously. Point estimates can be described in different ways. For example, the report found that the effect of CRA on the share of home mortgage lending to low- and moderate-income borrowers and areas was equivalent to the effect of a 1.3 percentage point decrease in the unemployment rate, while the actual drop in unemployment over that time period was about twice that figure.²⁷³ By this measure, CRA’s effect should be considered quite economically significant, although clearly much less than the effect of economic growth. In addition, the report found:

households. Lastly, Gunther repeats arguments that CRA lending is unsound, ignoring the contrary evidence from the Federal Reserve Board’s report. *See infra* note 313 and accompanying text.

²⁶⁸ BELSKY ET AL., *supra* note 243, at 22.

²⁶⁹ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 59.

²⁷⁰ *See, e.g., id.* at 64.

²⁷¹ *Id.* at 75 (finding turnover rate of 6.24% in low- and moderate-income CRA assessment areas and rate of 6.21% in low- and moderate-income non-CRA-assessment areas).

²⁷² *Id.* at 58.

²⁷³ *See id.* at 58–59.

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.

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.²⁷⁴

In reaching these conclusions, the report used two key variables to assess the impact of CRA: one measuring lending within, as opposed to outside, assessment areas, and one denoting whether community groups had signed CRA agreements with banks or thrifts that promised increased lending.²⁷⁵ Not surprisingly, given the messiness of the real world, some findings from the study are open to conflicting interpretations.

On the one hand, critics would contend that the growth of the subprime market may mean that CRA is less important than it once was, or may even challenge the idea 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 lending that shifted from subprime lenders to prime lenders, rather than a net increase in loans.²⁷⁶ Moreover, the significant increase in lending that the Joint Center attributed to CRA from lending to low- and moderate-income borrowers in middle- and high-income neighborhoods²⁷⁷ presumably led to lower positive externalities for neighborhoods than would lending to borrowers in low-income neighborhoods. Lending to low-income borrowers in these higher income areas lends less support to a market failure theory based on information externalities than would increased lending in low-income areas. To the extent that market failures are neighborhood-focused and to the extent that CRA is aimed at overcoming such failures, one would expect to see most of the change in lending under CRA directed at such areas. Moreover, the growth of subprime home purchase lending by independent mortgage and finance companies in low-income communities could be taken as evidence either that CRA is not working, or that it is not necessary.

²⁷⁴ *Id.* at 58.

²⁷⁵ *Id.* at 61–63.

²⁷⁶ *Id.* at 59, 72.

²⁷⁷ *Id.* at 59, 68.

On the other hand, each of these points is amenable to a contrary and often more plausible interpretation. The Joint Center's approach actually may understate the effect of CRA on changing banking practices, both within and outside assessment areas. Once banks decide to change their lending practices, it is more efficient to do so across the banks' operations. Banks likely 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. The costs of developing products and training personnel make the consistent application of these business practices more efficient across all lending areas. Thus, using lending outside of assessment areas as a control will understate the effects of CRA.

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,²⁷⁸ then the success of CRA also 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."²⁷⁹ As I argued above, while progress has been made, my intuition is that CRA is still required to overcome persistent market failures and much more could still be done by banks and thrifts to serve low-income communities.

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 in fact behaved worse. Glen Canner and his colleagues suggest that this is plausible, given that banks have higher costs of funds and business plans that tend to focus on higher cost services to a higher income clientele.²⁸⁰ Thus, comparisons between bank and non-bank lending to low- and moderate-income borrowers would understate CRA's impact on changing the lending patterns of banks and thrifts.

²⁷⁸ Increases in loan volume and liquidity make it more profitable for lenders to enter the market. Such lending increases available information and reduces information externalities from each additional loan.

²⁷⁹ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 60.

²⁸⁰ See, e.g., GLENN B. CANNER ET AL., DOES THE COMMUNITY REINVESTMENT ACT (CRA) CAUSE BANKS TO PROVIDE A SUBSIDY TO SOME MORTGAGE BORROWERS? 45-47 (Fed. Reserve Bd. Fin. & Econ., Discussion Series No. 2002-19, 2002), available at <http://www.federalreserve.gov/pubs/feds/2002/200219/200219pap.pdf>.

Furthermore, a focus on CRA lending only in low-income neighborhoods is too narrow. As explained in Part III, market failures, in principle, can occur both as to low-income communities and as to low-income borrowers. Discrimination, likewise, can affect minority borrowers wherever they choose to live. Banks and thrifts under CRA have likely lowered the cost of acquiring information and gaining expertise in serving low-income borrowers wherever they buy, in addition to borrowers in low-income neighborhoods, because the expertise and technology needed to develop alternative measures of creditworthiness would span both types of lending. CRA lending to low-income borrowers outside of poor neighborhoods improves social mobility by helping low-income borrowers move to better neighborhoods. In addition, CRA lending that gives minority borrowers the opportunity to move to less segregated, middle- and upper-income neighborhoods advances CRA's purposes in overcoming the legacy of discrimination. These patterns of increased CRA lending to low-income and minority borrowers in better neighborhoods also are consistent with the evidence of some deconcentration of poverty in the latter part of the 1990s in many metropolitan areas.²⁸¹

In addition, GSE affordable housing goals and fair lending laws likely increased lending by non-banks and banks,²⁸² but the different industry and regulatory structure affecting different types of institutions may vary the impact of these laws, so it is difficult to measure what independent mortgage companies and banks would have done in the absence of these laws. Ideally, one would want to model the interactions of these laws on different market participants and then test the model empirically.

Lastly, even if some gains in prime lending merely represent a substitution of prime lending for subprime lending, such shifts directly lower prices for borrowers who obtain a prime rather than a subprime loan. Over time, with increased competition, industry pricing and practice in low-income neighborhoods may move towards the standards of the prime market, which would provide significant benefits to low- and moderate-income and minority households. Enhanced competition in these markets, and increased volume and liquidity, from

²⁸¹ See PAUL A. JARGOWSKY, *THE BROOKINGS INST., STUNNING PROGRESS, HIDDEN PROBLEMS: THE DRAMATIC DECLINE OF CONCENTRATED POVERTY IN THE 1990s* (May 2003) (finding significant declines in concentrated poverty in 1990s), available at <http://www.brookings.edu/es/urban/publications/jargowskypoverty.pdf>.

²⁸² See LITAN ET AL., *BASELINE REPORT*, *supra* note 243, at 70 (noting effects of government-sponsored enterprise (GSE) affordable housing goals on purchases from both CRA-covered lenders and non-CRA-covered lenders); LITAN ET AL., *FINAL REPORT*, *supra* note 243, at 45 (finding correlation between increased CRA origination share and increased secondary market sales).

both prime and subprime lenders, is consistent with the theoretical model of CRA as helping to overcome collective action problems and information externalities.

Despite the robustness of these studies, other empirical research has failed to find significant effects of CRA. For example, economists at the Federal Reserve Board tried to measure whether increased mortgage lending under CRA has had any effect on *outcomes* in moderate-income neighborhoods.²⁸³ They found that CRA-eligible, moderate-income census tracts “had higher homeownership rates, higher growth in owner-occupied units, and lower vacancy rates than would have been predicted on the basis of changes in the not CRA-eligible census tracts” with slightly higher incomes; but these results were not robust, and two other outcome measures, for crime and median home values found that “lower-income neighborhoods actually fared worse than would have been predicted.”²⁸⁴ Generally speaking, the results were inconclusive as to the effect of CRA on neighborhoods.

It is not surprising that the study had difficulty isolating an effect of CRA not only on lending, but also on how increased lending, if any, affected neighborhood outcomes. There are too many policy and other factors that come into play in particular neighborhoods, and these factors are unlikely either to track census tracts or to be consistent across census tracts. Furthermore, some measures of outcomes, such as the measure for crime, are only distantly related to increased access to credit. Moreover, as the authors note,²⁸⁵ the census tract is likely too small a unit of analysis given that banks and thrifts are unlikely to target business practice changes at the census tract level. As explained above, looking for census tract level differences will mask the effect of CRA, if any, on changing bank and thrift practices as they affect low- and moderate-income areas and borrowers more generally, not just those that qualify for CRA eligibility. In addition, the study seeks to explore changes within a narrow band of income range of census tracts, from seventy to ninety percent of median income, which would exacerbate the problem of narrow geographic focus because tracts just above the cutoff for CRA eligibility are the tracts that are most likely to benefit from CRA-induced changes to bank practices. Lastly, the study does not include the effects of increased home mortgage lending to low- and moderate-income borrowers who choose to find homes in middle- and upper-income neigh-

²⁸³ Robert B. Avery et al., Bd. of Governors of the Fed. Reserve Sys., *The Effects of the Community Reinvestment Act on Local Communities* (2003), *available at* http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/cannerglen.pdf.

²⁸⁴ *Id.* at 27.

²⁸⁵ *Id.* at 28.

borhoods. As described above, expanded access to credit for such borrowers is an important element of CRA's success.

Two other studies lend support to the view of CRA's critics that CRA does not benefit low-income communities. One study found that banks that had been downgraded in their CRA ratings during the years from 1990 to 1995 did not respond in the year after the downgrade by increasing their targeted home mortgage lending to low-income borrowers and communities.²⁸⁶ Another study found that banks rated "needs to improve" and "substantial noncompliance" over the period from 1991 to 1997 did not increase their home mortgage lending to minority borrowers or reduce the disparities in denial rates after receiving such a rating.²⁸⁷ Both studies indicate that the examination process and ratings downgrades during the early and mid-1990s may not have had an impact on the behavior of banks and thrifts whose CRA performance was low or declining.

While both studies indicate that the CRA rating process may not be effective for some banks, and that regulators ought to pay greater attention to how to improve the performance of low ranked or declining performers, four important cautions should be noted. First, the studies focus on low or declining ratings. As one study notes, banks trying to maintain satisfactory ratings do appear to increase minority outreach.²⁸⁸ Second, CRA also plays an important role during merger reviews, and both the evidence on merger reviews specifically,²⁸⁹ and the evidence described above in this Section on CRA's effectiveness overall, suggest that CRA is helping to alter lender behavior. CRA may have more bite for institutions seeking to improve their ratings prior to a merger. Third, few banks are downgraded or receive low ratings,²⁹⁰ so the universe of banks is small for those to whom low ratings or downgrades are the operative force of CRA. Fourth, denial rates, which are used as one measure of performance in one of the studies,²⁹¹ are not a reliable measure of CRA

²⁸⁶ Drew Dahl et al., *Community Reinvestment Act Enforcement and Changes in Targeted Lending*, 25 INT'L REGIONAL SCIENCE REV. 307, 318-19 (2002).

²⁸⁷ Keith D. Harvey et al., *Disparities in Mortgage Lending, Bank Performance, Economic Influence, and Regulatory Oversight*, 23 J. REAL EST. FIN. & ECON. 379, 404-05 (2001).

²⁸⁸ *Id.* at 405.

²⁸⁹ See Part IV.B.2, *infra*.

²⁹⁰ See Dahl et al., *supra* note 286, at 312.

²⁹¹ Harvey et al., *supra* note 287, at 390. The incorrect equation of denial rate with low CRA rating has been made by other critics. Hylton charged that CRA uses loan rejection rates as a measure of performance, when this would punish banks for outreach into harder to serve communities. See Hylton, *supra* note 21, at 233 (implying that high rejection rates lead to negative CRA evaluations). *But see, e.g.*, FED. FIN. INST. EXAMINATION COUNCIL, COMMUNITY REINVESTMENT ACT EXAMINATION PROCEDURES FOR LARGE RETAIL INSTI-

performance. Regulators do not look at denial rates without controls for the creditworthiness of the applicant, but rather at the share of lending going to targeted borrowers, because denial rates could be evidence either of discrimination or failure to use more flexible underwriting standards on the one hand, or expanded marketing and outreach to low-income communities on the other. Increased denial rates could be evidence of looking harder for creditworthy borrowers. The study's second measure, of minority representation in the loan pool, is a much better predictor of changed lender behavior, and it does not suffer from this defect. On this measure, CRA again appears not to influence low-rated institutions, but does "suggest, however, that institutions with already satisfactory performance may target improving minority representation relative to lower-rated peer institutions as a means of maintaining their CRA rating."²⁹² On balance, these studies suggest caution in interpreting CRA examinations and ratings, in the absence of merger reviews, as effective in changing the behavior of low-rated institutions.

Home mortgage lending data represents the bulk of data available in understanding the role of CRA. There are, however, three additional categories of data: small business data, community development lending data, and community development investment data. Moving from home mortgage lending to small business lending, evidence from small business markets reinforces the view that CRA has been effective. The 1995 changes to the CRA regulations imposed a new requirement on large commercial banks and savings associations to report on small business lending. In 2003, the most recent year for which data is available, banks and thrifts subject to CRA's small business reporting requirement originated \$126 billion in loans to firms with revenues under \$1 million,²⁹³ nearly double the 1997 figure.²⁹⁴

A recent empirical study found "that CRA does increase lending to small businesses as intended."²⁹⁵ The study suggests that CRA increases the number of small businesses that can access credit by four to six percentage points.²⁹⁶ The study found that CRA generally

TUTIONS 8 (1997) (listing factors to be considered in evaluating loans, with number and volume of loans, not loan denials, considered under examination procedures), available at <http://www.ffiec.gov/cra/pdf/exlarge9.pdf>.

²⁹² Harvey et al., *supra* note 287, at 405.

²⁹³ See Fed. Fin. Inst. Examination Council, CRA National Aggregate Table 1, 2003, at <http://www.ffiec.gov/webcraad/cranaag.htm> (last visited Mar. 8, 2005). The earliest year with comparable data is 1997. See *id.*

²⁹⁴ See Fed. Fin. Inst. Examination Council, CRA National Aggregate Table 1, 1997, at <http://www.ffiec.gov/webcraad/cranaag.htm> (last visited Mar. 8, 2005).

²⁹⁵ ZINMAN, *supra* note 103, at 2.

²⁹⁶ See *id.* at 20.

increased access to credit for small firms, as intended by CRA, but the evidence did not support a finding that CRA increased access to credit for small firms located in low- and moderate-income areas, holding other factors constant.²⁹⁷ Moreover, the study determined that the increased lending to small businesses induced by CRA provided benefits to the real economy in the form of increased payrolls and reduced bankruptcies without any evidence that such lending either crowded out other financing available to small businesses or adversely affected bank profitability or loan performance.²⁹⁸ It is somewhat remarkable that studies of CRA show any effect on small business lending 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 also have increased their community development investments in low-income communities under CRA.²⁹⁹ Although comprehensive data on investments are not available and reporting is not standardized, one can assemble some broad aggregate statistics using data from other regulatory provisions.³⁰⁰ For example, national bank community development investments totaled \$15 billion from 1965 to 2002, with well over half of the investments coming during the last decade, when CRA regulatory oversight intensified.³⁰¹ Banks have engaged in inno-

²⁹⁷ See *id.*

²⁹⁸ *Id.* at 3–4.

²⁹⁹ Under the regulations, “qualified investment” includes an “investment, deposit, membership share [in a credit union], or grant that has as its primary purpose community development,” 12 C.F.R. § 25.12(s), as well as disposition of branch premises to minority or women-owned institutions, 12 C.F.R. § 25.23(d) (2004).

³⁰⁰ 12 C.F.R. pt. 24 (2004), implementing 12 U.S.C. §§ 24 (Eleventh), 93a, 481, 1818 (2000) (investments designed to promote public welfare). Banks are required to use the “Part 24” authority only for investments that otherwise would not be authorized for national banks, 12 C.F.R. § 24.1(d), so data collected under this authority may understate CRA-eligible investments; however, this data may overstate CRA-eligible investments because not all such investments are within assessment areas or necessarily otherwise included in the bank’s CRA performance. The CRA investment test could be improved if comprehensive, comparable data were available under that test.

³⁰¹ See COMPTROLLER OF THE CURRENCY, 2002 DIRECTORY OF NATIONAL BANK COMMUNITY DEVELOPMENT INVESTMENTS 4, 6 (author’s calculations), available at <http://www.occ.treas.gov/cdd/2002Part24Dir.pdf> (last visited Jan. 13, 2005). 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 FED. RESERVE BD., 2002 DIRECTORY, COMMUNITY DEVELOPMENT INVESTMENTS, BANK HOLDING COMPANIES, STATE MEMBER BANKS, <http://www.federalreserve.gov/DCCA/Directory/cdi02.pdf> (last visited Jan. 13, 2005).

vative efforts to serve low-income communities through investments.³⁰²

Such investments are in addition to community development loans, which are tracked under CRA. Community development loans totaled \$42.3 billion in 2003 alone, and \$184 billion since 1996, when community development loans were first reported under the revised CRA regulations.³⁰³ Although careful econometric work has not been done on community development lending and investment, the scale and innovative types of activity suggest that it is plausible that CRA has contributed to increased activity in these areas. Further research would be warranted to examine these effects.

CRA's benefits appear to have been substantial, but are they likely to continue? Changes in the 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 II, from 63% to about 29% in 1999.³⁰⁴ 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 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).¹ 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 2000.³⁰⁵

³⁰² See, e.g., RYAN TRAMMELL, FED. RESERVE BANK OF SAN FRANCISCO, UNDERSTANDING THE RELATIONSHIP BETWEEN INVESTMENT TEST EXAMINATION CRITERIA AND INVESTMENT TEST RATINGS, 1 (2004) (finding that qualitative factors, not solely investment volumes, drive CRA investment test ratings), at <http://www.frbsf.org/community/resources/QIfinal.pdf> (last visited Jan. 19, 2005).

³⁰³ Press Release, Federal Financial Institutions Examination Council (July 26, 2004), at <http://www.ffiec.gov/hmcpr/cra072604.htm> (last visited Mar. 30, 2005). A community development loan is a loan, other than a home mortgage loan, that "has as its primary purpose affordable housing for low- or moderate-income individuals, community services targeted to these individuals, activities that promote economic development by financing small businesses or small farms, or activities that revitalize or stabilize low- or moderate-income neighborhoods." *Id.* Prior year data summed from yearly National Aggregate Reports, at <http://www.ffiec.gov/reports.htm> (last visited Jan. 26, 2005).

³⁰⁴ LITAN ET AL., FINAL REPORT, *supra* note 243, at 9.

³⁰⁵ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 135.

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.³⁰⁶ 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 likely will come.³⁰⁷ Furthermore, the Gramm-Leach-Bliley Act made expansion into new activities, such as insurance and securities, contingent on banks' CRA performance.³⁰⁸ 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. In many ways, competition and CRA are driving in the same direction. Nonetheless, market pressures also will mean that financial intermediaries are under increasing pressure to serve the highest end of the market where larger margins and the potential for cross-selling exist. 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 likely will push advances in commodified lending markets, including home mortgages and credit-scored small business loans that can be sold into the secondary markets. Thus, there will likely be a continued need for CRA.

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 a statistically signifi-

³⁰⁶ LITAN ET AL., BASELINE REPORT, *supra* note 243, at 79; see also *FDIC-Statistics on Depository Institutions Report*, available at <http://www2.fdic.gov/sdi/index.asp> (comparing total assets held by depository institutions on September 30, 2004, September 30, 2003, September 30, 2002, and September 30, 2001).

³⁰⁷ See, e.g., Madeleine James et al., *Playing to the Endgame in Financial Services*, 4 MCKINSEY Q. 170, 172 (1997).

³⁰⁸ 12 U.S.C. §§ 2903(c), 1843(a)(1)(2) (2000).

cant and economically important role for CRA. Given the difficulty of finding such effects in policy analysis generally, these findings are remarkable. These studies cast serious doubt on the contention of CRA's critics that CRA provides little benefit to low-income communities and borrowers. Instead, these studies are more consistent with the theoretical case for CRA set forth in Part III. That is, CRA appears to increase lending to low- and moderate-income communities and minority borrowers more than one would predict based on market forces and other factors. Still, one cannot tell whether this increased lending is a result of forcing lenders to make bad loans, on the one hand, or is a result of effectively overcoming market failures and discrimination to lend to creditworthy borrowers, on the other hand, without examining the costs incurred. I turn next to that topic.

B. The Costs of CRA Have Been Overstated

Critics charge that CRA imposes high costs on the banking industry. Most importantly, in their view, CRA forces banks to make unprofitable, risky loans that undermine the health of the financial sector. If that were the case, such evidence would undermine the theoretical case for CRA based on market failures and discrimination. Forcing banks to make bad loans would be evidence that CRA matters, but is not theoretically justified. Moreover, they argue that CRA imposes undue burdens on the merger and acquisition process, and therefore impedes efficiency in the financial sector. CRA also is alleged to promote distortionary rent seeking by community groups and bank regulators. Critics charge that CRA has high compliance costs and that CRA's vague standards lead to uncertainty that further burdens financial institutions. In addition, critics argue that the 1995 reforms to CRA did little to alleviate these burdens, as measured by shareholder value. If these critiques were valid, they would cast significant doubt on the efficacy of choosing CRA as a policy response to market failures or discrimination. I take up these arguments in turn.

1. Profitability and Risk

Critics of CRA argue that if there were profitable loans to make in low-income communities, banks and thrifts would already be making them. For example, Macey and Miller argue that CRA "impairs the safety and soundness of an already overstrained banking industry" and "encourages banks to make unprofitable and risky investment and product-line decisions"³⁰⁹ While acknowledging that "[t]here is undoubtedly truth to the argument that profitable loan

³⁰⁹ Macey & Miller, *supra* note 21, at 295.

opportunities exist in low-income and moderate-income neighborhoods, and that some of these loans would not be made if it were not for the CRA[.]” Macey and Miller contend that such profitable loan opportunities are sparse. In their view, there may be “a few profitable loans,” but the search costs of finding them will make such lending unprofitable and “[t]he fact that there are some profitable loans to be made in low-income and moderate-income communities does not mean that greatly increasing lending in such communities is going to be a profitable activity.”³¹⁰ Because they find the existence of market failures or discrimination to be unlikely, they doubt that “CRA is plausibly going to increase the efficiency of lending by depository institutions”³¹¹ Thus, they charge that “CRA encourages depository institutions to devote depositor funds to low-profit or losing propositions in derogation of overall economic welfare”³¹²

Macey and Miller are correct to look to measures of profitability and risk in assessing whether CRA improves the efficiency of lending by overcoming market failures and discrimination, and that higher search costs ought to be factored in when weighing the profitability of CRA lending. Unfortunately, they present no serious evidence for their claims.

Recent empirical evidence suggests that those costs were overstated significantly by CRA’s critics. Instead, the evidence tends to support the theoretical underpinnings of CRA as resting on market failures and discrimination. Despite the significant increase in lending to low-income communities during the 1990s described above, CRA loans appear to be reasonably profitable—not “a few profitable loans,” but CRA lending generally. A Federal Reserve Board report issued in 2000³¹³ casts significant doubt on the claims made by critics about the likely performance of CRA loans. Most institutions responded that CRA lending was profitable or marginally profitable: 82% indicated that CRA-related home mortgage lending was profitable, 86% indicated that CRA-related home improvement lending was profitable, 93% indicated that CRA-related community development lending was profitable, and 96% indicated that CRA-related small business lending was profitable.³¹⁴ 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

³¹⁰ *Id.* at 319–320.

³¹¹ *Id.* at 319.

³¹² *Id.* at 321.

³¹³ PERFORMANCE AND PROFITABILITY, *supra* note 220, 43–64.

³¹⁴ *Id.* at 45, 52, 62, 58.

zero.³¹⁵ Most respondents reported that CRA lending was at least as profitable as comparable non-CRA lending.³¹⁶ The profitability of serving these borrowers and communities helped drive the increase in CRA-eligible lending by banks and their affiliates between 1993 and 1998.³¹⁷

Many respondents reported other benefits from such lending, which suggest that CRA lending, while strengthening communities, also is helping to improve profitability for banks. Some 81% of respondents, for example, developed new business opportunities from their CRA small business lending,³¹⁸ while 71% of respondents cited “source of additional profits” as a benefit of their community development lending, and 96% cited promoting “community growth and stability.”³¹⁹ These broader societal benefits also represent benefits for the banks operating in these communities because they reduce the risk of lending there. These additional benefits further contradict the notion that CRA forces banks to engage in unprofitable activity.

Moreover, CRA loans do not appear 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 rates (the net losses after collections) between CRA home mortgage loans and all such loans was zero.³²⁰ The institutions responding to the survey reported weighted median charge-off rates of 0.18% on CRA-related home mortgage loans and 0.40% on CRA-related small business loans.³²¹ About 70% of respondents reported credit losses for CRA home mortgage lending that were the same as or less than losses for other such lending, and 91% of respondents reported credit losses for CRA small business loans that were the same as or smaller than losses for all small business loans.³²² Community development loans had a median charge-off rate of zero.³²³ 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.

³¹⁵ *Id.* at 46 & tbl.5a.

³¹⁶ The exact percentages of responses of “about the same” or “somewhat higher” profitability for CRA loans were 56% for home purchase and refinance loans, 72% for home improvement loans, and 86% for small business loans. *Id.* at 45–46, tbl.3a, tbl.4a, tbl.5a.

³¹⁷ See *supra* text accompanying note 243.

³¹⁸ PERFORMANCE AND PROFITABILITY, *supra* note 220, at tbl.8.

³¹⁹ *Id.* at tbl.6.

³²⁰ *Id.* at tbl.3c.

³²¹ *Id.* at tbl.3e (home mortgage), tbl.5e (small business).

³²² *Id.* at tbl.3d (home mortgage), tbl.5d (small business).

³²³ *Id.* at tbl.7c.

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 and profitability of CRA "special programs" is not as strong as the performance and profitability of CRA loans in the institutions' general portfolios.³²⁴ Special programs account for only 17% of CRA-eligible lending as the Federal Reserve Board defines it.³²⁵ 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.³²⁶ Once these strategies are refined, they often are "graduated" to borrowers in the institutions' core product lines. Despite the programs' experimental status, the Board reported that 61% of respondents found CRA special programs to be profitable.³²⁷ Moreover, most institutions reported low delinquency and charge-off rates; the median charge-off rate on these programs was zero.³²⁸

The Federal Reserve Board survey finding that CRA loans generally are 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.³²⁹ The evidence of any such subsidy is "economically and statistically insignificant."³³⁰ Earlier studies found that institutions with strong CRA performance were as profitable as those with less CRA activity.³³¹ Similarly, an earlier survey by the Federal

³²⁴ Compare, e.g., *id.* at 69 (profitability of special lending programs) with *id.* at 45 (home purchase and refinancing), 52 (home improvement), 58 (small business), and 62 (community development).

³²⁵ PERFORMANCE AND PROFITABILITY, *supra* note 220, at 66.

³²⁶ See Robert B. Avery et al., *CRA Special Lending Programs*, 86 FED. RES. BULL. 711, 717–19 (describing features of special lending programs) (2000).

³²⁷ PERFORMANCE AND PROFITABILITY, *supra* note 220, at tbl.14a.

³²⁸ *Id.* at tbl.14c.

³²⁹ GLENN B. CANNER ET AL., DOES THE COMMUNITY REINVESTMENT ACT (CRA) CAUSE BANKS TO PROVIDE A SUBSIDY TO SOME MORTGAGE BORROWERS? 5–6 (Fed. Reserve Bd., Fin. & Econ. Discussion Series No. 2002-19, 2002), <http://www.federalreserve.gov/pubs/feds/2002/200219/200219pap.pdf>. The upper bound on such a subsidy, if any, is "tiny." *Id.* at 6.

³³⁰ *Id.* at abstract. A study by the Independent Community Bankers of America found that about 61% of larger banks it surveyed provided interest rate concessions under CRA and 41% of smaller banks provided such concessions, but the total dollar value of such reported concessions was small, and the study did not attempt any econometric controls. See GRANT THORNTON LLP, INDEP. CMTY. BANKERS OF AM., THE HIGH COST OF COMMUNITY BANK CRA COMPLIANCE: COMPARISON OF "LARGE" AND "SMALL" COMMUNITY BANKS 15 (2002), at www.icba.org/files/PDFs/crareport.pdf.

³³¹ See Bd. of Governors of the Fed. Reserve Sys., REPORT TO THE CONGRESS ON COMMUNITY DEVELOPMENT LENDING BY DEPOSITORY INSTITUTIONS (1993); Glenn B.

Reserve Bank of Kansas City had found that nearly all respondents reported CRA lending to be profitable, though not as profitable as other lending.³³²

That is not to say that the Federal Reserve Board's survey found no differences in the performance of CRA loans and other loans. In the survey, for example, 44% of respondents reported that CRA home purchase and refinance loans were less or somewhat less profitable than other loans, and about half reported higher delinquency rates for such CRA loans than for other loans.³³³ For these institutions, CRA lending was indeed more costly. Moreover, as critics have argued, CRA lending can entail greater risks and higher origination costs. As noted by the Board's report,³³⁴ previous studies had found that borrowers with higher loan-to-value ratios were more likely to default,³³⁵ and that a combination of negative home equity³³⁶ and a "triggering" event such as job loss was correlated with delinquency

Canner & Wayne Passmore, *The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks* 26 (Fed. Reserve Bd., Fin. & Econ. Discussion Series No. 1997-7, 1997) (suggesting that "lenders active in lower-income neighborhoods and with lower-income borrowers appear to be as profitable as other home purchase lenders," but noting some limitations in study), at <http://www.federalreserve.gov/pubs/feds/1997/199707/199707pap.pdf> (last visited Jan. 18, 2005); Glenn B. Canner & Wayne Passmore, *The Relative Profitability of Commercial Banks Active in Lending in Lower-Income Neighborhoods and to Lower-Income Borrowers*, in PROC. 32ND ANN. CONF. ON BANK STRUCTURE & COMPETITION, FED. RES. BANK OF CHICAGO 531, 546 (1996); David Malmquist et al., *The Economics of Low-Income Mortgage Lending*, 11 J. FIN. SERVICES RES. 169, 182 (1997) (finding that "low-income lending generates higher gross mortgage-related revenues but also higher costs," and also that "low-income lending is associated with a higher level of credit losses but that low-income lending is no more and no less profitable than non-low-income lending").

³³² Larry Meeker & Forest Myers, *Community Reinvestment Act Lending: Is It Profitable?*, 1996 FIN. INDUSTRY PERSP. 13, 16-17.

³³³ PERFORMANCE AND PROFITABILITY, *supra* note 220, at tbls.3a, 3c.

³³⁴ See *id.* at 7-14 (summarizing previous research on performance and profitability of CRA-related lending).

³³⁵ James A. Berkovec et al., *Discrimination, Competition, and Loan Performance in FHA Mortgage Lending*, 80 REV. ECON. & STAT. 241, 245-47 (1998) (finding important effects for high loan-to-value ratios and also noting smaller effects for higher housing-expense-to-income ratios and lower income and liquid asset levels); R. Jeffery Green & George M. von Furstenberg, *The Effects of Race and Age of Housing on Mortgage Delinquency Risk*, 12 URB. STUD. 85, 89 (1975) (concluding that mortgagor income has significant impact on mortgage delinquency risk); George M. von Furstenberg & R. Jeffery Green, *Home Mortgage Delinquencies: A Cohort Analysis*, 29 J. FIN. 1545, 1547 (1974) (noting that "rising incomes also contribute significantly to raising the quality of home mortgages").

³³⁶ Chester Foster & Robert Van Order, *An Option-Based Model of Mortgage Default*, 3 HOUSING FIN. REV. 351, 362 (1984); Roberto G. Quercia & Michael A. Stegman, *Residential Mortgage Default: A Review of the Literature*, 3 J. HOUSING RES. 341, 375 (1992).

and default.³³⁷ Affordable home mortgage products with significant multiple risk factors also were found to be more prone to default.³³⁸ 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.³³⁹

The basic picture that emerges from the evidence regarding the performance and profitability of CRA lending is this: CRA's critics were generally wrong that CRA induces banks and thrifts to engage in deeply unprofitable, overly risky lending. Instead, CRA lending appears to be reasonably profitable and not overly risky. Most banks and thrifts find such lending to be as profitable as other lending, but a significant minority faces somewhat higher costs and weaker performance. Although the evidence regarding the performance and profitability of CRA lending is open to conflicting interpretations, it is on balance more consistent with the theory that CRA helps overcome market failures and discrimination than with the theories of CRA's critics that there were only "a few profitable loans" to be found.

The studies do not show, however, that CRA lending is generally more profitable than other things that banks and thrifts could do with their funds on a risk-adjusted basis. That is, the studies show that CRA lending is generally profitable from an accounting or business perspective, as profit would be thought of on an income statement, and that most banks and thrifts generally do not see CRA lending as out of line with other profits and risks they take. The studies do not prove that CRA lending is always profitable in the formal, economic sense of accounting profits from the activity exceeding those that could be obtained from an alternative use of the firm's capital.³⁴⁰ The size of the difference between accounting profits and economic profit depends on the relative capital constraint facing each firm. Thus, to the extent that CRA induces firms to engage in lending that is profitable from an accounting perspective but may or may not be with respect to the opportunity cost of funds, the effects of CRA on a

³³⁷ Dennis R. Capozza et al., *Mortgage Default in Local Markets*, 25 REAL EST. ECON. 631, 654 (1997); Kerry D. Vandell & Thomas Thibodeau, *Estimation of Mortgage Defaults Using Disaggregate Loan History Data*, 13 J. AM. REAL EST. & URB. ECON. ASSOC. 292, 314 (1985).

³³⁸ Michael K. Stamper, *Revisiting Targeted-Affordable Lending: Fresh Evidence Finds Far Lower Default Rate*, 14 SECONDARY MORTGAGE MARKETS 1, 17-18 (1997).

³³⁹ Robert Van Order & Peter M. Zorn, *Income, Location and Default: Some Implications for Community Lending*, 28 REAL EST. ECON. 385, 386-87 (2000).

³⁴⁰ See DENNIS W. CAROLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 334 (2d ed. 1994) (defining economic profits as revenues minus opportunity costs).

firm's lending activity will be more binding the higher its capital constraints.

2. *Mergers and Acquisitions*

Macey and Miller and other critics of CRA argue that it has "impeded" bank mergers and acquisitions that improve the efficiency of the banking system. They cite cases of delays in merger approvals in order to hold public hearings and instances in which mergers were abandoned because of CRA concerns. Moreover, they contend that responding to CRA "protests" diverts essential bank resources into "public relations" and "window-dressing." In addition, they view increased lending as "an implicit tax that the CRA imposes on the process of depository institution consolidation."³⁴¹

Critics are correct that merger reviews—which encompass anti-trust concerns, deposit concentration limits, safety and soundness, CRA, and other matters—add to the costs of mergers. Yet they significantly overstate the contention that CRA is a costly barrier to efficient mergers and acquisitions. There are three potential costs: the costs of providing and assessing information about the bank's CRA record, the cost of actual delay or disapproval, and the cost imposed by the threat of delay or disapproval.

As to actual delay or disapproval, Treasury Department analysis shows that CRA likely imposes little cost from disapproval or delay of mergers, acquisitions, or other applications subject to CRA review.³⁴² From 1985 to 1999, only 692 out of 92,177 applications subject to CRA review received any adverse public comment—less than 0.7%.³⁴³ Of those applications, most received adverse public comment or regulatory scrutiny on both CRA and other grounds.³⁴⁴ Only 1% of the applications receiving comment—eight applications—were denied, 4% withdrawn, and 1% returned, for reasons that may or may not have related to CRA, leaving 94% approved.³⁴⁵ 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. Again, as with application approval data, data on application processing times include CRA and all the other issues that regulators

³⁴¹ Macey & Miller, *supra* note 21, at 322–23.

³⁴² TREASURY DEP'T, APPLICATIONS SUBJECT TO CRA THAT WERE PROTESTED ON CRA GROUNDS (July 7, 2000) [hereinafter APPLICATIONS SUBJECT TO CRA] (document on file with author).

³⁴³ *Id.*

³⁴⁴ *Id.*

³⁴⁵ *Id.*

must evaluate in an application. Since CRA's enactment, the bank agencies processed 63% of applications facing CRA protests within 90 days, and processed 88% of such applications within 180 days.³⁴⁶ Still, I agree that there have been cases in which CRA protests likely increased regulatory delays,³⁴⁷ and the time it takes to hold public hearings and to evaluate public comments likely does increase the costs of merger reviews. We do not have data on the costs to banks of providing or to regulators of assessing information about CRA during merger reviews even though such data would ideally form part of our analysis of the costs and benefits of CRA in merger reviews.

Nonetheless, the 1995 regulations likely contributed to improved processing, as did other changes in application reviews more broadly. With respect to CRA, regulators exercise their discretion to ignore frivolous comments, and the interagency staff guidelines indicate that prior examinations are "an important, and often controlling, factor" in assessing an institution's CRA performance during the course of application reviews.³⁴⁸ Processing times have improved under the 1995 CRA regulations: Almost 75% of all applications subject to CRA review are now decided within 90 days and more than 94% are decided within 180 days.³⁴⁹

Of course, critics would rightly argue that the lack of delay or denial is not evidence that CRA is either ineffective in changing behavior, or, conversely, without cost in doing so. If the benefits of merging are high enough, the merger will proceed, despite the costs of merger applications, including CRA. 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 review during mergers had a significant effect on expanding lending to low-income communities, controlling for bank characteristics. The study found that banks increased their lending in "economically important" ways to low- and moderate-income neighborhoods in anticipation of the regulatory and public scrutiny from CRA that accompanies mergers.³⁵⁰ The effects were more pronounced for larger institutions,

³⁴⁶ *Id.*

³⁴⁷ See, e.g., *Hibernia Corp.*, 72 FED. RES. BULL. 656 (1986); *Somerset Bankshares, Inc.*, 74 FED. RES. BULL. 619 (1988); *First Union Corp.*, 76 FED. RES. BULL. 83 (1990).

³⁴⁸ Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,640 (July 12, 2001) (Federal Financial Institutions Examination Council).

³⁴⁹ APPLICATIONS SUBJECT TO CRA, *supra* note 342.

³⁵⁰ RAPHAEL BOSTIC ET AL., REGULATORY INCENTIVES AND CONSOLIDATION: THE CASE OF COMMERCIAL BANK MERGERS AND THE COMMUNITY REINVESTMENT ACT, at 18 (Fed. Reserve Bank of Chi., Working Paper No. WP-2002-06, 2002), at <http://www.chicago.fed.org/publications/workingpapers/papers/WP2002-06.pdf> (last visited Mar. 30, 2005).

which face the most public and regulatory scrutiny during merger applications, and the effects became stronger as public and regulatory attention increased under CRA during the 1990s.³⁵¹ Thus, this study of bank merger activity reinforces the earlier conclusion that CRA review during merger applications appears to be working as intended.

The question then arises whether and how to measure CRA's effectiveness in changing lending behavior as a cost. In my judgment, this question collapses into the earlier inquiry into the substance of the theoretical justification for CRA. This altered behavior might constitute a significant, unjustifiable cost if CRA loans were not profitable or were overly risky because such costs would undermine my contention that CRA helps to overcome market failures and discrimination. Macey and Miller contend that "the costs of the uneconomic loans that are the implicit price of CRA approval" are "significant."³⁵² Their factual conclusion follows not from evidence but inevitably from their view that banks and thrifts would have made the loans if they were profitable because that is how competitive markets work. But the Federal Reserve Board's evidence suggests that CRA lending is relatively profitable and relatively safe.³⁵³ This evidence is more consistent with the theoretical justifications for CRA. Thus, the cost to banks and thrifts during or in anticipation of the merger process that arises from altered lending practices is likely to be relatively low and justified by CRA's role in overcoming market failures and discrimination. As discussed earlier, the benefits to low-income communities seem to be high, consistent with the view that CRA is helping to overcome such market deficiencies. In sum, the critics overstated the costs of CRA to efficient mergers for the same reason that they overstated the costs of CRA to bank safety and soundness. Markets sometimes do not work as well as they should, and CRA incentives do not appear to result in costly lending.

3. *Rent-Seeking*

Macey and Miller—and prominent political figures such as former Senate Banking Committee Chairman Phil Gramm of Texas—argue that CRA creates fertile ground for pervasive "rent-seeking" or "extortion" by community groups using the application process to force banks and thrifts to make grants to their organizations.³⁵⁴ In

³⁵¹ *Id.* at 16–17.

³⁵² Macey & Miller, *supra* note 21, at 323.

³⁵³ See *supra* text accompanying notes 309–332.

³⁵⁴ Phil Gramm, *The New Banking Legislation: The Financial Modernization for the Twenty-First Century*, 53 SMU L. REV. 371, 373 (2000); Macey & Miller, *supra* note 21, at 295–96.

their view, “[m]any of these groups have become adept at using the CRA as a vehicle for extracting payments from depository institutions, either for their own maintenance and welfare or for their favored causes.”³⁵⁵ They argue that “[p]roviding support and assistance to the most effective local pressure groups and community activists is often the best way to purchase what amounts to an insurance policy against the threat of a CRA challenge. . . .”³⁵⁶ There are undoubtedly cases of abuses of the kind alleged by CRA’s critics, but these critics overstate the extent of the problem, and understate the extent to which community groups can play a role in overcoming market failures.

Critics of CRA tend to lump grants to community groups and rent-seeking together. In analyzing this question, I distinguish grants to community groups that add value to banks, thrifts, and society generally by improving the ability of creditors to make sound loans, from grants that waste resources by simply redistributing bank income for community groups’ private purposes. To the extent that community groups engage in the latter activity, it is properly thought of as rent-seeking and is socially wasteful. Rent-seeking has occurred when transfers produce transaction costs but no social benefit, or more broadly when the costs of transfers exceed the social benefit.³⁵⁷ To the extent that community groups engage in the former set of activities, however, transfers may contribute to net social gains in overcoming market failures and discrimination.

There are theoretical grounds for believing there is less rent-seeking than critics suggested. The highly public nature of CRA examinations and the resulting evaluations, merger reviews and the availability of public hearings during such reviews, and written public comments and publicized protests make rent-seeking difficult to conceal. In addition, the involvement of regulators, banks, and a relatively large number of community groups make capture of all the relevant players much more costly. The fact that these players must repeatedly interact with one another in the regulatory process increases incentives for reasonable conduct.³⁵⁸

³⁵⁵ Macey & Miller, *supra* note 21, at 333.

³⁵⁶ *Id.* at 335.

³⁵⁷ See generally Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*, 5 W. ECON. J. 3, 228 (1967) (explaining socially wasteful effects of rent-seeking); Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974) (coining the phrase “rent seeking”).

³⁵⁸ On the role of public involvement in improving the regulatory process, see IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 71–73 (1992) (explaining how involvement of private sector, regulator and public interest groups can help to deter capture through “tripartism”).

In addition, 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. Banks and thrifts often promise to do more lending during merger reviews. The fact that community protests succeed in convincing banks and thrifts to issue voluntary pledges or even to make agreements with community groups to do more CRA lending to low-income borrowers or communities is not improper in and of itself. In fact, increased lending in such communities is precisely the point of CRA.

The banking agencies have not provided comprehensive data on CRA agreements. Analysis by the National Community Reinvestment Coalition, an umbrella organization of community groups, suggests that only a small fraction of "CRA agreements," which are themselves a small fraction of CRA activity engaged in by banks and thrifts, result in payments—for services or otherwise—to the community groups making the "protest."³⁵⁹ According to their report, recent disclosures required under the "sunshine" amendments to CRA have revealed little evidence of the rent-seeking feared.³⁶⁰ Only 0.3% of loans and investments committed under CRA agreements went to operating support for community groups.³⁶¹

Some of these payments may be improper, but 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. One would need to analyze whether these operating funds furthered the banks' ability to meet their obligations under CRA before deciding whether to characterize even these operating support funds as rent-seeking. Bank support for community organizations is a legitimate way to help overcome market failures. Such community organizations can reduce the costs of acquiring and interpreting information about low-income borrowers and communities, can help coordinate lending activities to overcome collective action problems, and can share risk to reduce bank exposure to problems of adverse selection and moral hazard that arise from information asymmetries. In my view, the new requirements for disclosure of these payments ought to minimize further any concerns about improper rent-seeking by community-based organizations.

³⁵⁹ See NAT'L CMTY. REINVESTMENT COALITION, CRA SUNSHINE REVEALS BENEFITS OF BANK-COMMUNITY GROUP PARTNERSHIPS 11 (2002), at http://69.36.186.20/policy/cra/Sunshine_report_with_covers.pdf (last visited Jan. 18, 2005).

³⁶⁰ *Id.*

³⁶¹ *Id.* at 11. The CRA Sunshine provisions are found at 12 U.S.C. § 1831y (2000).

A recent study by Bostic and Robinson confirms the view that CRA agreements can enhance the performance of bank and thrift lending. The study found that banks and thrifts increased their lending significantly after entering into CRA agreements.³⁶² Moreover, the study found that CRA agreements that included a role for community groups in mortgage counseling and technical assistance resulted in higher levels of lending.³⁶³ These higher levels of lending continued even after the terms of the agreements had ended, and the effects were more pronounced the longer the agreement, providing support for the view that CRA agreements had led institutions over time to find profitable lending opportunities in low-income communities.³⁶⁴ Bostic and Robinson's study thus undermines the argument of critics who alleged that CRA agreements are generally a costly form of rent-seeking.

4. *Compliance Costs*

As the critics note, banks and thrifts also face other costs of compliance with CRA that should be weighed in evaluating whether CRA is an efficient response to market failures and discrimination. These compliance costs include, for example, paperwork burdens, examination time, compliance officers, and the geocoding of loan data.³⁶⁵ These types of costs are difficult to measure; regulators likely underestimate them, downplaying transition costs, while industry trade groups tend to inflate them, often by conflating transition costs with ongoing ones.³⁶⁶

The bank and thrift regulators estimated in 1999 that the annual compliance burden from CRA for data collection and reporting was about 554 to 635 hours per year for large banks and about ten hours per year for small banks, totaling nearly 1.25 million hours per year and costing \$35.4 million industry-wide.³⁶⁷ That year, such a compliance burden would have constituted essentially 0% of the \$6 trillion in

³⁶² See generally Raphael Bostic & Breck L. Robinson, What Makes CRA Agreements Work? A Study of Lender Responses to CRA Agreements (2003), http://www.chicagofed.org/cedric/files/2003_conf_paper_session5_bostic.pdf.

³⁶³ *Id.* at 20.

³⁶⁴ *Id.* at 18–19.

³⁶⁵ Related to compliance cost is the administrative cost to the banking agencies of implementing CRA, including examinations, merger reviews, and, perhaps, the community development staff who publish information about best practices and engage in outreach with banks and community groups. Unfortunately, there is no data of which I am aware that would shed light on the magnitude of these costs. Further empirical research would usefully add to this analysis.

³⁶⁶ I thank Howell Jackson for this insight.

³⁶⁷ Submission for OMB Review, 64 Fed. Reg. 29,083, 29,084, 29,086 (Treasury Dep't May 28, 1999), and author's calculations based on *id.*

bank assets and 3 billion hours of total bank employee time,³⁶⁸ and less than 0.2% of the cost of bank regulation.³⁶⁹ Even though these more recent estimates for large banks are much higher than they had been at the time of the 1995 reforms, as regulators had underestimated geocoding costs, the 1999 figures are strikingly low, and such costs have likely decreased since 1999.³⁷⁰

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 the Home Mortgage Disclosure Act (HMDA).³⁷¹ In addition, small banks are subject only to a streamlined lending examination, rather than a full scope review under the lending, investment, and services tests.³⁷² The Independent Community Bankers of America (ICBA), the trade group for small- to mid-sized banks, surveyed its membership about the costs of CRA regulation.³⁷³ Although the study is designed to highlight the high compliance costs of CRA, the data reported in the study suggest otherwise. The mean employee cost for CRA compliance was \$84,445 per year for small banks, with average assets of \$216 million, and about \$30,000 more per year for larger "community" banks, with average assets of \$666 million.³⁷⁴ CRA

³⁶⁸ Author's calculations based on CRA-Banks and Thrifts with Assets Over \$250 Million Sheshunoff Database (1998) (on file with the *New York University Law Review*).

³⁶⁹ This calculation derives from GREGORY ELLIEHAUSEN, *THE COST OF BANK REGULATION: A REVIEW OF THE EVIDENCE* 23 (1998) (estimating that total costs of bank regulation in 1991 were \$15.7 billion), at <http://www.federalreserve.gov/pubs/staffstudies/171/ss171.pdf> (last visited Mar. 30, 2005). Presumably, the total cost of bank regulation increased between 1991 and 1999, thus the 0.2% estimate may even overstate the relative cost of CRA data reporting.

³⁷⁰ Geocoding costs likely have 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.

³⁷¹ In part, this shifts some of the costs of compliance from small banks to the regulators, who have to do more to assess the institution's lending than if the bank kept more detailed data. This shifted compliance cost is borne in part, depending on the institution regulated and the funding structure of the relevant federal agency, by general bank assessments that support the relevant agency, in part by deposit insurance premia (to the extent paid), and in part by taxpayers (to the extent that the agency is supported by interest on reserves).

³⁷² See 12 C.F.R. § 25.26 (2005) (small bank performance standards); § 25.42 (noting that small banks are not required to collect data required under this provision).

³⁷³ GRANT THORNTON, *supra* note 330. The ICBA survey had only a 28% response rate (276 responses to 1000 surveys) and thus should be treated with caution. *Id.* at 3.

³⁷⁴ *Id.* at 4, 13. The Independent Community Bankers of America (ICBA) surveyed small banks, as well as larger "community" banks with assets up to \$2 billion.

employee costs as a percentage of assets were negligible—0.017% for larger “community” banks, and 0.039% for small banks.³⁷⁵

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.³⁷⁶ CRA ranked ninth out of twenty laws and regulations studied, just after Flood Insurance Rules.³⁷⁷ This rank represents a dramatic improvement over just a decade ago, when CRA often topped the ABA survey for most burdensome regulation before the 1995 reforms.³⁷⁸ And the improvement came during a time of acknowledged increase in scrutiny of activities regulated by CRA and improved CRA performance.

Critics of CRA also contend that the vagueness of CRA’s standard leads to uncertainty about what will be required of banks and thrifts in the CRA examination and merger process and that this uncertainty itself raises compliance costs.³⁷⁹ Costs may be higher because lenders devote significant time and resources to 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 or profitable. One might also 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. This additional activity may have an opportunity cost from the bank’s perspective. However, the additional CRA activity, if prudent, also confers a social benefit that must be weighed in addition to the profit to the institution. Of course, the obverse case would constitute a significant cost: That is, if banks and thrifts underestimate the level of performance required to achieve a satisfactory grade, their poor performance might lead to a lower-than-expected grade, bad public relations, a lower likelihood of being acquired, or a delay in a proposed merger.

³⁷⁵ Author’s calculations, based on ICBA survey. *See id.*

³⁷⁶ *Being Good Is Just the Beginning: The Nationwide Bank Compliance Officer Survey*, ABA BANKING J., June 2003, at 35.

³⁷⁷ The top ten of the twenty 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.* at 35 (ranking higher in bank categories over \$1 billion).

³⁷⁸ *See Burden of Regulation: Bank Compliance Costs Equal More Than Half of Industry Profits*, BANKING POL’Y REP., July 6, 1992, at 5; *see also* AM. BANKING ASS’N, CUT THE RED TAPE (Nov. 1992) (finding that CRA topped the list for “most time-consuming” regulation and “most headaches” among 34% and 40% of banks surveyed, respectively) (on file with the *New York University Law Review*).

³⁷⁹ 2002 JOINT CENTER CRA REPORT, *supra* note 226, at 117.

Although Macey and Miller charged that the pre-1995-reform CRA process was so vague as to give regulators unfettered discretion,³⁸⁰ recent evidence suggests that CRA generally was applied consistently even 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.³⁸¹ In scheduling examinations, “supervisors allocate[d] their resources toward institutions with observed CRA compliance inadequacies.”³⁸² Moreover, the “level of residential lending” influenced the CRA ratings of banks.³⁸³ That is, CRA ratings were found to be primarily related to performance, not community “gripping,” extortion, or regulator arbitrariness. The study concluded that “CRA enforcement during this period reflected, at least in part, objective evaluation criteria.”³⁸⁴

The study’s findings of relative congruence between rating and performance undermine critics’ charges of the inherent arbitrariness of standards. Furthermore, the study focused on the period prior to full implementation of the 1995 reforms. Regulator consistency likely has improved substantially under the 1995 reforms, which focus more on objective measures of lending, investment, and services. Still, critics are right to focus on the importance of consistent application of standards, and to look for ways in which regulators can perform better in that regard, both within and across banking agencies.

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.³⁸⁵ The problems faced by event studies, which seek to measure the way in which an event, such as a regulatory change, enhance shareholder value as measured, usually, by stock price, in general are well

³⁸⁰ Macey & Miller, *supra* note 21, at 326–29; see also Leonard Bierman et al., *The Community Reinvestment Act: A Preliminary Empirical Analysis*, 45 HASTINGS L.J. 383, 398 (1994) (identifying “apparent subjectivity involved in the awarding of rankings” as “most troubling problem in the administration of the CRA”).

³⁸¹ Drew Dahl et al., *The Timing and Persistence of CRA Compliance Ratings*, 23 J. FIN. SERVICES RES. 113, 114 (2003).

³⁸² *Id.* at 123.

³⁸³ *Id.* at 130.

³⁸⁴ *Id.* at 113.

³⁸⁵ 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. FIN. SERVICES RES. 59, 75 (2003).

known.³⁸⁶ Carefully designed event studies nevertheless can shed light on regulatory changes designed to enhance shareholder value.³⁸⁷ Yet an event study of a reform (such as the 1995 CRA regulatory amendments) 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, 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.”³⁸⁸

In sum, the critics have significantly overstated the costs of CRA. CRA lending does not appear to be unprofitable and overly risky. There is little evidence that CRA has had a significant chilling effect on efficient mergers and acquisitions; instead, merger reviews seem to contribute to increased levels of CRA lending. Charges of rampant rent-seeking by community groups based on anecdotal evidence do not seem to be supported by the record, although there may be individual cases of abuse.³⁸⁹ While it is difficult to measure all of the compliance and administrative costs of CRA, available evidence suggests that such costs are quite low by a number of important measures of regulatory burden.

The relatively low costs and high benefits of CRA support the theoretical case that CRA is helping to overcome market failures reasonably efficiently. If market failures and discrimination were absent, one would have expected studies to find little or no independent role

³⁸⁶ See, e.g., Lucian Bebchuck et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1792–93 (2002) (discussing problem of confounding events).

³⁸⁷ See, e.g., Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 AMER. LAW & ECON. REV. 141 (2002).

³⁸⁸ Ely & Robinson, *supra* note 385, at 65 n.3 (citation omitted).

³⁸⁹ Needless to say, however, I have not examined every case of alleged misbehavior and there may have been individual instances of such problems.

for CRA and highly unprofitable, risky lending when such a role is to be found. The evidence instead tends to support the opposite conclusion: Market failures and discrimination likely persist, and CRA appears to be helping to overcome them. Moreover, the empirical case undermines critics' contentions that CRA is poorly designed to overcome these failures. Instead, the evidence tends to support the view that CRA is a plausible policy response to these problems. With the foregoing analysis as a foundation, the next Part reexamines from both a theoretical and empirical perspective the critics' contentions that the approach of using a standard for CRA, rather than a rule-based regime, is flawed.

V

CRA'S STANDARDS APPROACH COMPARED TO A RULES APPROACH

Many of the criticisms of CRA described in Part II find at their root a criticism of the decision to employ a standard rather than a rule. Critics' arguments about uncertainty, regulatory discretion, and rent-seeking, as well as policy arguments in favor of safe harbors or tradeable obligations, boil down to arguments in favor of rules as opposed to standards. In this Part, I first defend the choice for CRA of something closer to a standard rather than something closer to a rule, and draw some broader implications for the standards versus rules debate more generally. Parts V.B and V.C reject proposals to integrate tradeable permits and safe harbors, respectively, into CRA. Both of these proposals would make CRA a more rule-based regulatory regime. Although there are some advantages to both proposals, I will argue that they would likely not be preferable to the current approach.

A. *CRA's Standard Compared to a Rule*

The CRA statute and its implementing regulations can be characterized as employing an approach closer to legal standards than rules. 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.³⁹⁰ Another way of thinking about standards and rules is to think of them as lying on a continuum, from mechanistic, computer-programming-type rules (e.g., if a = 1, then go to c), which provide an "empirical" trigger with a "determined" response, to open-ended standards that require judgment

³⁹⁰ Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 382-83 (1985).

(e.g., decide whether this action is “just” based only on “human experience”), which provide an “evaluative” trigger with a (quite loosely) “guided” response. Actual legal rules and standards fall somewhere between these extremes.

The CRA statute directs 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, and branch openings and closings.³⁹¹ 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.”³⁹² 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.

As the statute’s standard is implemented, first through regulation, then examiner guidance, and finally individual examinations and merger reviews, repeated many times across institutions, experience will suggest patterns of regulatory response that could be articulated as something like “rules.” Financial institutions and regulators develop experience that in a given market with given constraints, a given level of lending is “enough”—all to the good in terms of predictability. If it were not so cumbersome, one could label the results of such iterative learning a “rule derived from a standard” or a “learned-rule-standard,” or some such hybrid, and nothing would be lost in terms of my argument here. I am not relying on the label of “standard” as such, but on the fact of contextualism and bottom-up engagement to suggest the features of this approach that are promising.

The debate over whether standards or rules should be preferred has a long pedigree.³⁹³ Three basic approaches emerge in this debate. First, scholars have identified philosophical underpinnings of rules

³⁹¹ 12 U.S.C. § 2903(a) (2000).

³⁹² Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,162 (May 4, 1995) (codified at Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.21(b) (2003)).

³⁹³ See, e.g., FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 72–73 (1944); MARK KELMAN, *A GUIDE TO CRITICAL LEGAL STUDIES* 15–63 (1987); FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE* 149–55 (1991); Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181, 185 (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, 101–07 (1997); Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U. L. REV. 781

and standards.³⁹⁴ Second, other scholars have rejected the notion that formal distinctions between rules and standards have any meaning.³⁹⁵ A third group of scholars has attempted to discern general principles for deciding when standards or rules are more appropriate.³⁹⁶ Among the last group, law-and-economics scholars have used transaction-cost economics to argue that the higher cost of articulating rules *ex ante* is worthwhile when many people engage in the activity being regulated, multiplying the *ex post* transaction costs many times over.³⁹⁷ Yet translating transaction-cost theory into application is difficult because it is hard to measure the costs and benefits of alternative rules and standards formulations.

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.³⁹⁸ 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.

The lack of certainty in standards for meeting community needs under CRA does have *ex post* 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

(1989); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); Schlag, *supra* note 390.

³⁹⁴ See, e.g., Kennedy, *supra* note 393, at 1685 (arguing that standards reflect altruism while rules reflect individualism); Rose, *supra* note 393, at 609 (suggesting that debate is over what our relationship with strangers should be).

³⁹⁵ See, e.g., Radin, *supra* note 393, at 819 (arguing that every application of rule involves reinterpretation of it); Schlag, *supra* note 390, at 383 (arguing opposition between rules and standards is "arrested" dialectic).

³⁹⁶ See, e.g., Kennedy, *supra* note 393, at 1710 (listing qualities associated with rules and standards).

³⁹⁷ See, e.g., Kaplow, *supra* note 393, at 562–63. *But see* Posner, *supra* note 393, at 103–04 (arguing that logic of economic optimization implied by Kaplow's approach leads to infinite regress rather than basis for decisionmaking); Rose, *supra* note 393, at 609 (criticizing law-and-economics approaches).

³⁹⁸ See *supra* Part II.

disapprobation that accompanies a low rating.³⁹⁹ 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. The lack of precision in setting a standard is a matter of degree, and the pre-1995 CRA standard was widely criticized for vagueness and circularity.⁴⁰⁰

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 in this context. Kaplow suggests that the cost of rulemaking will be higher *ex ante* than the cost of developing a standard.⁴⁰¹ 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 homeowner-ship assistance; the particular characteristics of the bank or thrift; and other factors. Delineating these factors in advance would be enormously costly, and even so there would be a high risk of getting them wrong. Moreover, the factors are likely to have to be changed over time to keep up with rapid changes in the market. Even developing the current approach under CRA required an extensive notice and comment process. This extensive process drove the *ex ante* costs of CRA closer to the costs of developing a more detailed rule. Thus, CRA's standard may already have been costlier to develop, *ex ante*, than an even more general standard, and a more detailed rule would have been costlier still.

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 "substantial noncompliance" rating on their examina-

³⁹⁹ For a strong form of this argument, see Posner, *supra* note 393, at 113–16, describing the overcompliance with the social norm against wearing Western-made motorcycle helmets in the Soviet Union.

⁴⁰⁰ See, e.g., Macey & Miller, *supra* note 21, at 326–27.

⁴⁰¹ Kaplow, *supra* note 393, at 562–63.

tion, but dropped the idea, in part because other agencies opined that such fines were not authorized by the statute.⁴⁰²

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 *ex post* inefficient, at least given the existing framework for examinations and merger reviews.⁴⁰³ 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. Moreover, such a rule would become stale over time, and would not easily be adapted to changing market conditions.

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. 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. 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.⁴⁰⁴ The CRA standard can evolve with changes in the market at relatively low cost.

⁴⁰² See Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,158 (May 4, 1995).

⁴⁰³ At some much larger number of CRA reviews it would be possible to make transaction costs swamp these substantive benefits. That is, advocates of rules are correct that *ex post* efficiency does depend, in part, on the number of transactions.

⁴⁰⁴ 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., 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 (Jan. 12, 1998), at <http://www.federalreserve.gov/boarddocs/speeches/1998/19980112.htm> (last visited Mar. 30, 2005); see also PERFORMANCE AND PROFITABILITY, *supra* note 220, at 95-96.

The legislative history indicates that the Congress did not intend for the CRA to result in government-imposed credit allocation. The expectation, rather, was that 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 these goals. They provide for flexi-

More broadly, a second reason to prefer a CRA standard over a rule is that using standards, together with a process for iterative public comment, permits banks and local communities to participate in the formation of the legal directive. This participation occurs not simply in the notice and comment process for rulemaking, but in each instance of the application of the CRA standard in an examination, or merger review, both of which are made public. Use of a standard with public participation in its application has two main benefits: accuracy and legitimacy.

CRA lets *banks* help to shape the content of the standard in CRA's application to them, in their local context, during their CRA evaluation and in merger applications. This increases the likelihood that the performance will be analyzed according to the regulated entity's view of an appropriate standard for the institution, as compared with either an industry-wide numerical target for lending⁴⁰⁵ or regulator judgment alone. On its own, such participation might raise important concerns about regulatory capture, but CRA examinations and merger reviews are made public, and CRA engages citizen participation in the standard setting at the same time.

CRA examinations, merger reviews, and development of a performance context permit greater *citizen* participation in the formation of the assessment, which may also increase its accuracy and its legitimacy. CRA assessment through public disclosure, rating the institution's performance, and taking public input permit greater citizen participation in the decision about application of the standard. The public is more likely to view application of the standard as legitimate if the public has been engaged in the administrative process. This procedure may be even more important in contexts, such as CRA, in which regulators are given significant discretion in interpreting a statute. While public participation in detailed rulemaking is also a means to enhance legitimacy, that participation occurs only at the moment of the notice and comment process required for rulemaking under the Administrative Procedure Act. By contrast, the process of encouraging public participation in application of the standard is an important means to enhance the accountability of the regulatory agencies beyond the notice and comment period. Moreover, the iterative process of public engagement also enhances the expertise of local

bility and direct that performance be evaluated in the context of the specific circumstances faced by each institution.

⁴⁰⁵ For analysis of Klausner's proposal for tradeable obligations based on numerical targets and Swire's proposals for safe harbors based on numerical targets, see *infra* Parts V.B & V.C.

organizations, which in turn improves the potential performance of loans made in their community, the very purpose of the Act.

In that regard, public engagement in application of the standard may be a useful model in other contexts for enhancing the accountability of regulatory agencies and the legitimacy of regulatory action.⁴⁰⁶ By encouraging public engagement throughout the life of the law, such an approach is more likely to enhance legitimacy.⁴⁰⁷ While public involvement in implementing a standard that requires regulatory discretion adds to the transaction costs of CRA implementation, the benefits of civic engagement also should be weighed. This kind of "bottom-up" lawmaking through public engagement in implementing standards can have important advantages over clear rules.⁴⁰⁸ Once a rule is established, there is much less room for meaningful citizen participation in its application. That is, standards can open up the possibility for meaningful civic engagement.

Third, some of the downsides critics generally associate with standards, such as arbitrary and unaccountable decisionmaking and agency or regulated entity rent-seeking, are mitigated in the case of CRA. The regulator's CRA review in examinations and merger applications becomes public and so can be subjected to analysis, and compared to other CRA reviews by the same and other bank agencies, both as to individual institutions and across the industry. The review includes notice and comment proceedings, often with the opportunity for hearings, which enhances transparency and permits all affected

⁴⁰⁶ There has been some increased attention recently to enhancing public participation in the administrative process. See, e.g., AYRES & BRAITHWAITE, *supra* note 358, at 71 (arguing that public participation can enhance accountability and reduce capture); Mariano-Florentino Cuellar, *Rethinking Regulatory Democracy*, 57 ADMIN. L. REV. (forthcoming 2005) (on file with author) (calling for increased public participation in rulemaking through new specialized independent agency); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000) (advocating greater private sector role in administrative process in order to enhance accountability). For an early proponent of greater citizen involvement, see Roger C. Cramton, *The Why, Where & How of Broadened Public Participation in the Administrative Process*, 60 GEO. L.J. 525 (1972) (calling for greater public participation in rulemaking). For a skeptical view, see generally Mark Seidenfeld, *Empowering Stakeholders: Limits on Collaboration as the Basis for Flexible Regulation*, 41 WM. & MARY L. REV. 411 (2000).

⁴⁰⁷ For an example testing the empirical link between participation and perceptions of legitimacy, see Michael E. Morrell, *Citizens' Evaluations of Participatory Democratic Procedures: Normative Theory Meets Empirical Science*, 52 POL. RES. Q. 293, 317-18 (1999) (finding that public acceptance of decisionmaking increased with frequency of public participation).

⁴⁰⁸ Cf. PETER H. SCHUCK, *THE LIMITS OF LAW: ESSAYS ON DEMOCRATIC GOVERNANCE* 452 (2000) (describing bottom-up forms of law as presenting low administrative costs, embeddedness, and high legitimacy); see also Orin L. McCluskey, *The Community Reinvestment Act: Is It Doing the Job?*, 100 BANKING L.J. 33, 57 (1983) (coining phrase "regulation from below" to describe role of community groups under CRA).

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. The iterative nature of these interactions increases the incentives for consistent, reasonable, and reliable analyses from all three of the major players—regulators, the public, and banks. The continuing role for the public in implementing the standard helps to diminish the possibility that the agencies will be captured by the entities that they regulate.⁴⁰⁹ 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.⁴¹⁰ The form of the legal directive can enhance compliance because the law helps create social norms, reveals instances in which actors transgress those norms, and contributes to compliance even absent legal consequences. Public engagement with the meaning of CRA's standard can reinforce a norm of access to credit. If the public cares about the social norm of access to credit, and if creditors care about their reputation with the public, CRA's effectiveness can be enhanced through public acceptance of the social norm. Of course, as critics of standards suggest, 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 creditworthi-

⁴⁰⁹ See AYRES & BRAITHWAITE, *supra* note 358, at 71–73 (arguing that public interest groups can help to prevent capture). In other countries where the concern over corruption is larger, and transparency more lacking, detailed rules might be preferable to standards on grounds of legitimacy even if citizen input is minimal, assuming the rule itself is not substantively oppressive. I am not making a claim that standards with citizen input are more legitimate than detailed rules in all circumstances, but rather that in the context of the application of CRA to banks and thrifts in the United States, the standards approach likely enhances the legitimacy of CRA. The same point is of course true with respect to efficiency; if government is ineffectual or incompetent, rules might be preferable on efficiency grounds.

⁴¹⁰ See generally Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000) (providing comprehensive account of aims and features of expressive theories).

ness, 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 rulemaking that should be counted among the law's benefits. The expressive effects of law should be considered alongside the operational effects.⁴¹¹ 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.⁴¹² 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.

B. CRA's Standard Reasonably Addresses Market Failures and Does So Better than Tradeable Obligations

In Part IV, I argued that CRA's standard was a reasonable policy response to market failures and discrimination in low-income communities. 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 and that a rules-based regime would be preferable.⁴¹³ 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.⁴¹⁴ Klausner argued that banks and thrifts could not invest efficiently in the expertise needed to lend successfully in all the low-income communities within their assessment areas.⁴¹⁵ 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 suc-

⁴¹¹ Cf. *id.* But see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000) (arguing that expressive theories are not persuasive).

⁴¹² 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).

⁴¹³ Klausner, *supra* note 21, at 1564.

⁴¹⁴ *Id.* at 1574.

⁴¹⁵ *Id.* at 1574-75.

cessful lending will benefit competitors in that area.⁴¹⁶ Furthermore, with large numbers of creditors involved, he argued that coordination to develop loan consortia would be more difficult.⁴¹⁷ In addition, Klausner suggested that competition from big banks seeking to meet CRA obligations would hurt specialized lenders focusing on low-income areas.⁴¹⁸ 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.⁴¹⁹

Instead of CRA, Klausner suggested a rule, in the form of a quota for lending to low-income borrowers that could be met by trading obligations among banks.⁴²⁰ In his view, a tradable quota would permit banks to specialize in lending to particular communities 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 tradeable quota would cost less than the discretionary standards implicit in CRA.⁴²¹

Based on nearly a decade of experience since the 1995 reforms, evaluated in detail in Part IV, 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 rules-based, 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 and help to overcome incomplete markets; that added liquidity decreases the riskiness of each bank's loan. CRA fosters competition among banks and thrifts in serving low- and moderate-income communities in a variety of ways. At bottom, banks and thrifts have an affirmative obligation under CRA to lend in their

⁴¹⁶ *Id.* at 1576.

⁴¹⁷ *Id.* at 1577.

⁴¹⁸ *Id.* at 1575.

⁴¹⁹ *Id.* at 1574–75.

⁴²⁰ *Id.* at 1580.

⁴²¹ *Id.* at 1585–91.

entire communities.⁴²² Moreover, they are judged, in part, based on an assessment of their market share in low-income communities as compared to their peer institutions.⁴²³

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 Community Development Financial Institutions (CDFIs) and community-based organizations to penetrate low-income markets where they have not operated at scale before.⁴²⁴ CRA encourages banks to do this directly, through the investment test,⁴²⁵ and indirectly, because banks view partnering with these specialized entities as important ways to meet their obligations under the investment, lending, and services tests.⁴²⁶

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, the grandfather of the community development banking sector, 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, spurred in part by the CRA investment test.⁴²⁷ 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 later may find cost-effective. Specialized lenders play important roles in

⁴²² 12 U.S.C. § 2901(a)(3) (2000).

⁴²³ Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.22(b)(2)(i) (2003).

⁴²⁴ See *supra* note 221.

⁴²⁵ See Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.23 (2003).

⁴²⁶ See *supra* note 221.

⁴²⁷ *Id.*

low-income communities, but they are no substitute for robust and competitive markets that include mainstream banks and thrifts.⁴²⁸

Fourth, CRA provides a pre-commitment device that actually helps banks coordinate lending to reduce information costs. Because CRA requires all insured depositories to lend to their entire communities, it reduces the free-rider problems that otherwise would plague loan consortia. In other words, even though Klausner is right that a monopoly also would avoid the problem of free riders, CRA can reduce or eliminate the problem of under-production from externalities by requiring banks to compete to lend in these communities in any event. CRA thus serves as a pre-commitment device to coordinate lending and overcome collective action problems. As evidence from the last decade that I evaluated in Part IV 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.⁴²⁹

Lastly, CRA after the 1995 reforms provides much of the flexibility and other benefits Klausner’s proposal for tradeable obligations would have offered.⁴³⁰ And it does so without the downside of fixed quotas for lending, which are not required for a trading system to

⁴²⁸ See *supra* Part IV.

⁴²⁹ See Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.22(a)(3), (d) (2004); Joint Final Rule, Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,166 (May 4, 1995) (codified at Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.21(b) (2003)) (“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.”).

⁴³⁰ CRA shares some traits with the kind of output regulations Klausner favors. Output regulation, increasingly favored in the environmental protection context, usually sets a numerical target for performance rather than requiring a firm to undertake certain specified actions that would affect the target. For example, an environmental output regulation might set a level for emission of a particular pollutant, but permit the firm to figure out how to meet that emission standard. Output regulation can be more efficient than input regulation because it lets firms choose how to shape conduct to meet output requirements. See generally STIGLITZ, *supra* note 26, at 230–31 (differentiating between “performance-based”—or “output”—regulations and “input” regulations). Firms presumably have greater expertise in figuring out which technology and management practice it can most efficiently use to meet the numerical target.

work. Under the 1995 reforms, banks and thrifts get equal CRA consideration for both originating and purchasing eligible loans,⁴³¹ 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.

C. The Standards Approach Compares Favorably with 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.⁴³² As Swire explains, safe harbors are, in effect, a partial rules-based regime.⁴³³ In his view, a safe harbor would provide a strong incentive for banks to make more loans or invest in CDFIs at lower compliance costs. This proposal was an effort to strengthen CRA in reaction to an earlier period thought to have been characterized by high bureaucratic burden and weak CRA results. Under his proposal, regulators would set a target level of community development investment.⁴³⁴ If a bank met the target, the institution would not undergo CRA examinations or face CRA scrutiny during merger

CRA is similar to output regulation, in that under the 1995 revisions, regulators no longer look to such “input” factors as how many community meetings the bank held, but rather to the bank’s actual performance in meeting community credit needs. Moreover, banks and thrifts rely on their own expertise and judgment in meeting community credit needs. Compared with input regulation over credit practices, for example, requiring a certain kind of underwriting, this type of output regulation provides for greater flexibility and enhances rather than stifles innovation. CRA, however, lacks numerical targets normally associated with output regulation, and employing a standard, rather than a rule, for output regulation is unusual.

⁴³¹ 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, which firm 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.

⁴³² Swire, *Safe Harbors*, *supra* note 21, at 349, 359–65.

⁴³³ *Id.* at 350.

⁴³⁴ *Id.* at 352.

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.⁴³⁵

A safe harbor based on a bank's CRA rating has a number of disadvantages compared to the current approach. 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 usually are 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 its entire community. 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 where the lender is more active generally receives more weight.⁴³⁶ Thus, a bank may receive a "satisfactory" CRA rating even when there is documented poor performance in small communities.⁴³⁷

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 V.A, 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, and the public is more likely to be genuinely engaged, 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, and a

⁴³⁵ See, e.g., H.R. 2491 104th Cong. § 2304 (1995) (vetoed by President Clinton); H.R. 3567, 104th Cong., § 323 (1996); H.R. 31, 105th Cong. § 4 (1999).

⁴³⁶ See, e.g., CRA PERFORMANCE EVALUATION: CITIBANK, *supra* note 217, at 13.

⁴³⁷ See, e.g., *id.* at 40.

safe harbor would diminish the likelihood of obtaining such information.

Under the Swire proposal, regulators would set numerical targets for investment and other activities, and institutions meeting that target would not even be subject to examination.⁴³⁸ 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. If the targets are set too high, 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 thus raises serious objections on the grounds of regulator-mandated, inefficient 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 also would 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.⁴³⁹ Despite some cases to the contrary, a strong prior CRA record is usually an indicator for successful completion of CRA reviews during mergers.⁴⁴⁰ Regulatory discretion, rather than a safe harbor, provides the mode for analysis and the incentive for performance. 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. The current approach thus approximates the incentives Swire sought to achieve, without losing CRA's flexibility and responsiveness to local concerns and changing market conditions.

⁴³⁸ Swire, *Safe Harbors*, *supra* note 21, at 352.

⁴³⁹ See generally Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620 (July 12, 2001).

⁴⁴⁰ But see Macey & Miller, *supra* note 21, at 328–29, 334–37 (citing examples of community protests of institutions that generally had received good CRA ratings on prior examinations).

As part of the Gramm-Leach-Bliley Financial Modernization Act (GLBA), 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.⁴⁴¹ Small banks with satisfactory ratings generally will be examined every four years.⁴⁴² Notwithstanding these provisions, small banks still will 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.⁴⁴³ 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 appropriate and to undertake a CRA review when small banks merge or apply for deposit facilities, which can have significant effects on local communities.

In a sense, one of the GLBA changes acts in ways that are similar to a safe harbor. If all of the insured depositories in a holding company obtained a CRA rating of satisfactory or better on their most recent CRA examination, the holding company can engage in newly authorized financial activities in insurance and securities. The procedure for engaging in activities that are financial in nature generally does not provide for an application or any hearing or public comment process. Thus, there is no opportunity for the public to comment on CRA (or any other matter) at that time. An institution with a satisfactory CRA record can engage in newly authorized financial activities even if new information comes to light that casts doubt on its CRA performance, at least until its next CRA examination. Moreover, if the next CRA examination brings the institution to a rating below satisfactory, it need not divest itself of newly authorized entities; rather, it may not acquire any new entities or engage in any new financial activities going forward until it regains its satisfactory status. Empirical research in a few years may begin to shed light on whether

⁴⁴¹ 12 U.S.C. § 2908(a)(1) (2000).

⁴⁴² *Id.* § 2908(a)(2).

⁴⁴³ *Id.* § 2908(b)-(c).

the CRA requirement of GLBA has helped to continue to keep CRA relevant or is insufficiently attentive to current CRA performance.⁴⁴⁴

VI

THE SCOPE OF CRA

Critics have charged that CRA has an overly narrow focus, both in terms of its geographic scope and the institutions it covers. In their view, narrow geographic scope harms low-income communities by distorting banks' decisions about where to locate and lend money, and narrow institutional scope harms banks and thrifts by targeting regulatory burdens and incentives to some, but not all, financial intermediaries.⁴⁴⁵ Both arguments raise plausible concerns, and the precise geographic and institutional contours of CRA are not essential to its success. On balance, however, I think something like the current approach is reasonable and defensible. I suggest why that is so, and offer some direction for ways in which the scope of CRA might be reasonably altered.

A. Geography

1. CRA is Not Anachronistically "Localist" in Its Operation

Critics charge that CRA had its origins in "localist" rhetoric that has no place in the globalized financial marketplace.⁴⁴⁶ 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. The idea that all local depositor funds should be recycled only into local loans, taken literally, would undermine geographic diversification, starve local communities of outside capital, and impede the efficient flow of capital. Moreover, today, bank geographic restrictions have largely given way to real competition in interstate banking and to massive consolidation in the industry.⁴⁴⁷ Many banks lend across a wide geographic area, as well as over the Internet. Credit scoring reduces the need in some contexts for local knowledge, especially as to the lowest risk borrowers. Banks raise funds on national and international capital markets and accept deposits from a wide variety of sources. An emphasis on local lending loses a lot of its meaning in this

⁴⁴⁴ For an early assessment, see LITAN ET AL., BASELINE REPORT, *supra* note 243, at 13–14, describing interviews with banks and thrifts that suggest that CRA requirements of GLBA will continue to provide strong incentives for performance.

⁴⁴⁵ See *supra* Part II.D.

⁴⁴⁶ See, e.g., Macey & Miller, *supra* note 21, at 303.

⁴⁴⁷ See *supra* note 449.

context. Moreover, geographic and other diversification of assets 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. Community-development financial institutions and bank and thrift CRA programs have shown that local knowledge can be an important determinant in finding creditworthy borrowers that otherwise would have been overlooked.⁴⁴⁸ Moreover, studies of bank small business lending have shown that geography has not disappeared as a factor in lending even in competitive, national credit markets. When large banks merge, they often lose market share in small business loans that instead are offered by local players.⁴⁴⁹ As to these local institutions, geographic distance still matters.⁴⁵⁰ Most small businesses rely on lenders with a local presence for credit.⁴⁵¹ This is consistent with a theory of informational advantage for local creditors in assessing highly opaque small business assets and other data.⁴⁵²

Yet supporters of CRA need not rely on localist theories, given that market failures and discrimination provide adequate theoretical foundations for CRA. Overcoming market failures from information externalities and collective action problems does require a focus on some "place" where information will be produced and volume and

⁴⁴⁸ See *supra* notes 220–224.

⁴⁴⁹ 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, 294 (2004) (finding that small banks gain market share from large banks during consolidations); David A. Carter et al., *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, 234 (2004) (finding that small banks have 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, 208 (2004) (discussing small-bank informational advantages).

⁴⁵⁰ KENNETH P. BREVOORT & TIMOTHY H. HANNAN, COMMERCIAL LENDING AND DISTANCE: EVIDENCE FROM COMMUNITY REINVESTMENT ACT DATA 1 (Fed. Reserve Bd., Feb. 2004) (on file with *New York University Law Review*) (finding that "distance is negatively associated with the likelihood of a local commercial loan being made and that deterrent effect of distance is consistently more important, the smaller the size of the bank," and moreover that importance of distance appears to be increasing rather than decreasing in recent years).

⁴⁵¹ JONATHAN A. SCOTT ET AL., CREDIT, BANKS, AND SMALL BUSINESS—THE NEW CENTURY app.2 tbl.9 (Nat'l Fed'n of Indep. Bus. Research Found. Ed., 2003) (finding median travel time of six to ten minutes between small business and its bank), at <http://www.nfib.com/object/3747922.html> (last visited Mar. 30, 2005); Myron L. Kwast et al., *Market Definition and the Analysis of Antitrust in Banking*, 42 ANTITRUST BULL. 973, 986 (1997) (finding median distance at or under six miles between small businesses and their bank providers of most credit products).

⁴⁵² See, e.g., Arnoud W.A. Boot, *Relationship Banking: What Do We Know?*, 9 J. FIN. INTERMEDIATION 7, 9–12 (2000).

liquidity increased. To the extent that discrimination is rooted in a lack of knowledge or understanding of local minority communities—made worse by the costs of trying to control agents' behavior—the same may be said of discrimination. That is, overcoming discrimination may require CRA's kind of focus on getting loan officers, for example, to think differently about low-income communities by actively seeking out loans in low-income neighborhoods.

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 their asset size as a whole, and the lending of their peer institutions and other contextual factors.⁴⁵³ 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 diminish the local character of CRA-eligible lending.

2. *CRA Does Not Cause Banks to Avoid Low-Income Communities*

If financial institutions could avoid CRA's requirements by strategically choosing their location, CRA's efficacy in encouraging banks to serve low-income communities would be undermined significantly. Macey and Miller suggested 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.⁴⁵⁴ Their contention was subject to some doubt even at the time that they made it, but today, under the revised rules, 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."⁴⁵⁵ 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 expected to serve."⁴⁵⁶ However, assessment

⁴⁵³ Community Reinvestment Act and Interstate Deposit Production Regulations, 12 C.F.R. § 25.21(b) (2003).

⁴⁵⁴ Macey & Miller, *supra* note 21, at 295–96; *see also* Hylton, *supra* note 21, at 233.

⁴⁵⁵ 12 C.F.R. § 25.41(c).

⁴⁵⁶ *Id.* § 25.41(d).

areas “[m]ay not reflect illegal discrimination” and “[m]ay not arbitrarily exclude low- or moderate-income geographies.”⁴⁵⁷ 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 not small spots on a map in the few blocks around a bank branch. Rather, assessment areas are generally drawn broadly to comport with political boundary lines,⁴⁵⁸ and would include whatever range of neighborhoods measured by income, race, and other demographics that are contained in such boundaries.⁴⁵⁹ 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 already will 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.⁴⁶⁰ Finally, regulators have discretion to evaluate a bank’s investments and community development lending outside its assessment areas, diminishing the importance of the area’s precise boundaries.⁴⁶¹

Nonetheless, changes in the assessment area definitions may be helpful. Assessment areas, which are somewhat 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 state and 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

⁴⁵⁷ *Id.* § 25.41(e).

⁴⁵⁸ *See generally id.* § 25.41(c).

⁴⁵⁹ *See, e.g.,* CRA PERFORMANCE EVALUATION: CITIBANK, *supra* note 217, at app. C-2 (describing assessment area as all counties in New York metropolitan area except Putnam County).

⁴⁶⁰ 12 C.F.R. § 25.41(e)(3).

⁴⁶¹ *See, e.g., id.* § 25.23(a) (noting that agencies may consider investments in “a broader statewide or regional area that includes the bank’s assessment area(s)”; § 25.12(i)(2)(ii) (defining community development loans as including loans that benefit “a broader statewide or regional area that includes the bank’s assessment area(s)”).

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.

B. 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.⁴⁶² They argue that applying CRA to these institutions, but not to others, disadvantages banks relative to non-banks in the financial system, and that such a unique burden is both unfair and inefficient.⁴⁶³ They argue that there is no net subsidy to banks, and that if there is such a subsidy, it does not justify CRA.⁴⁶⁴ There is some validity to the critique, in the sense that banks and thrifts are asked to bear some of the costs of overcoming informational and other barriers to lending in low-income and minority communities, while the positive externalities from such bank lending are shared by other market participants.

Nonetheless, I will argue that applying CRA to banks and thrifts is not as illogical, inefficient, or unfair as critics suggest. Federally insured depository institutions benefit from government subsidies, including deposit insurance, access to the Federal Reserve Board's discount window, and the Reserve Board's role in the payments system.⁴⁶⁵ The largest institutions also likely benefit from "too big to fail" subsidies, explained below, and a wide range of institutions across asset size receive subsidies through membership in the Federal Home Loan Banks. This Section first provides a brief overview of these and other subsidies and then explains why such subsidies provide some justification for applying CRA to banks and thrifts. Finally, the Section explains how depository institutions' specialized role in

⁴⁶² See *supra* note 96.

⁴⁶³ See *id.*

⁴⁶⁴ See *supra* notes 94–95.

⁴⁶⁵ The Federal Deposit Insurance Corporation insures deposits held in FDIC-member banks and thrifts up to \$100,000 per account. The Federal Reserve Board provides access to credit through its "discount window" for members of the Federal Reserve System in the event that they are unable to access funds through the market. The Board guarantees payments among banks and has sponsored and provided the backbone for the payments system. For further details, see *infra* Part VI.B.

financial markets, and their role in overcoming market failures, provides support for CRA's application to them.

1. *Subsidies to Banks and Thrifts*

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.⁴⁶⁶

Most banks receive the benefits of deposit insurance at no annual cost to them.⁴⁶⁷ While these rules strongly need reform, better risk-based pricing would not fully eliminate the governmental subsidy because the government effectively acts as a backstop to the FDIC in case of catastrophic losses or systemic failures.⁴⁶⁸ In ordinary circumstances, the government subsidy probably benefits small banks disproportionately to their asset size. Small banks rely more on insured deposits for funding than large banks do. Furthermore, small banks

⁴⁶⁶ *The Financial Services Act of 1990: Hearing on H.R. 10 Before the S. Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. 70 (1998) [hereinafter *The Financial Services Act of 1990*] (testimony of Alan Greenspan, Chairman of Federal Reserve Board), available at <http://www.federalreserve.gov/boarddocs/testimony/1998/19980617.htm> (last visited Apr. 14, 2005).

⁴⁶⁷ Under rules prescribed by the Deposit Insurance Fund Act of 1996, almost all banks—92%—do not pay annual deposit insurance premiums. Memorandum from Arthur J. Merton, Director of the Division of Insurance and Finance, FDIC, to Board of Directors, FDIC 16–17 (May 5, 2004), available at http://www.fdic.gov/deposit/insurance/risk/2004_02/bif_2004_02.pdf. 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. *The Federal Deposit Insurance System and Recommendations for Reform: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs* 47 (2002) [hereinafter *The Federal Deposit Insurance System and Recommendations for Reform*] (testimony of Alan Greenspan, Chairman of Federal Reserve Board), available at <http://www.federalreserve.gov/boarddocs/testimony/2002/20020423>. Even the weakest institutions pay only a \$0.27 premium on every \$100 of deposits. FDIC, RISK-BASED ASSESSMENT SYSTEM: ASSESMENT RATE SCHEDULE AND FICO RATES, available at <http://www.fdic.gov/deposit/insurance/risk/assesrte.html> (last visited Jan. 13, 2005).

⁴⁶⁸ *The Federal Deposit Insurance System and Recommendations for Reform*, *supra* note 467, at 46 (testimony of Alan Greenspan, Chairman of Federal Reserve Board) (“[W]e should not delude ourselves that even a wider range in the risk-based premium structure would eliminate the need for a Government backup to the deposit insurance fund, that is eliminate the Government subsidy in deposit insurance.”).

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.⁴⁶⁹ Important legal changes at the end of the 1990s significantly curtailed the discretion regulators have to bail out uninsured depositors.⁴⁷⁰ Yet the market perception likely persists, and plausibly so, that the government will intervene to assist large institutions and that such assistance will benefit creditors and shareholders even if they must bear some loss in the process.⁴⁷¹ Banks uniquely receive subsidies from other sources as well. The Federal Reserve Board’s sponsorship of the payments network,⁴⁷² and its low cost provision of riskless financial settlement by guaranteeing large payments among banks,⁴⁷³ are additional sources of subsidy to the banking system.⁴⁷⁴ Direct access to the Federal Reserve Board’s discount window provides assurance to the

⁴⁶⁹ See Harold A. Black et al., *Changes in Market Perception of Riskiness: The Case of Too-Big-to-Fail*, 20 J. FIN. RES. 389, 404–05 (1997) (finding that 1984 announcement of OCC’s explicit “too big to fail” policy resulted in increases in institutional holdings in bank holding companies, even among those not named by Comptroller, providing evidence of indirect subsidy to banks from policy).

⁴⁷⁰ See, e.g., 12 U.S.C. § 1831 (2000) (requiring prompt corrective action); § 1823(c)(4) (requiring least-cost resolution). Congress enacted both sections in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. No. 102-242, 105 Stat. 2236, 2253–75 (1991) (codified as amended in scattered sections of 12 U.S.C.).

⁴⁷¹ See JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* 248 (3d ed. 2001) (noting “the widespread public perception (substantially confirmed by handling of Continental Illinois National Bank failure) that certain banks are ‘too big to fail’”); CRAIG FURFINE, *THE COSTS AND BENEFITS OF MORAL SUASION: EVIDENCE FROM THE RESCUE OF LONG-TERM CAPITAL MANAGEMENT* 25–28 (2002) (finding that large, complex banking organizations saw their cost of funds decline after Federal Reserve Board’s intervention when hedge fund Long Term Capital Management collapsed in 1998, although such effects are difficult to disentangle from investors’ general “flight to safety” following LTCM collapse), <http://www.chicagofed.org/publications/workingpapers/papers/wp2002-11> (last visited Apr. 14, 2005).

But see *The Federal Deposit Insurance System and Recommendations for Reform*, *supra* note 467, at 48 (testimony of Alan Greenspan, Chairman of Federal Reserve Board) (arguing that “the market clearly believes that large institutions are not too big for uninsured creditors to take at least some loss”).

⁴⁷² See FED. RESERVE BD., *FEDERAL RESERVE’S KEY POLICIES FOR THE PROVISION OF FINANCIAL SERVICES*, at <http://www.federalreserve.gov/paymentsystems/pricing/default.htm> (last visited Mar. 30, 2005).

⁴⁷³ Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, 12 FDIC BANKING REV. 1, 3 (1999).

⁴⁷⁴ *The Financial Services Act of 1990*, *supra* note 466, at 72 (testimony of Alan Greenspan, Chairman of Federal Reserve Board) (“The markets place substantial values on these safety net subsidies [specifically the discount window and riskless financial settle-

market about banks' and thrifts' stability, and provides liquidity to banks that otherwise could not borrow at all. It therefore allows institutions to obtain lower cost of funds, regardless of whether they actually draw on the window and take advantage of the price the Board charges. Lastly, banks benefit from subsidies through government-sponsored enterprises and other government programs, some of which subsidize lending to low- and moderate-income borrowers and others of which simply provide a lower cost of funds to banks and thrifts.⁴⁷⁵ Admittedly, the gross subsidies to banks are offset to some degree by the costs of bank regulation, including reserve requirements to the extent that they exceed what banks would hold in the absence of the requirements.⁴⁷⁶

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.⁴⁷⁷ However, each of these first-best solutions to reduce bank and thrift subsidies has faced enormous political opposition and would

ment], clearly in excess of the cost of regulation. . . . [W]ere it otherwise, some banks would be dropping their charters.").

⁴⁷⁵ For example, bank and thrift members of the Federal Home Loan Bank (FHLB) system accrue ninety percent of the \$3 billion in flows of governmental subsidy to the FHLBs, in the form of lower cost advances and higher dividends, while only ten percent is passed on to home buyers in lower mortgage rates. See CONG. BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSEs 25–28 (2001) [hereinafter CBO STUDY 2001], available at <http://ftp.cbo.gov/ftpdocs/28xx/doc2841/GSEs.pdf>. Some portion of the subsidy that accrues to banks is passed on to non-home-mortgage borrowers of the banks.

⁴⁷⁶ See Jones & Kolatch, *supra* note 473, at 7. 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. *Id.* at 10–15. The debate was effectively resolved by legislating “firewalls” between the bank and its affiliates and subsidiaries such that any net subsidy could not be passed through effectively to other entities engaged in new activities. *Id.* at 13.

⁴⁷⁷ 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 the perception 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. See, e.g., Press Release, Federal Reserve Board (Oct. 31, 2002) (noting changes to discount window regulations that would result in credit being provided through discount window at rates above target federal funds rate), <http://www.federalreserve.gov/boarddocs/press/bcreg/2002/200210312/default.htm> (last visited Apr. 14, 2005).

. Government-sponsored enterprise (GSE) subsidies that are passed through to banks and thrifts could be reduced through higher capital standards and other means.

entail significant costs.⁴⁷⁸ 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. Government-subsidized secondary market participants and insurance programs hold a good portion of the credit risk of bank and thrift lending to low- and moderate-income and minority borrowers.⁴⁷⁹ 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.⁴⁸⁰

2. *Role in Financial Markets*

Given that market failures have plagued low-income communities and minority households have faced discrimination in credit and housing markets,⁴⁸¹ I have argued that government regulation has a role in overcoming these problems. In my judgment, it is reasonable for government policy to focus on the role that depository institutions ought to play in overcoming them. Banks play a special role in financial markets by focusing on relational lending and investing in tech-

⁴⁷⁸ 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. See, e.g., Barr, *supra* note 3, at 222 (arguing that Federal Reserve Board should consider lowering prices for certain electronic payment services in order to expand access to banking services for poor individuals). 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 simply may balloon subsidies going to the FHLBs and insured depositories. See White, *supra* note 8, at 54–55. Furthermore, FHLB "reform" has tended to expand, rather than restrict, use of subsidized advances. 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.

⁴⁷⁹ See, e.g., Glenn B. Canner et al., *Distribution of Credit Risk Among Providers of Mortgages to Lower-Income and Minority Homebuyers*, 82 FED. RES. BULL. 1077, 1089 (1996) (finding that "FHA is the primary bearer of credit risk for home purchase loans to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods").

⁴⁸⁰ Cf., e.g., White, *supra* note 8, at 52 (explaining why eliminating GSEs would not necessarily lead to more efficient policy outcomes).

⁴⁸¹ See *supra* Part II.

niques to “thicken” the markets within which they operate by generating and analyzing information on opaque values.⁴⁸² This role is distinct from that of capital markets,⁴⁸³ which focus on information-rich, transparent, and larger firms.⁴⁸⁴ 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.⁴⁸⁵ Instead, most of these loans from independent mortgage companies are packaged and sold on the secondary market where risks are spread more broadly. In sum, it was reasonable for Congress to look to insured depositories to overcome market failures and discrimination, given their specialized role in credit markets, and the governmental subsidies that banks and thrifts receive. Given the evidence on the performance and profitability of CRA loans, CRA does not appear to be a significant drag on the profitability or soundness of the banking industry, which reinforces the view that relying on banks and thrifts to overcome these market failures is a reasonably efficient choice.

3. Credit Unions

The fact that credit unions are not subject to CRA is an anomaly in this regard. There is little justification for 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 same types of 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

⁴⁸² See, e.g., CANNER ET AL., *supra* note 329, at 3, 11.

⁴⁸³ See *id.* at 2 (discussing differences between bank loans and capital market instruments); see also Patrick Bolton & Xavier Freixas, *Equity, Bonds, and Bank Debt: Capital Structure and Financial Market Equilibrium Under Asymmetric Information*, 108 J. POL. ECON. 324 (2000) (developing model of financial market segmentation); Arnoud W.A. Boot & Anjan V. Thakor, *Can Relationship Banking Survive Competition?*, 55 J. FIN. 679 (2000) (describing specialized role of banks in relationship lending being altered by competition from other banks and capital markets); Arnoud W.A. Boot & Anjan V. Thakor, *Financial System Architecture*, 10 REV. FIN. STUD. 693 (1997) (describing specialized role of bank credit when information is costly and monitoring of moral hazard is important).

⁴⁸⁴ On the role of financial intermediation in enhancing the efficiency of markets, see ALLEN & GALE, *supra* note 115, at 469.

⁴⁸⁵ CANNER ET AL., *supra* note 329, at 10–13. This may help to explain why subprime lenders focus on making loans to existing home mortgage borrowers as to whose creditworthiness others already have invested in learning.

"persons of modest means."⁴⁸⁶ For that reason, CRA, or something like it, should be extended to credit unions.⁴⁸⁷

4. *Affiliates*

As financial institutions increasingly rely on a broad range of affiliations to carry on their businesses,⁴⁸⁸ it is both possible and desirable to take account of affiliate activity while respecting the fact that CRA applies only to insured depositories. For example, CRA regulations already provide that evidence of illegal credit practices will affect an institution's CRA rating.⁴⁸⁹ 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 should be the illegal credit practices of affiliates not so included. Given the cost of examining all affiliates for such practices, enforcement of other credit laws should occur through risk-based examinations of affiliates.⁴⁹⁰ The results of such compliance examinations should be taken into account in the performance context under CRA.

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. The regulators now give CRA consideration for "promoting" borrowers from the subprime to the prime market,⁴⁹¹ and banks and thrifts should thus have in place procedures to ensure that borrowers with good credit histories get access to their prime mortgage units.

Moreover, the other agencies should adopt the current approach of the OCC, which considers a bank's subsidiaries' assets in deter-

⁴⁸⁶ Credit unions are tax exempt, 12 U.S.C. § 1768 (2000), because their mission is to serve "individuals of modest means," 12 U.S.C. § 1751 (2000).

⁴⁸⁷ 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 Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759 (1994)).

⁴⁸⁸ See, e.g., LITAN ET AL., BASELINE REPORT, *supra* note 243, at 45.

⁴⁸⁹ 12 C.F.R. § 25.28(c) (2004).

⁴⁹⁰ That is, the regulators could determine whether evidence suggests that an affiliate poses a risk of engaging in abusive practices, and then devote examination resources to investigating the extent of any such practices.

⁴⁹¹ Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,628 (July 12, 2001).

mining the performance context in which a bank operates.⁴⁹² 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.

Holding companies provide scale economies to their subsidiaries in complying with bank regulations.⁴⁹³ 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. 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 and its subsidiaries 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, taking the expertise and resources of the parent institution into account. The agencies should thus include the assets and activities of affiliates in assessing performance context for CRA examinations of banks and thrifts, as part of an effort to ensure the appropriate institutional scope for CRA.

In sum, there is some force to critics' arguments that CRA is too narrowly focused geographically on communities surrounding bank branches, and too narrowly focused institutionally on banks and thrifts rather than other market participants. Nonetheless, the problems associated with this narrow focus are less significant than critics allege, and the bases for the current approach are stronger than

⁴⁹² See OCC Bulletin 97-26, July 3, 1997 (noting that examiners should consider subsidiaries in bank's performance context); Letter from Julie L. Williams, Acting Comptroller, OCC, to Congressman Bruce L. Vento, May 8, 1998 (noting that "OCC examiners . . . include operating subsidiary assets when assessing a national bank's capacity for community reinvestment").

⁴⁹³ See ELLIEHAUSEN, *supra* note 369, at 26 (noting economies of scale for compliance with ongoing regulations).

critics admit. In particular, banks and thrifts enjoy a range of governmental subsidies, and given the constraints of the second-best world in which we live, it is not improper to ensure that some portion of those subsidies goes to a public purpose by applying CRA to banks and thrifts. With respect to geographic scope, the 1995 reforms provided for a more inclusive and flexible approach to defining communities that minimizes the potential downside of focusing on a bank's deposit taking facilities. Still, reforms focused on greater flexibility with respect to assessment areas and affiliates are warranted.

VII

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 is 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.⁴⁹⁴ The extent of these problems cannot be assessed in the abstract. One needs to compare CRA with alternative systems for redressing market failures and discrimination.⁴⁹⁵ Thus, to evaluate CRA, I compare it to a series of other policies designed to expand access to capital.

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),⁴⁹⁶ bar discrimination against minority borrowers. Third, disclosure laws may be thought of as having two subtypes. Some laws, such as the Home Mortgage Disclosure Act (HMDA),⁴⁹⁷ assist in the enforcement of other legal rules or social norms by requiring public disclosure of lending data. Other

⁴⁹⁴ See, e.g., STIGLITZ, *supra* note 26, at 8–10.

⁴⁹⁵ See, e.g., NEIL K. KOMESAR, *IMPERFECT ALTERNATIVES* 98–121 (1994); STIGLITZ, *supra* note 26, at 76–90 (applying such types of comparative analysis).

⁴⁹⁶ 15 U.S.C. §§ 1691 (2000).

⁴⁹⁷ 12 U.S.C. § 2801 (2000). The Federal Reserve Board implements HMDA under Regulation C, 12 C.F.R. pt. 203.1 (2004).

disclosure laws, such as the Truth in Lending Act (TILA),⁴⁹⁸ provide information to consumers to ensure a well-functioning market and are backed by enforcement of the disclosure requirement. Fourth, Congress enacted substantive regulation restricting certain loan products in the Home Owners Equity Protection Act (HOEPA).⁴⁹⁹ Fifth, government subsidies are pervasive in the housing credit market.⁵⁰⁰

I compare CRA to these other modes of credit market regulation, and I also compare CRA to demand-side subsidies in the form of income redistribution. 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. For our purposes here, I only wish to contend that an exploration of the trade-offs involved in other approaches suggests that, contrary to critics' claims, the presence of these other laws does not present a compelling rationale for elimination of CRA. In an ideal world, we might have a different mix of laws, but given the constraints of the world we live in, it is not unreasonable to include CRA as part of the mix, rather than eliminating it from the mix.

A. CRA Compared with Fair Lending Law

Critics of CRA contend that, if CRA is aimed at redressing racial discrimination, the government simply should enforce ECOA instead.⁵⁰¹ 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."⁵⁰² For home mortgage lending, that prohibition also is reinforced by the Fair Housing Act of 1968.⁵⁰³ As with other antidiscrimination laws, ECOA prohibits both animus-based discrimination and statistical discrimination, as measured by the disparate treatment and disparate impact tests.⁵⁰⁴ ECOA's rule that statistical discrimination is prohibited, as opposed to a rule that subsi-

⁴⁹⁸ 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b). The Federal Reserve Board implements TILA under Regulation Z, 12 C.F.R. § 226.1 (2004).

⁴⁹⁹ Pub. L. No. 103-325, § 151, 108 Stat. 2190, 2190 (1994) (codified at 15 U.S.C. § 1601 (2000)).

⁵⁰⁰ See, e.g., White, *supra* note 8, at 46 (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'").

⁵⁰¹ Klausner, *supra* note 21, at 1563–64.

⁵⁰² 15 U.S.C. § 1691(a)(1) (2000).

⁵⁰³ 42 U.S.C. § 3605 (2000). The Fair Housing Act also covers other forms of discrimination in residential real estate transactions beyond fair lending violations.

⁵⁰⁴ See Policy Statement on Discrimination in Lending, 59 Fed. Reg. 18,266, 18,268, 18,269–70 (Apr. 15, 1994).

dized 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.

Empirical evidence suggests that ECOA seems 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 twenty-one percent to twenty-eight percent from 1993 to 1999.⁵⁰⁵ Most of the increase occurred during a period of intense Justice Department focus on enforcing fair lending laws from 1993 to 1995.⁵⁰⁶ HMDA data also show improvements in lending to minority and low-income borrowers.⁵⁰⁷

Yet, relying on ECOA lawsuits alone to advance antidiscrimination 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 nor 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, provide different levels of assistance to borrowers in completing credit applications, or 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 on the basis of race 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.⁵⁰⁸ ECOA's disparate impact test as currently formulated cannot easily detect discriminatory overages, yield spread premiums, or risk-based pricing because of the difficulty of identifying the factor causing the

⁵⁰⁵ LITAN ET AL., FINAL REPORT, *supra* note 243, at 27.

⁵⁰⁶ *Id.* The Justice Department cases resulted in important consent decrees. See Consent Decree, *United States v. Long Beach Mort. Co.*, No. CV-96-6159 (C.D. Cal., Sept. 5, 1996); Consent Decree, *United States v. First Nat'l Bank of Vicksburg*, No. 5-94-CV-6(B)(N) (S.D. Miss., Jan. 21, 1994); Consent Decree, *United States v. Shawmut Nat'l Corp.*, No. 93-CV-2453 (D. Conn., Dec. 13, 1993); Consent Decree, *United States v. Decatur Fed. Savings and Loan Assoc.*, No. 1-92-CV-2198-CAM (N.D. Ga., Sept. 17, 1992).

⁵⁰⁷ See *supra* notes 227-229.

⁵⁰⁸ See ROSS & YINGER, *supra* note 110, at 316.

discriminatory effect, as opposed to factors appropriately based on objective measures not related to race. Moreover, because ECOA focuses on the policies of each lender, ECOA has difficulty addressing the different experience of minority borrowers relying on different lenders than white borrowers in highly segmented subprime, as compared to prime, markets, even though the market-wide effect on minorities could be significant.⁵⁰⁹

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 antidiscrimination norms, and should be strengthened. Banking regulators could pay greater attention to rooting out problems arising from disparate impact. The FTC and the Justice Department could be given greater resources to investigate fair lending abuses, together with investigatory authority. Building on the strength of HMDA, a disclosure law requiring creditors to disclose the borrower's credit score and the creditor's rate sheet could help address price discrimination.⁵¹⁰ A new law on product regulation could bar the payment of yield spread premiums, which disproportionately fall on minority borrowers.⁵¹¹

Still, each of these new measures would have their own costs, and CRA plays an important role in reinforcing the antidiscrimination principles underlying ECOA and in expanding access to credit for minority borrowers. CRA may help uncover and remedy some practices with discriminatory effects that both disparate treatment analysis and disparate impact analysis, as they are currently formulated, have difficulty detecting or remedying. Moreover, 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, on one side, by equal protection jurisprudence limiting consideration of race to assist minorities and, on the other, by the business necessity defense

⁵⁰⁹ See *id.* at 33. But see *Cason v. Nissan*, No. 3:98-0223, 212 F.R.D. 518 (M.D.Tenn. 2002) (ECOA suit based on discriminatory overages in automobile market leading to settlement order).

⁵¹⁰ See *supra* notes 207–210. A full exploration of this proposal is beyond the scope of this Article. For more on this proposal and the concept of “cross modal” policies, see Barr, *supra* note 8.

⁵¹¹ See Barr, *supra* note 8.

permitting the use of factors that have an adverse effect on minorities if such factors are justified by business necessity.⁵¹²

CRA can help to overcome the legacy of decades of official and private-sector discrimination reflected in segregated, low-income neighborhoods, while ECOA is only addressed to discrimination by current market participants. In addition, by encouraging banks and thrifts to get to know these communities, CRA may help to overcome cultural barriers to equality. Moreover, CRA goes beyond ECOA's focus on credit discrimination to address broader market failures affecting low-income borrowers and communities, from collective action problems, information externalities, information asymmetries, and neighborhood externalities. Overcoming these market failures not only improves the functioning of the market, but also furthers antidiscrimination goals. While CRA helps to reinforce ECOA, fair lending laws are no substitute for CRA.

B. CRA Compared with Disclosure Law

Disclosure laws are perennial favorites in the legal literature,⁵¹³ and I agree that disclosure can help improve the home mortgage credit market. However, I take issue with disclosure advocates on three grounds. First, as I will explain below, 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 overcome market failures than legal scholars have recently espoused.⁵¹⁴ Third, I thus argue that disclosure is no substitute for CRA.

1. Types of Disclosure Laws

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. The Truth in Lending

⁵¹² 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").

⁵¹³ See, e.g., Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1230-37 (2003); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1533-37 (1998).

⁵¹⁴ See Camerer et al., *supra* note 513, at 1232-35 (arguing that TILA "provides potentially substantial benefits to those who are less than rational" and "may save some consumers, otherwise uninformed, from possible catastrophic outcomes, such as losing their homes").

Act (TILA) represents the first type. TILA requires disclosures to consumers regarding the cost of loans.⁵¹⁵ This type of disclosure seeks to remedy asymmetric information and improve market competition and efficiency through price disclosure, which would make it easier to comparison shop.⁵¹⁶ It is this type of disclosure that scholars who favor disclosure usually advocate.

HMDA represents the second type of disclosure. HMDA requires most home mortgage creditors to disclose annually to the public information about home mortgage loans made or purchased, as well as loan applications denied.⁵¹⁷ Regulations require disclosure of race, ethnicity, sex, and income of borrowers. HMDA is not designed to enhance borrower information, but rather to increase the ability of the public, regulators, and fair lending enforcement agencies to assess whether lenders are engaged in discriminatory practices and how lenders are meeting their CRA obligations. These broader disclosures are designed to reinforce positive social norms, promote market efficiency, and enhance the regulatory effectiveness of other laws. The collection and public disclosure of information is an essential underpinning of CRA and ECOA in expanding access to credit. 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 financial institution performance. Public debate over the large gap between loan denial rates for whites

⁵¹⁵ See, e.g., 12 C.F.R. pt. 226.17 (2001).

⁵¹⁶ See 15 U.S.C. § 1601 (2000) ("The Congress finds that . . . competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened through informed use of credit. [Furthermore, i]t is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him . . ."); 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) (describing opportunities that information asymmetries provide for predatory lenders and brokers); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 635 (1979) ("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)).

⁵¹⁷ 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. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 1211, 103 Stat. 183, 524–26 (1989) (codified as amended in scattered sections of 12 U.S.C. § 1811 (2000)). 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 rates and fees. See Barr, *supra* note 198, at 459 (suggesting further reforms).

and blacks likely contributed to increased lending to minorities in the 1990s.

2. *Problems with Disclosure Laws*

TILA disclosure likely improves transparency in the market, and thus efficiency, even if not all consumers understand the disclosures.⁵¹⁸ Yet we should be concerned not only with an efficient market in the aggregate, but also with efficiency within markets serving low- and moderate-income households, and with the consequences of inadequate disclosures for affected consumers. Although TILA facilitates 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.⁵¹⁹ Decision theory suggests a need for simplicity: Individuals faced with complex problems simplify them to one or two major decisions.⁵²⁰ The need for simplicity conflicts, however, with the goal of producing comprehensive disclosures that permit consumers to comparison shop based on the real price of loans.

In addition, borrowers 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. Even in competitive retail consumer markets for simple products (e.g., a box of Cheerios in a grocery store) price dispersion can persist.⁵²¹ In home mortgage transactions, borrower understanding of complicated home mortgage terms is likely to be

⁵¹⁸ See Schwartz & Wilde, *supra* note 516, at 630.

⁵¹⁹ See Bd. of Governors of the Fed. Reserve Sys. and the Dep't of Hous. and Urban Dev., *Joint Study on the Truth in Lending Act and the Real Estate Settlement Procedures Act* 9, 17, 62 (1998) (noting consumers' difficulty in understanding mortgage terms with or without disclosure), available at <http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf>.

⁵²⁰ See, e.g., Jonathan Baron, *Thinking and Deciding* 43–68 (3d ed. 2000); Robin M. Hogarth, *Judgment and Choice* 4–6 (1980); Scott Plous, *The Psychology of Judgment and Decision Making* 107–88 (1993).

⁵²¹ See Dennis Carlton & Jeffrey Perloff, *Modern Industrial Organization* 437–41 (3d ed. 2000) (citing empirical examples of price dispersion in retail markets); see also Vernon L. Smith et al., *Competitive Market Institutions: Double Auctions vs. Sealed Bid-Offer Auctions*, in *Papers in Experimental Economics* 201, 201–20 (1991); Vernon L. Smith & Arlington W. Williams, *An Experimental Comparison of Alternative Rules for Competitive Market Exchange*, in *Papers in Experimental Economics*, *supra*, at 172, 172–99 (using experimental design to establish price dispersion in competitive markets).

much lower. Thus, transactions for home mortgages present an even greater possibility for price differentials based on race, sophistication, willingness, and ability to shop for better terms, or other factors.⁵²² Moreover, with credit scoring, creditors know whether borrowers qualify for less expensive loans under the lenders' pricing schedules, while most borrowers do not realize this about themselves.⁵²³

Unfortunately, TILA is extraordinarily complex.⁵²⁴ The efficacy of disclosures is diminished by inadequacies in the nature and timing of disclosures,⁵²⁵ their limited effect on consumer behavior, and consumers' cognitive limitations. TILA disclosure may not actually be noticed, read, or understood.⁵²⁶ TILA disclosures may also inundate the consumer with too much information to process.⁵²⁷ Moreover, low-income and minority buyers are the least likely to shop for alternate financing arrangements.⁵²⁸ Lastly, these problems are exacer-

⁵²² See Jackson & Berry, *supra* note 164, at 63. Ayres has documented similar price discrimination in automobile sales and other markets. See AYRES, *supra* note 158, at 19-44.

⁵²³ Credit reports and credit scores will now be available to borrowers upon request. See Fair and Accurate Credit Transactions Act of 2003, Pub. L. 108-159, §§ 211-12, 117 Stat. 1952, 1968-69 (2003) (codified as amended at 15 U.S.C. § 1681 (2003)).

⁵²⁴ See, e.g., *Emery v. Am. Gen. Fin., Inc.*, 71 F. 3d 1343, 1346 (7th Cir. 1995) (describing ineffectiveness of TILA in conveying relevant information and concluding, "[s]o much for the Truth in Lending Act as a protection for borrowers"); Thomas A. Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, 88 FED. RES. BULL. 201, 208 tbl.9 (2002) (finding that seventy-five percent of respondents either agreed somewhat or agreed strongly that TILA credit card disclosures are complicated).

⁵²⁵ 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 timing problem under prior law). Early disclosure is now required by Regulation Z, 12 C.F.R. § 226.19(b) (2004) (requiring certain disclosures "at the time an application form is provided or before the consumer pays a non-refundable fee, whichever is earlier"); *id.* § 226.5a (requiring disclosures "on or with a solicitation or an application to open a credit or charge account"); *id.* § 226.5b (requiring disclosures related to "open-end credit plans secured by the consumer's dwelling . . . at the time an application is provided to the consumer"), although borrowers will have expended some search effort prior to disclosures.

⁵²⁶ 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).

⁵²⁷ Eskridge, *supra* note 525, at 1133-35; Landers & Rohner, *supra* note 525, at 722-25. For home mortgage and other "closed end" loans, this problem is likely not as bad as for credit card and other "open end" loans because, for closed end loans, the APR is put in a box on the disclosures.

⁵²⁸ See, e.g., Jeanne M. Hogarth & Jinkook Lee, *Consumer Information for Home Mortgages: Who, What, How Much, and What Else?*, 9 FIN. SERVICES REV. 277, 283 (2000) (noting that lower-income and minority households are less likely to comparison shop for home mortgages). But see Jeanne M. Hogarth & Jinkook Lee, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MAR-

bated in the subprime market, making disclosure laws less likely to be effective for borrowers in the subprime market.⁵²⁹

Moving from the first type of disclosure law to the second, the Home Mortgage Disclosure Act requires a shift in thinking about both the purpose of disclosure and the mode of enforcement. 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 sufficiently about their reputation with the public.

Yet the social norm expressed through HMDA may push behavior beyond what is efficient or fall short of what was intended by the promulgators of the standard. HMDA would be less effective without other laws, including CRA. Relying on HMDA alone to overcome market failures and discrimination could in theory lead to overenforcement of antidiscrimination and community investment norms. HMDA information does not contain measures of creditworthiness, loan terms, or property characteristics that influence creditor decisions. Therefore, relying *solely* on HMDA data showing disparities in rates of lending and loan denials to members of different races can lead to 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 if the data are not contextualized.

Conversely, relying solely on public disclosure could lead to underenforcement of equal protection norms and would likely be insufficient to overcome market failures. The need to maintain good public relations is assuredly an important component of why HMDA matters. Without fair lending laws, however, HMDA's disclosure might convey less approbation because ECOA increases the sanction from, and itself reinforces, the societal norm against discrimination. Similarly, without CRA, disclosure under HMDA that a bank did little lending in low-income communities would have little consequence unless two conditions were met. First, there would have to be a societal norm, apart from CRA, that failure to lend to low-income

KETING 66, 70 (1999) (noting that "[i]ncome was not associated significantly with consumers' understanding of the APR-CIR relationship").

⁵²⁹ See *supra* Part III.C.

borrowers and communities was morally wrong. Second, the public would have to enforce that norm against banks and thrifts in a manner that replicates the enforcement power of CRA ratings and merger reviews. Public approbation alone is unlikely to be sufficient to change corporate conduct unless shareholders and customers care enough about the norm, and have a sufficiently definite view of its contours, that they will penalize the firm for noncompliance with it. CRA may help to develop such a norm, and it provides strong incentives for banks and thrifts to comply.

3. *Disclosure Reforms Compared with CRA*

Both TILA and HMDA play important roles in improving credit markets, and reforms of such laws to improve their efficiency would likely contribute to improvements in credit markets. TILA has likely contributed to improved efficiency and fewer abuses, and public disclosure of HMDA data has likely helped to spur more lending to low- and moderate-income and minority borrowers. Disclosure laws can and should undoubtedly be simplified and refined to improve price transparency.⁵³⁰

In addition, financial education can play a role in helping consumers understand disclosures better. It is hard to find scholarly literature that does not end a discussion of disclosure with a call for consumer financial education.⁵³¹ The problem is that expenditures for financial education lead to strong positive externalities, so it is quite difficult to induce private market participants to offer financial education to the borrowing public at anything like the scale it would take to make a difference.

The federal government also could help to reduce information externalities by producing, analyzing and disseminating information about low-income borrowers and communities. This third type of disclosure—aimed at neither borrowers (as is TILA) nor at the public and regulators (as is HMDA), but at the banks and thrifts them-

⁵³⁰ See, e.g., Dep't of Hous. and Urban Dev., Real Estate Settlement Procedures Act (RESPA), Pub. L. No. 93-533, 88 Stat. 1724 (codified at 12 U.S.C. §§ 2601-2617 (2000)); Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134 (July 29, 2002) (to be codified at 24 C.F.R. pt. 3500) (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), available at <http://www.ftc.gov/os/2002/11>.

⁵³¹ See *supra* note 516.

selves—may improve market efficiency by lowering information costs. Still, a central aspect of the information creditors need—whether this type of borrower in this neighborhood is credit worthy—is best measured by lending itself.

More fundamentally, the current structure of the home mortgage market in low-income communities strongly suggests that disclosure alone would not be enough to overcome, even in theory, the market failures or discrimination that this Article earlier explored. Disclosure laws are no substitute for CRA. CRA gives strong incentives to banks and thrifts, those most able to alter their behavior in response to the problem of information externalities, information asymmetry, and collective action.⁵³² CRA can enhance competition—and thus can improve efficiency and transparency—in fragmented markets where information asymmetry, coupled with a wide range of price and term differentials, mean that disclosure seems unlikely on its own to significantly affect market structure. Moreover, CRA encourages banks and thrifts to engage in the kind of contact with low-income communities that may be required to overcome cultural, discriminatory, and other non-rational barriers to lending. 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 through TILA disclosures. Furthermore, CRA is better positioned than disclosure laws to overcome the collective action problem in providing financial education, which generates significant positive externalities. CRA encourages banks and thrifts to partner with community organizations to provide financial education to low-income households, both because such education helps banks and thrifts to meet the CRA services test,⁵³³ and because such education likely bolsters their ability to make sound loans to creditworthy borrowers in fulfillment of the CRA lending test.

C. CRA Compared with Abusive Practice Prohibitions

CRA is designed to expand access to credit, but it can and should also play a role in combating abusive lending practices by enhancing competition from banks and thrifts in serving low-income borrowers and neighborhoods. In contrast to the affirmative obligation inherent in CRA to expand access to credit, the dominant form of public policy addressing predatory lending practices is product regulation: Con-

⁵³² Cf., e.g., GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 24–39 (1970) (discussing “cheapest cost avoider”).

⁵³³ See Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,628 (July 12, 2001) (describing financial education as an example of community development services).

gress enacted HOEPA in 1994 to respond to unscrupulous lending practices in the subprime home equity mortgage market.⁵³⁴ For some “high cost” loans, HOEPA imposes restrictions on certain contract provisions, provides for enhanced disclosures, and enhances remedies for violations.⁵³⁵ In addition to product regulation, HOEPA provides, directly and indirectly, for enhanced disclosures for borrowers facing high cost loans. Directly, HOEPA enhances disclosure by requiring creditors to disclose mortgage terms three days in advance of closing. Indirectly, HOEPA product restrictions would tend to drive more of the cost of the loan into the APR because lenders cannot use the prohibited mortgage terms to cover costs. With more of the cost of the mortgage reflected in the APR, it would be easier for consumers to understand the costs of the loan and comparison shop.

Given the existence of a law designed to address problems of the subprime sector, why look to CRA at all? As a theoretical matter, HOEPA is underinclusive. It is designed to address a problem of abusive practices, rather than overcoming broader market failures or discrimination. Moreover, as a practical matter, HOEPA’s record has been decidedly mixed.⁵³⁶ In response, a Treasury-HUD report proposed a four-part approach to curbing predatory lending.⁵³⁷ Many

⁵³⁴ Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, § 151, 108 Stat. 2190 (1994) (codified at 15 U.S.C. § 1601 (2000)).

⁵³⁵ Under current Federal Reserve Board regulations, HOEPA now covers mortgage refinancing loans and closed-end home equity loans with annual percentage rates more than eight percentage points above the yields on comparable Treasury securities or loans with certain points and fees that exceed eight percent of the loan amount or an amount adjusted for inflation (just under \$500 for 2004). Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001) (codified at 12 C.F.R. pt. 226). HOEPA restricts prepayment penalties, balloon payments, and negative amortization under some circumstances. *Id.* at 65,605. 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). *Id.* 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. *Id.* 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. *Id.*

⁵³⁶ See, e.g., HUD-TREASURY REPORT, *supra* note 191 (gathering extensive evidence of predatory practices despite HOEPA).

⁵³⁷ See *id.*; Barr, *supra* note 198. The plan called for changes that would improve consumer literacy and disclosure, prohibit harmful sales practices, restrict abusive terms and conditions, and improve overall market structure. *Id.* 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. Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001) (codified at 12 C.F.R. pt. 226). This rule takes significant steps towards limiting abusive practices, but congressional action would improve matters further. See *supra* note 198. Rule changes made in December 2001, 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. Federal Reserve System, Home Mortgage Disclosure; Final and

other improvements to abusive practice regulation are possible, but politically unlikely.

CRA, by contrast, could play an increasingly important role in overcoming market failures and discrimination, and thereby reducing abuses. Banks and thrifts can, and should, play an important role in improving competition in the credit market for lower-income consumers. Competition from banks and thrifts can help to drive out abusive practices and improve price transparency in these markets. CRA still has a long way to go in this regard. For example, low-income borrowers may be ending up in a bank's subprime unit or affiliate when they could qualify for better terms. Recognizing this fact, regulators now give CRA consideration for promoting borrowers from the subprime to the prime market.⁵³⁸ Banks and thrifts should have in place procedures to move borrowers with good credit histories into their prime units. Moreover, to bolster CRA's capacity to make more of a difference in overcoming problems in the subprime market, subprime affiliates should also be seen as a part of the performance context for evaluating banks and thrifts under CRA.⁵³⁹ By promoting competition from banks and thrifts in serving low-income neighborhoods and borrowers, CRA can help thwart abuses in the subprime market without the risk of cutting off access to credit that overly restrictive product regulation might entail.⁵⁴⁰

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 by overcoming market failures, not simply to weed out bad actors or discourage predatory lending. The effectiveness of HOEPA and state anti-predatory lending laws also relies in significant part on policing brokers, who are numerous, small, and difficult to monitor, as well as independent finance and mortgage companies, which are generally not subject to comprehensive supervision, instead

Proposed Rule, 67 Fed. Reg. 7,221 (Feb. 15, 2002) (codified at 12 C.F.R. pt. 203). The rule could be strengthened by requiring disclosure of all rate spreads, points, and fees, as well as other loan characteristics. See Barr, *supra* note 198, at 459.

⁵³⁸ Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,622 (July 12, 2001).

⁵³⁹ See *supra* Part VI.B.4 (arguing that affiliates should be part of performance context).

⁵⁴⁰ Moreover, 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.

of CRA's focus on regularly examined and supervised banks and thrifts. In addition, HOEPA's product regulation approach is more prescriptive than CRA, and it is unlikely that any of CRA's critics would prefer more extensive product regulation to the flexible approach provided under 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, which focuses on ending the worst abuses, CRA attempts to overcome market failures in order to bring low-income households into the financial services mainstream.

D. CRA Compared with Subsidies

One alternative to CRA is to rely more on subsidies, either to the private sector or to households. At some level, subsidies can become substitutes for regulation. If the government pays private sector participants a sufficient amount, for example, they will look harder 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. 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.⁵⁴¹ 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. Subsidies to overcome market failures, by contrast, do not arouse the same sense of moral disapproval, and so might be a more appropriate policy choice in that context. Critics of CRA argue that the costs of overcoming market failures in low-income communities should be born by society as a whole, not by banks.⁵⁴²

⁵⁴¹ See Policy Statement on Discrimination in Lending, 59 Fed. Reg. 18,266, 18,267-68 (Apr. 15, 1994).

⁵⁴² See, e.g., Klausner, *supra* note 21, at 1592; Macey & Miller, *supra* note 21, at 296; White, *supra* note 21, at 290-91.

But critics rarely reach the second point: One would need to determine whether it is likely that one could provide the amount of subsidy necessary to have the desired effect without generating undesirable windfalls to recipients. In principle, subsidies should be used “to make marginal private costs equal marginal social costs, and to make marginal private benefits equal to marginal social benefits.”⁵⁴³ 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. Previous experience suggests both that sufficient incentives are hard to create and that windfalls would be difficult to control if the incentives are sufficient.

1. Supply-Side Subsidies Through the Government Sponsored Enterprises and the Federal Housing Administration

Subsidies are pervasive in the home mortgage market.⁵⁴⁴ Most housing subsidies are not well-targeted at overcoming market failures to improve access to credit for low- and moderate-income borrowers, or at 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), the Government National Mortgage Association (Ginnie Mae)) and government-sponsored enterprises (GSEs),⁵⁴⁵ 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 subsidize housing markets. I leave analysis of the housing subsidies in the tax code for others.⁵⁴⁶ Here I focus only on

⁵⁴³ STIGLITZ, *supra* note 26, at 224 (discussing fines).

⁵⁴⁴ See, e.g., White, *supra* note 8, at 46.

⁵⁴⁵ “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” CBO STUDY 2001, *supra* note 475, at 1 n.2.

⁵⁴⁶ See generally PETER BRADY ET AL., REGIONAL DIFFERENCES IN THE UTILIZATION OF THE MORTGAGE INTEREST DEDUCTION (Office of Tax Analysis, OTA, U.S. Dep’t of Treasury, Paper 88, Aug. 2001) (finding that subsidy from mortgage interest deduction benefits high-income homeowners more than twice as much as homeowners earning at or below median), available at <http://www.treas.gov/offices/tax-policy/library/ota88.pdf>; 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) (demonstrating that home mortgage interest deduction largely benefits upper income, married homeowners who would have owned homes in any event), at <http://post.economics.harvard.edu/hier/2002papers/2002list.html> (last visited Mar. 30, 2005).

comparing CRA to FHA and the GSEs as illustrative of widespread housing subsidies.⁵⁴⁷

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.”⁵⁴⁸ FHA, which operates within HUD, insures home mortgage loans made by private lenders in the event of default.⁵⁴⁹ Ginnie Mae, also within HUD, provides a credit enhancement to pools of FHA loans and places them for sale on the secondary market. The housing GSEs—Fannie Mae, Freddie Mac, and the FHLBs—were created to “provide liquidity and stability to the home mortgage market.”⁵⁵⁰ Fannie Mae and Freddie Mac issue debt to buy and hold mortgages in portfolio and insure mortgage-backed securities issued to investors.⁵⁵¹ The FHLBs were created to provide short-term loans (“advances”) to thrifts in order to stabilize mortgage lending in local markets.⁵⁵² Today, FHLB membership is broad, including commercial banks, and advances to members can be issued on a variety of collateral and used for any purpose.⁵⁵³

The GSEs benefit from their relationships with the federal government in a variety of ways. Fannie Mae and Freddie Mac are exempt from state and local taxation,⁵⁵⁴ are exempt from Securities and Exchange Commission (SEC) registration,⁵⁵⁵ can borrow from the Treasury,⁵⁵⁶ and issue debt that banks and thrifts can hold under

⁵⁴⁷ In addition to subsidies in the credit markets, subsidies affect other aspects of the home mortgage transaction. Such non-credit-market subsidies alter the market context for home mortgage credit and themselves may be alternatives to subsidizing the credit market.

⁵⁴⁸ Pennington-Cross & Yezer, *supra* note 172, at 358.

⁵⁴⁹ DEP'T OF HOUS. & URBAN DEV., FISCAL YEAR 2004 BUDGET SUMMARY 13 (Feb. 3, 2003), available at <http://www.hud.gov/about/budget/fy04/budgetsummaryu.pdf>.

⁵⁵⁰ *Fed. Subsidies for the Housing GSEs Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enter. of the Comm. on Fin. Servs.* 1 (2001) (statement of Dan L. Crippen, Director of Congressional Budget Office), available at <http://financialservices.house.gov/media/pdf/052301cr.pdf>; see also U.S. DEP'T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 1 (1996) [hereinafter TREASURY STUDY].

⁵⁵¹ TREASURY STUDY, *supra* note 550, at 2. Fannie Mae was a government corporation, but Congress divided its functions into two parts, and Fannie Mae became a GSE in 1968. *Id.* at 18. Ginnie Mae, the part that remained government-owned, insures securities of FHA loans. *Id.* at 19 n.5.

⁵⁵² CBO STUDY 2001, *supra* note 475, at 7.

⁵⁵³ *Id.* at 3–4, 7.

⁵⁵⁴ *Id.* at 13.

⁵⁵⁵ See MBS DISCLOSURE REPORT, *supra* note 142, at 4, 23–24, 28.

⁵⁵⁶ CBO STUDY 2001, *supra* note 475, at 13–14.

capital standards that favor the GSEs over private conduits.⁵⁵⁷ Most importantly, the GSEs?similar to the largest banks⁵⁵⁸?benefit from the credit enhancement of an implicit guarantee that the federal government will intervene in the event of financial collapse.⁵⁵⁹ Measuring the subsidy provided to the GSEs is the subject of intense debate.⁵⁶⁰ Estimates are sensitive to assumptions about the funding advantages GSEs receive and about how to model the pass-through to borrowers.⁵⁶¹ 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 generally met or surpassed the affordable housing goals that HUD sets for them from the time that the goals first were formally promulgated in 1992 through subsequent revisions that have increased the goals over time.⁵⁶² However, the share of GSE

⁵⁵⁷ Risk-Based Capital Guidelines, 12 C.F.R. pt. 3, app. A, § 3(a)(2)(vi)–(viii) (2004).

⁵⁵⁸ See *supra* text accompanying notes 469–471.

⁵⁵⁹ 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. CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC 10–11 (1996), available at <http://ftp.cbo.gov/0xx/doc13/Fanfred.pdf>.

⁵⁶⁰ 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. CBO STUDY 2001, *supra* note 475, at 2. 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. *Id.* at 1. CBO did not calculate the benefits of the affordable housing goals in determining the net GSE subsidy. CBO estimated that Fannie Mae and Freddie Mac retained \$3.9 billion (thirty-seven percent) of the subsidy for their shareholders or other stakeholders. *Id.* at 5. As for the FHLBs, CBO estimated that they passed on only \$300 million of their \$3 billion subsidy to mortgage borrowers, with ninety 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. *Id.*

⁵⁶¹ Compare *id.* at 22 (finding that GSE securitization lowers interest rates on conventional, conforming mortgages), with ANDREA HEUSON ET AL., CREDIT SCORING & MORTGAGE SECURITIZATION: IMPLICATIONS FOR MORTGAGE RATES AND CREDIT AVAILABILITY 6–8, 41 (Fed. Reserve Bd., Finance and Economics Discussion Series No. 2000-44, Dec. 21, 2000) (arguing that lower interest rates lead to higher levels of securitization, not reverse), at <http://www.federalreserve.gov/pubs/feds/2000/200044/200044pap.pdf> (last visited Mar. 30, 2005).

⁵⁶² See OVERVIEW OF THE GSE'S HOUSING GOAL PERFORMANCE, 1993–2001 (2002) [hereinafter OVERVIEW] (comparing statistics on annual housing performance to articulated goals), at <http://www.huduser.org/datasets/GSE/gse2001.pdf> (last visited Mar. 30, 2005); OFFICE OF POL'Y DEV. AND RES., U.S. DEP'T OF HOUS. & URBAN DEV., ISSUE BRIEF NO. 5: HUD'S AFFORDABLE LENDING GOALS FOR FANNIE MAE AND FREDDIE

purchases financing affordable housing under the goals lagged behind that of the primary market during the 1990s.⁵⁶³ 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.⁵⁶⁴ In addition to the affordable housing goals, other factors contributed to this activity, such as the GSEs' business strategies, the effects of CRA, HMDA, and ECOA, and the shift in the primary mortgage market towards greater levels of lending to low-income borrowers. Fannie Mae and Freddie Mac have also contributed, however, to affordable housing in other ways. For example, both GSEs sponsor home counseling programs, train loan originators and support community organizations to increase affordable lending. The GSEs have also increasingly used more flexible underwriting criteria for loan purchases.

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.⁵⁶⁵ In addition, the

MAC 3 (2001) (describing revision for 2000), at <http://www.huduser.org/publications/pdf/gse.pdf> (last visited Mar. 30, 2005); SUMMARY: HUD'S PROPOSED HOUSING GOAL RULE 1-2 (2004) (describing proposal for goals for 2005 through 2008), at <http://www.hud.gov/offices/hsg/gse/summary.doc> (last visited Mar. 30, 2005). 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. See TREASURY STUDY, *supra* note 550, at 54 n.15. The GSE definition of low- and moderate-income households, one-hundred percent of area median income, includes households with higher incomes than as defined for CRA. OVERVIEW, *supra*, at n.2. Under CRA, low- and moderate-income households are defined as having incomes less than eighty percent of area median. 12 C.F.R. § 25.12 (n) (2005).

⁵⁶³ Dep't of Housing & Urban Dev., Proposed Rule, HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 24 C.F.R. pt. 81, App. A, at 27, 58, 62 (2000); TREASURY STUDY, *supra* note 550, at 56-61.

⁵⁶⁴ See Glenn B. Canner & Wayne Passmore, *Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers*, 81 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. *Id.* at 1000-01.

⁵⁶⁵ CBO STUDY 2001, *supra* note 475, at 5. The FHLBs made \$16.8 billion in net advances to members in 2002, with \$490 billion outstanding at the end of that year. FED. RESERVE BD., FEDERAL RESERVE STATISTICAL RELEASE Z.1, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS FIRST QUARTER 33, 78, 124, (2003) (listing dollar levels and flows for Government Sponsored Enterprises), available at <http://www.federalreserve.gov/Releases/Z1/Current/20030605/z1.pdf>.

FHLBs have begun to experiment with untargeted secondary market operations in the hopes of competing with the other GSEs.

In contrast to the GSEs, FHA is operated by the federal government. FHA specializes in serving borrowers who make "low down payment[s], have high debt-to-income ratios, and/or have tarnished credit."⁵⁶⁶ These borrowers tend to be first-time, minority, or low-income and tend to live in low-income or minority-concentrated neighborhoods.⁵⁶⁷ A higher share of FHA lending goes to low-income and minority borrowers, and low-income areas, compared to the GSEs.⁵⁶⁸ 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.⁵⁶⁹ FHA also serves a role in regions with falling wages, increasing unemployment, and dropping house prices.⁵⁷⁰ At times, FHA has competed with conventional lenders.⁵⁷¹ As the conventional market serves the more creditworthy portion of FHA's pool of borrowers,⁵⁷² adverse selection will leave FHA with higher risk. That problem is exacerbated because FHA lags the private sector in risk management.⁵⁷³ The FHA portfolio is becoming riskier.⁵⁷⁴

In sum, government subsidies generate windfalls for the GSE shareholders and others. GSE subsidies are not transparent, making it difficult for the public to weigh their costs and benefits. FHA subsi-

⁵⁶⁶ SARAH ROSEN WARTELL, SINGLE-FAMILY RISKSHARING: AN EVALUATION OF ITS POTENTIAL AS A TOOL FOR FHA 11 (2002), at <http://www.mhc.gov/papers/wartell.doc> (last visited Mar. 30, 2005).

⁵⁶⁷ *Id.* at 11–14. 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. See Pennington-Cross & Yezer, *supra* note 172, at 367.

⁵⁶⁸ See WARTELL, *supra* note 566, at 11 (noting FHA role in serving minorities); Canner et al., *supra* note 479, at 1089 (same); Pennington-Cross & Yezer, *supra* note 172, at 362 (same).

⁵⁶⁹ See TREASURY STUDY, *supra* note 550, at 64.

⁵⁷⁰ Pennington-Cross & Yezer, *supra* note 172, at 362.

⁵⁷¹ 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 363–66.

⁵⁷² See, e.g., WARTELL, *supra* note 566, at 17 (noting that PMI Mortgage Insurance Company increased portion of high [loan-to-value ratios (LTV)] loans insured to ten percent of their insured loans and that Fannie Mae and Freddie Mac had increased portion of high LTV loans purchased to four to six percent).

⁵⁷³ 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), available at <http://www.pwcglobal.com/gx/eng/indissue/endowment/images/credit.pdf>.

⁵⁷⁴ See WARTELL, *supra* note 566, at 21 ("For FHA loans, delinquency and foreclosure rates have grown while these rates for conventional loans have dropped; average LTVs [loan-to-value ratios] have increased; borrowers are carrying greater debt burdens; and credit scores appear to be declining.").

dies are more transparent because the cost of the subsidy appears as user fees and as an item in the federal budget.⁵⁷⁵ 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.

Seen in light of the tradeoffs involved with dominant existing subsidy regimes through the GSEs and FHA, the tradeoffs involved in CRA should be viewed as quite reasonable. Although the costs and benefits of both CRA and the GSE subsidies are not fully transparent, 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.⁵⁷⁶ 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 experience should augur caution. It is difficult to design general subsidies that are effective, generate little windfall for recipients, and protect taxpayers. In this context, it makes little sense to abandon CRA as a strategy for overcoming market failures and discrimination.

2. *CRA Compared with Targeted Supply-Side Subsidies*

In addition to subsidies to the secondary markets or to banks and thrifts more generally, targeted subsidies to specialized community development lenders can be an important means of expanding the reach of these lenders, as well as banks and thrifts. Indeed, many critics of CRA argue that targeted subsidies are to be preferred.⁵⁷⁷ I

⁵⁷⁵ GSE activity is noted in federal budget documents, even though the GSEs are not "on budget." See TREASURY STUDY, *supra* note 550, at 25.

⁵⁷⁶ See generally, e.g., 12 U.S.C. § 1831o (2000) (prompt corrective action); 12 C.F.R. Part 3, App. A (2004) (minimum capital).

⁵⁷⁷ See, e.g., Calomiris et al., *supra* note 21, at 654–57 (arguing for government programs to subsidize community development banks); Hylton, *supra* note 21, at 225 (promoting ethnic lending); Klausner, *supra* note 21, at 1580–92 (discussing success of SouthShore Bank); Swire, *Safe Harbors*, *supra* note 21, at 354–59, 367–68 (arguing for investment in

have long been an advocate of targeted subsidies as a strategy to expand access to capital and financial services for low-income communities.⁵⁷⁸ Appropriately designed subsidies can, in principle, help to overcome market failures and improve social welfare at a reasonable cost. Nonetheless, as I will explain below, I do not believe that CRA should be abandoned in favor of such subsidies.

One prominent example of targeted subsidies that both critics of CRA and I agree should be supported is the Treasury Department's Community Development Financial Institutions (CDFI) Fund, established in 1994.⁵⁷⁹ The CDFI Fund is designed to create a national network of financial institutions focused on low-income communities.⁵⁸⁰ The CDFI Fund has provided over \$535 million to locally based, private sector CDFIs, as well as mainstream banks and thrifts.⁵⁸¹ The Fund's investments have helped its awardees to increase their capitalization, develop stronger infrastructure and operations, and expand their reach.⁵⁸²

However, the small size and scale of CDFIs suggests that it would be inefficient to switch from relying on the banking system to a system based solely on such specialized lenders.⁵⁸³ Moreover, without the impetus of CRA, it is doubtful that banks and thrifts would have invested so heavily in CDFIs over the last decade. CRA gives strong impetus for banks and thrifts to provide loans, investments, and services to CDFIs. Such activity directly receives consideration under CRA examinations. Moreover, support for CDFIs bolsters the ability of banks and thrifts to serve their communities. 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

community development banks); Macey & Miller, *supra* note 21, at 346 (citing example of community development credit union), 344–45 (promoting ethnic lending).

⁵⁷⁸ See, e.g., Barr, *supra* note 3, at 128–29; Barr, *supra* note 198, at 453–55.

⁵⁷⁹ Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 104, 108 Stat. 2166, 2166 (1994) (codified at 12 U.S.C. § 4703 (2000)).

⁵⁸⁰ See *id.* at § 107, 108 Stat. at 2172.

⁵⁸¹ See DEP'T OF TREASURY, CDFI FUND OVERVIEW, at <http://www.cdfifund.gov/overview/index.asp> (last visited Mar. 30, 2005).

⁵⁸² 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. See DEP'T OF TREASURY, FY 1999 ANNUAL SURVEY PRELIMINARY FINDINGS: CDFI PROGRAM—CORE COMPONENT (2001), at http://www.cdfifund.gov/news/pdf/1999_CORE_FY_Survey.pdf (last visited Mar. 30, 2005).

⁵⁸³ Compare, for example, the \$535 million in CDFI Fund investments, from 1993 to 2000, see *id.*, with the more than \$800 billion in CRA loans over the same time period.

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 incurred in shifting to a system of targeted subsidy.⁵⁸⁴ Lastly, the CDFI Fund is subject to the vagaries of the annual appropriations process. The Fund has seen its budget cut in half over the last four years and now has been proposed to be effectively eliminated in the Administration's most recent budget.⁵⁸⁵

3. *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.⁵⁸⁶ 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 usually can 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 aim only for efficiency.⁵⁸⁷

Macey and Miller argue that CRA could be characterized as a tax on banks and thrifts aimed at redistribution and that income transfers

⁵⁸⁴ More serious objections could be made to switching to a system in which the government delivers the benefit directly—a system in which the government directly provided loans and other banking services to low-income communities. This approach would require the government to create a loan distribution system parallel to the banking sector. Not only would the transition costs be enormous, but the government probably would 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.

⁵⁸⁵ See DEP'T OF TREASURY, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2006, at 258 (2005), available at <http://a255.g.akamaitech.net/7/255/2422/07feb20051415/www.gpoaccess.gov/usbudget/fy06/pdf/budget/treasury.pdf>.

⁵⁸⁶ See Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157, 161 (2003).

⁵⁸⁷ See 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 include programs that transfer income to the poor) to redistribute income." 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, 822 (2000). But see Logue & Avraham, *supra* note 586, at 161 (arguing that legal rules may optimally redistribute social welfare under some circumstances). See generally Kaplow & Shavell, *supra* note 98; Kaplow & Shavell, *supra*.

should be preferred in accomplishing this goal.⁵⁸⁸ 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 distortional,⁵⁸⁹ and income transfers may have high administrative or compliance costs.⁵⁹⁰

If income is transferred as an in-kind subsidy, the costs may be higher than "cash" transfers—or even legal rules.⁵⁹¹ Nor is transferring income as "cash" without controversy. To begin with, 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.⁵⁹² Similarly, the literature debating tax expenditures is voluminous.⁵⁹³ 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 tax-

⁵⁸⁸ Macey & Miller, *supra* note 21, at 296.

⁵⁸⁹ STIGLITZ, *supra* note 26, at 462–63.

⁵⁹⁰ For example, government income transfers to the unbanked often require costly financial services transactions to convert a check into cash. See Barr, *supra* note 3, at 134.

⁵⁹¹ See generally STIGLITZ, *supra* note 26. First, in-kind subsidies are considered less efficient than cash subsidies because the recipient may only use the in-kind subsidy for specified purposes. See, e.g., *id.* at 254–58 (presenting arguments concerning substitution versus income effect). 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. See generally Edgar K. Browning, *A Theory of Paternalistic In-Kind Transfers*, 19 ECON. INQUIRY 579 (1981). 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. See, e.g., STIGLITZ, *supra* note 26, at 397.

⁵⁹² See, e.g., COMM. 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. 2000) (discussing administrative costs, compliance costs, disincentives to work, and other inefficiencies).

⁵⁹³ For the debate over tax expenditures, see generally 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: 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).

payers—in relation to the tax structure generally, all would remain.⁵⁹⁴ That is, the decision to run the redistribution through the tax system does not eliminate any of the theoretical or policy tradeoffs involved in a regulatory system. For example, to decide whether it is “fair” for banks to pay the tax, one would need to decide, among other things, whether the current level of taxation of banks is itself “fair.” In addition, transition costs from laws that redistribute income to a tax and transfer program would diminish the benefits of such a change.

Still, if the main goal of CRA were to redistribute income, as a theoretical matter it would seem 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 one assumes away transition costs, provides that the tax and transfer system chosen will be the most administratively efficient possible, and ignores the political difficulty of the task, then income redistribution through significant expansion of the tax and transfer programs may be preferable.⁵⁹⁵ But all these conditions seem unlikely to hold in the real world.

One also could think of credit market regulation as about redistributing not income, but access to credit.⁵⁹⁶ 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.⁵⁹⁷ Redistribution of mortgage credit also would have “expressive” value,⁵⁹⁸ 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

⁵⁹⁴ See, e.g., David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 995 (2004).

⁵⁹⁵ See Kaplow & Shavell, *supra* note 98.

⁵⁹⁶ For a thoughtful discussion of the role of legal rules in distributing non-income goods, see Logue & Avraham, *supra* note 586, at 161, discussing the different types of redistributive policy tools for non-income goods.

⁵⁹⁷ See GLAESER & SHAPIRO, *supra* note 546, at 3 (describing positive externalities from homeownership and from housing consumption).

⁵⁹⁸ On “expressive” benefits, see generally Anderson & Pildes, *supra* note 410. But see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000) (arguing that expressive theories of law are not persuasive conceptually). I discuss this further in exploring the benefits of standards over rules in *supra* Part V.

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 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 justified primarily 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.⁵⁹⁹

Critics of CRA often point to alternative means of effectuating CRA’s goals without adequately addressing whether these alternatives would, in theory and in fact, perform better. Yet, all five policy approaches to overcoming market failures and discrimination, as well as policies to redistribute income, involve tradeoffs. None of them is clearly superior to the tradeoffs involved in CRA. Given the political, economic, and practical constraints of policymaking, and the imperfect nature of highly regulated and subsidized credit markets, CRA is reasonable policy and should not be eliminated in favor of these other policy approaches.

CONCLUSION

The Community Reinvestment Act has been widely criticized by leading scholars. Critics have contended that CRA lacks any theoretical grounding, both because, in their view, competitive credit markets render alleged market failures and discrimination illusory, and because in their judgment CRA is an ill-considered policy response to market failures or discrimination even if they did exist. They have alleged that the costs of CRA are considerable in lost profits, high

⁵⁹⁹ *But see* Calomiris et al., *supra* note 21, at 645–46 (arguing that income transfers would redress moral hazard by increasing ability of households to make larger downpayments that would demonstrate “attachment” to their homes).

risk, and regulatory burden. They have contended that CRA impedes efficiency in the financial system and burdens banks and thrifts and not other market participants. Critics have contended that the standard used under CRA is vague, empowering rent-seeking by community groups and regulators alike, and should be abandoned, or at the very least replaced with safe harbors or clear rules. Others have pointed to alternative strategies to achieve CRA's aims, such as disclosure, fair lending enforcement, subsidies, and the tax and transfer system. In their view, CRA should be abandoned.

This Article takes aim at these criticisms on theoretical, empirical, and comparative grounds. As a theoretical matter, I have explained how market failures, discrimination, and the combined force of these problems lay a solid theoretical foundation for the Act. Market failures in low-income communities stem from a range of sources. I have shown how information externalities can produce credit constraints that affect creditworthy borrowers in "thin" markets. Relying on Stiglitz and Weiss, I have also explained why the problem of credit rationing, which derives from information asymmetries between lenders and borrowers that give rise to adverse selection and moral hazard, is more acute for low-income households, who have a greater difficulty than other households in demonstrating their creditworthiness and avoiding the credit-rationing trap given their low incomes and low wealth. I have also shown how these informational failures can lead to a collective action problem in which creditors delay entry into low-income markets. Neighborhood externalities exacerbate these barriers, as do agency problems in financial institutions and in the market more broadly. Low-income markets can become stuck, with low volume and liquidity blocking creation of a complete market.

The Article has demonstrated that CRA constitutes a reasonable policy response to these market failures. CRA helps to overcome information externalities, for example, by inducing lenders to increase their activity in low-income communities, helping to build volume and liquidity in low-income markets. CRA helps mitigate collective action problems by providing an effective means for banks to commit to increased lending and coordination mechanisms that decrease information costs and increase market thickness. CRA also provides incentives for banks and thrifts to reform corporate structures to overcome agency problems, and CRA can be part of an overall strategy to reverse negative neighborhood externalities from low levels of homeownership and investment.

The Article also explored racial discrimination. As a theoretical matter, I described how credit rationing models explain the possibility

for discrimination based on racial animus to persist even in reasonably competitive markets, and why statistical discrimination is even more immune to competitive pressures. I explored the empirical evidence that indicates that discrimination likely persists in credit markets, although such evidence is not incontrovertible. I also described the problem of price discrimination, particularly in fees paid to mortgage brokers. The market failures and discrimination that I describe find more acute manifestations in the subprime market, through which low-income and minority households often borrow, particularly for refinancing. I analyzed how CRA could play an important role alongside the Equal Credit Opportunity Act in helping to redress problems of racial discrimination, and could, but has not yet, played a key role in ending abuses in the subprime sector by fully overcoming market failures that stymie bank and thrift entry. Further competition from banks and thrifts in the subprime sector would likely diminish opportunities for abuse.

The Article marshaled considerable empirical evidence that CRA is helping to overcome market failures and reduce discrimination in significant ways and at relatively low cost. Home mortgage and other credit expanded dramatically during the 1990s for low-income and minority households. I evaluated a series of empirical studies, some of which I directed, that controlled for a wide range of factors, and found statistically significant evidence that CRA is providing real, economically meaningful benefits to low- and moderate-income and minority households. For example, one study found that the effect of CRA on home mortgage lending was equivalent to a 1.3 percentage point drop in unemployment over the time period studied.

The Article also analyzed extensive evidence about the costs of CRA and argued that the relatively low costs of CRA are more consistent with the theory I have advanced that CRA is helping to overcome market failures and discrimination, than with the theories of CRA's critics. The Article showed that these costs were seriously overstated by CRA's critics, in part because they dismissed the significance of market failures and discrimination and the role that CRA could play in overcoming them. CRA lending is reasonably profitable and not overly risky. CRA does not appear to be a drag on the efficiency of banks and thrifts or the financial sector as a whole. The rampant rent-seeking feared by critics finds little support in the evidence, and compliance costs have also been significantly overstated. Although the benefits and costs of CRA as we have them are not, strictly speaking, summable, even a rough sense of the costs and benefits of the regulation suggests that it is, on net, socially beneficial, and consistent with the underlying theories justifying CRA. My conclu-

sions have been based on a wide range of empirical studies, but I recognize that further empirical research will be warranted as credit markets continue to evolve.

Turning to the form of the legal directive of CRA, I argued that CRA more closely approximates a standard, rather than a rule. Contrary to the views of CRA's critics, I contended that there are significant benefits to this approach. Employing a standard is likely somewhat less costly than a rule *ex ante*, even given the extensive notice and comment process employed in the 1995 revisions to the regulation. More importantly, and contrary to the general literature on rules and standards, the CRA standard appears superior to a detailed rule, even *ex post*. The CRA standard provides the flexibility needed to assess banks based on local context and business strategy rather than a one-size-fits-all national rule. Permitting the meaning of the standard to vary according to local context and to change over time as the market evolves increases the likelihood that CRA will remain both relevant and efficient. Those who favor rules over standards *ex post* highlight the transaction costs associated with standards but fail to take appropriate account of the substantive benefits of flexible standards. If the need for flexibility is strong enough, and the numbers of transactions not too high, these substantive benefits may swamp transaction costs. Furthermore, I explained why the current standards approach is preferable both to tradeable obligations and to safe harbors that rely on a numerical target or similar rules because the positive incentives those approaches sought to harness can be catalyzed under CRA's standard without the inefficiencies that inflexible targets would create.

In addition, I argued that the rules and standards debate is missing an important point: Employing a standard, coupled with an iterative process of public engagement on its implementation, enhances both the accuracy of the evaluation and the legitimacy of the regulatory response. Regulators, the banks, and the public are engaged in interpreting the meaning of the CRA standard during examinations as well as merger reviews. A rule would provide far less room for meaningful public engagement. The iterative process of public participation in the shaping of a legal norm, far beyond the normal process of public input into notice and comment rulemaking, could be employed in other areas of the law where regulators enjoy significant discretion and concerns about regulatory accountability are heightened. This level of ongoing civic engagement furthers regulatory accountability and democratic legitimacy, and thus ought to be counted among CRA's benefits. Moreover, CRA's standard conveys expressive benefits by articulating a norm of inclusion and setting out

a structure for an ongoing dialogue among the public, banks, and regulators about the meaning of that norm. These expressive benefits ought to be weighed alongside the transaction costs of public involvement.

Critics have often argued without serious analysis that alternatives to CRA are preferable. In order to place CRA in the context of other alternative institutional arrangements, the Article considered the policy tradeoffs implicit in CRA with other approaches to market failures and discrimination. I compared CRA to four other types of credit market regulation—fair lending laws, disclosure, product regulation, and subsidy—as well as to the tax and transfer system. Contrary to critics' claims, I argued that the presence of these alternatives is not a sound ground for elimination of CRA. Each of these alternatives involves tradeoffs, as to both theoretical foundations and practical results, as does CRA, which makes it hard to argue as a matter of either theory or practice that eliminating CRA would be preferable. Viewing CRA in the context of these other real-world or plausible alternatives reinforces the essential argument of the Article that CRA is a reasonable policy response to market failures and discrimination, and that abandoning CRA would be imprudent.

More broadly, it is my hope that the Article has contributed, at least by way of example, to a non-utopian form of legal analysis that takes seriously the economic, institutional, and political constraints under which regulatory policy is made. I have shown that CRA is justified in theory, that the empirical evidence is more consistent with these theoretical justifications than with the views of CRA's critics, and that comparative analysis supports my contention that CRA effectively responds to market failures and discrimination. A number of different structures could plausibly be employed to overcome market failures and discrimination in credit markets. I have not sought to defend the Community Reinvestment Act as the "ideal" form of policy. I have made what I hope is a persuasive case that it is a reasonable one. In my experience, an assessment of whether a policy is reasonable or not is more useful, and more honest, than an evaluation of whether it is ideal. In that regard, the case for CRA is strong.