1999

The Community Reinvestment Act: Questionable Premises and Perverse Incentives

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I. INTRODUCTION

Having just passed the twentieth anniversary of the enactment of the Community Reinvestment Act 1 ("CRA" or "Act"), this is an appropriate time to take stock of the effectiveness of the legislation and to consider whether it continues to be useful as a tool for addressing the problems of neighborhood decline and discrimination in the lending market. Although discrimination in lending and the decline of certain inner-city neighborhoods is a problem that the CRA has not been able to solve, most observers would agree that the situation has improved since the mid-1970s. 2 In particular, there has been notable progress toward the elimination of explicit redlining 3—a problem the CRA was designed to address. 4 Perhaps it is impossible to demonstrate what portion of that progress is due to the CRA itself and what is a result of broader economic and social change that has occurred in this country over the last twenty years. Nevertheless, both supporters and opponents of the CRA generally agree that the Act has been an important factor in pushing banks to lend in previously under-served areas. 5

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3 See id. at 303-04 (describing efforts to increase better lending performance).


In this paper we will argue that the CRA as it is currently understood and enforced is no longer an appropriate tool for dealing with discrimination in the lending market and the lack of access to credit in neighborhoods dominated by minorities and people of modest, or minimal, means. The statute is based on premises that are questionable in today’s lending market, and thus it is not clear that the social benefits provided by the statute are significant. Further, enforcement of the statute generates certain perverse incentives that are costly to society. We emphasize the costly incentive effects in this paper. While the goals of the CRA remain desirable, the current enforcement framework should be reformed.

II. THE CRA DEBATE AND THE REVISED CRA REGULATIONS

A. Background on the CRA Debate

The Community Reinvestment Act, enacted as Title VIII of the Housing and Community Development Act of 1977, requires appropriate federal banking regulators to “encourage . . . [financial] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.” The


Since the passage of the CRA, there have been several law review articles examining the desirability of the legislation from an economic perspective. See, e.g., Keith N. Hylton & Vincent D. Rougeau, Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act, 85 GEO. L.J. 237 (1996); Macey & Miller, supra note 5, at 291; Peter P. Swire, The Persistent Problem of Lending Discrimination: A Law and Economics Analysis, 73 TEX. L. REV. 787 (1995); Taibi, supra note 5, at 1465; Lawrence J. White, The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction, 20 FORDHAM URB. L.J. 281 (1993).

In writing this paper, we set out to make two contributions to this literature. First, we wanted to state the premises or assumptions of the CRA’s proponents in a reasonably (or highly) defensible form and examine those premises in light of current market conditions. We thought that there was a tendency in some of the economic critiques of the CRA to put the proponents arguments in a weak form. Second, and most important, we wanted to provide a careful statement of the incentive effects of the statute. The earlier articles on the CRA have not provided as careful an analysis of the incentive effects as we provide here.

statute provides that regulators should evaluate a financial institution's CRA performance "when examining financial institutions" and that regulators may take CRA performance into account "in an application for a deposit facility." 8

From the perspective of the banking industry, the heart of the argument against the CRA focuses on its cost. The CRA imposes an enormous regulatory burden on banking institutions, which requires extensive data collection and record keeping. 9 In recent years, profound changes in the banking marketplace have meant that banks and savings banks have been bearing the burden of CRA compliance, while other non-banking institutions have been able to enter the lending market free from any responsibilities under the Act. 10 Simply put, this provides a major cost advantage to many institutions that compete against banks and savings banks for a share of the lending market. Furthermore, CRA enforcement has been primarily through protests of bank expansion applications by community groups, which has caused many institutions to acquiesce to expensive demands in order to avoid negative publicity or major delays. 11 On a more theoretical level, many in the banking industry are philosophically opposed to "credit allocation," or government-mandated lending to specific groups or geographic areas, and believe that a competitive market for financial services would be more effective than the CRA in addressing the problems of lending discrimination and redlining. 12

Community groups have insisted over the years that the regulators have not held banks accountable on their CRA performance and it is only

9 See Macey & Miller, supra note 5, at 324-25 (stating that "[b]ankers today regard the CRA as the single most costly regulation facing them. . .").
10 See Ralph T. King Jr., Skewed Marketing: Some Mortgage Firms Neglect Black Areas More than Banks Do, WALL ST. J., Aug. 9, 1994, at A4 (noting that unregulated mortgage bankers make up 75 of the 100 largest mortgage lenders; however, 50 of those 75 showed "deficient" levels of lending in black areas). The disparate application of the CRA also has been criticized on a conceptual level. See, e.g., Leonard Biernan et al., The Community Reinvestment Act: A Preliminary Empirical Analysis, 45 HASTINGS L.J. 383, 406-07 (1994) (noting that the CRA "regulatory tax" discriminates in favor of non-banks); Overby, supra note 4, at 1442 (pointing out that the CRA provides no justification for why only certain types of institutions were selected for coverage).
11 See Macey & Miller, supra note 5, at 333-34; Taibi, supra note 5, at 1487-88.
12 See Macey & Miller, supra note 5, at 333-34.
through outside pressure that any real change has occurred. These groups have generally urged tougher enforcement of the CRA by calling for public disclosure of examinations and strong sanctions for poor CRA performance, such as civil money penalties and cease and desist orders. These groups argue that in order for the CRA to have any real effect, it has to be more than an aspiration; the legislation has to be given some teeth. Community groups want the CRA to produce tangible results, and they want recalcitrant institutions forced to improve.

These conflicting views on the CRA came to a head over the last few years, following the 1992 election of President Clinton and the 1994 election of a Republican Congress. President Clinton, along with most Democrats, is a strong supporter of the CRA. On the other hand, most Republicans are sympathetic to the banking industry’s problems with the CRA and support changes to the Act ranging from outright repeal to streamlined enforcement. In 1993, President Clinton called for a complete overhaul of the CRA regulations then in effect. In 1995, the bank regulatory agencies promulgated revised CRA regulations that were designed to address some of the important concerns of the banking industry and community groups. These revisions were followed by a report from the General Accounting Office ("GAO") to the Congress, which evaluated the effectiveness of the Act and prospects for improvement under the new regulations.


14 See id. at 297 (explaining that although community groups have used the CRA to secure funding for development projects, they are unable to meet all of the needs perceived within low-income communities).

15 See JACK M. GUTTENTAG & SUSAN M. WACHTER, REDLINING AND PUBLIC POLICY 38 (1980) (writing that community groups are critical of banks for being too conservative in their overall lending policies, having an insufficiently local focus within their defined service areas, and failing to provide broad enough lending services).


B. The GAO Report

Ironically, after extensive discussions with all of key parties in the CRA debate, the GAO found some general agreement about the major problems with the Act. Four issues were identified: (1) the CRA relies too heavily on documentation of efforts and processes and too little on lending results, which leads to an excessive paperwork burden; (2) the regulators are inconsistent in their conduct of CRA exams; (3) the examinations are often based on insufficient information and may not accurately reflect an institution’s performance; and (4) the regulatory enforcement of the CRA relies too heavily on community group protests against expansion plans. Of course, these groups do not necessarily agree on how the CRA should be enforced and the affected parties differ on what they see as an effective response to these problems.

For example, the Home Mortgage Disclosure Act (“HMDA”) data provide information on lending results, but they also present numerous interpretive problems. The GAO found that many bankers were concerned that HMDA data could be misleading if not properly explained and that some of the information reveals too much about their business and should not be publicly disclosed. Bankers also objected to having to provide additional data that they would not ordinarily generate as part of and which “may not fully reflect their [normal] business activities.” The regulators believed that statistical data were necessary for judging CRA compliance, but were only useful if accurate. They also noted problems with HMDA data, which they said were sometimes poorly kept or inconsistently reported. The limitations of the data make additional information essential, particularly when an institution is not heavily involved in mortgage lending. Finally, there were concerns about the limited regulatory resources available for CRA enforcement. Some examiners lacked the time or training necessary to

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20 See id. at 44.
21 See id. at 44, 45.
22 See Hylton & Rougeau, supra note 6, at 274-79.
23 See GAO Report, supra note 19, at 47.
24 Id.
25 See id. at 48.
26 See id.
27 See id.
perform proper analyses of HMDA data. Many bankers complained that the examiners' CRA reviews often were arbitrary and inconsistent.

The revised CRA regulations attempt to address some of the problems noted in the GAO report. The CRA evaluation now focuses more on the results of an institution's efforts to improve its community reinvestment performance. Larger institutions are rated under a three-part test that evaluates lending, investment, and retail service throughout the institution's service area based on standard quantitative data provided by the institution. The increased reliance on quantitative data in the evaluations and a more results-based process are also designed to address the problem of inconsistent evaluations. Because small banking institutions have been particularly concerned with the paperwork burden imposed by the CRA, the revised regulations include a streamlined examination for small banks and permits all banks to have their CRA performance evaluated based on a strategic plan approved by their regulator.

Despite these changes, dissatisfaction with the CRA remains. It was the GAO's opinion that the revised regulations will not solve many of the CRA's enforcement difficulties. CRA evaluations will still involve numerous subjective judgments by regulators and will still require the sophisticated analysis of quantitative data. The GAO was concerned about the ability of the regulatory agencies to devote the staff and other resources necessary for truly effective enforcement of the Act. Although many parties involved agree the revised regulations should be given a chance to work, there is a general feeling that total reevaluation of the Act may be necessary.

The role of community groups also presents a significant problem in the CRA scheme. These groups have a wide variety of goals and represent

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28 See id.
29 See id. at 46.
30 See id. at 50.
31 See id. at 36-38.
32 See id. at 55, 59. The GAO also noted that training and examiner judgment would be key to increased consistency in examinations. See id.
33 See id. at 35.
34 See id. at 39-40.
35 See id. at 51-52.
36 See id. at 62-64.
37 Informal discussions that the authors have had with CRA officers of banks from the Chicago metropolitan area earlier this year tend to support this assessment.
Although all probably agree that the banking industry should be pushed to increase community lending, they do not agree on the methods. Community lending initiatives that satisfy some groups are not acceptable to others. Many of the groups have noted that enforcing the CRA mandates is limited to denying an institution's application for expansion or generating negative publicity following a low CRA rating. Bankers have argued, on the other hand, that a CRA rating of "satisfactory" or better should shield them from protests and the current system creates perverse incentives that discourage community lending. We note that this problem presents a substantial challenge to the current CRA framework, not only because it may keep banks out of certain neighborhoods, but also because of the distasteful political posturing it tends to generate. Although the revised CRA regulations create a more objective standard for rating a bank's community lending performance, many community groups no doubt will continue to argue that banks receiving "satisfactory" or better ratings from the regulators still are not doing enough and that public pressure through negative publicity remains necessary. The conflicting demands of the banking industry and community groups make it extremely difficult to create regulations that satisfy all of the affected constituencies. The GAO concluded:

The varied positions taken by the affected parties further demonstrate that the debate about how best to achieve the goals of community reinvestment is both complicated and contentious. The approach embodied in the current CRA statute uses the levers of compliance examinations and application approvals to increase community reinvestment lending. The new regulations are an attempt to generate better results with less regulatory burden. However, given

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38 For example, in Boston, some of the groups involved in ensuring community lending include those organized around specific neighbors, such as the Codman Square Neighborhood Development Corporation, and those organized around specific constituencies, such as the Union Neighborhood Assistance Corporation. See Bad Credit in Dorchester, BOSTON GLOBE, Oct. 28, 1996, at A14.
39 See GAO REPORT, supra note 19, at 35.
40 See id. at 49.
41 See id. at 6.
42 See Macey & Miller, supra note 5, at 340.
43 See Hylton & Rougeau, supra note 6, at 281.
the positions of the different parties, it is not clear that the results will fully satisfy all of those parties.44

III. QUESTIONABLE PREMISES

The current impasse regarding the CRA can be traced to some questionable premises underlying the statute, particularly given the economic and social realities of the 1990s. The oft-repeated idea behind the CRA is that financial institutions sometimes fail to meet the credit needs of the communities in which they are located.45 Of course, this is a vague charge. How does one define the credit needs of the community? Who defines these credit needs? No one has provided a clear answer to these questions. However, the basic sense of failure that motivated legislators to enact the statute can be described easily. Proponents of the legislation were concerned that depositors in older, minority-populated areas of inner-cities saw very little of their money return to their communities in the form of business loans or home mortgages.46 The implication is that those loans typically were provided to mortgage applicants and businesses located in wealthier neighborhoods.47

Thus, in the eyes of the CRA’s proponents, banks were reluctant to provide loans to applicants from inner-city, minority communities but they were quite willing to accept risk-free deposits from the same people. This coupled with the economic decline of most inner-cities during the late 1960s and 1970s48 gave rise to the view that banks were facilitating a process of disinvestment in inner-city communities.49 Some proponents envisioned that

44 GAO REPORT, supra note 20, at 89.
45 See id. at 16.
46 See Marsico, supra note 14, at 287-88 (citing congressional intent, while drafting the CRA, to have banks return more credit to their communities).
47 See Macey & Miller, supra note 6, at 298-99.
49 See Overby, supra note 4, at 1446; Michael H. Schill & Susan M. Wachter, The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America, 143 U. PA. L. REV. 1285, 1311 (1995); see also Taibi, supra note 5, at
the statute would reverse this trend by forcing banks to lend in relatively under-served areas.\textsuperscript{50}

Because banks typically make loans not out of altruism but out of an intention to make a profit, it is important to point out why in the eyes of proponents banks were reluctant to lend in inner-city, minority communities. The term "redlining" has been used to describe the policies of banks, but the fundamental claim is that lending institutions discriminated against minority applicants or applicants from minority neighborhoods\textsuperscript{51} Prior to the enactment of the CRA, there was some empirical evidence to support this charge. Much of it is referred to in the legislative history of the Act,\textsuperscript{52} and it convinced many people that some type of action was necessary.

This is the account—call it the community disinvestment story—that CRA advocates generally have accepted and continue to believe, and it contains three premises. First, banks should lend primarily in the areas in which they receive deposits. Second, banks refuse to do this largely because of discrimination against minority groups. Third, the economic decline of many inner-city, minority communities is due in substantial part to the lending policies of banks.

The first premise—that banks should lend in the communities where they receive deposits—has been criticized by Macey and Miller,\textsuperscript{53} and although we do not agree entirely with their argument,\textsuperscript{54} we would point to the same flaws in the premise that they have identified. The fundamental flaw is that the "localism" premise confuses the role of banks as financial intermediaries. The premise rests on an assumption that banks should aim to do their business locally. But in their role as financial intermediaries, banks recently have not attempted to conduct their business on a local basis.\textsuperscript{55} Given a set of risk and return characteristics banks would consider acceptable for lending, they transfer money from geographic markets in which there is

\textsuperscript{1484-86} (noting that "banks were redlining or neglecting important credit needs within their communities, and regulators' efforts to deter such behavior were inadequate.").

\textsuperscript{50} See Schill & Wachter, \textit{supra} note 49, at 1316-20.

\textsuperscript{51} See Overby, \textit{supra} note 4, at 1450.

\textsuperscript{52} See \textit{id.} at 1453 (in a review of banking and credit legislation of the 1970s, describing the CRA as the "linchpin in the effort to ameliorate the problems of discrimination, redlining, and disinvestment"). For a thorough discussion of the history of the CRA, see Overby's comments at pages 1453-58.

\textsuperscript{53} See Macey & Miller, \textit{supra} note 5, at 310-12.

\textsuperscript{54} See Hylton & Rougeau, \textit{supra} note 6, at 264-65 (discussing localism argument).

\textsuperscript{55} See Macey & Miller, \textit{supra} note 5, at 305-06.
an excess supply of funds to those in which there is an excess demand.\textsuperscript{56} Because communities differ in terms of lending risks and in terms of savings propensities, this implies some communities will receive fewer loans relative to their deposits than other communities. Further, banks increasingly solicit funds nationwide,\textsuperscript{57} which makes it more difficult today to make a general claim that local funds are being lent outside of the community.

The localism premise has been discussed at length elsewhere,\textsuperscript{58} and we will not extend the debate here. The second and third premises (dealing with discrimination and causation, respectively) strike us to be more important, so we will focus on them in this section.

A. Assessing the Plausibility of the Lending Market Discrimination Theory

The literature on the economics of discrimination has offered two categories of discriminatory motive. One is taste-based discrimination, which refers to discrimination based solely on the discriminator's disutility or distaste for contact with members of the target group.\textsuperscript{59} The other type of discriminatory motive is statistical or rational discrimination, which occurs when the discriminator uses race as a proxy for other information that would influence his decision.\textsuperscript{60}

\textsuperscript{57} See Macey & Miller, supra note 5, at 305-307.
\textsuperscript{58} See Hylton & Rougeau, supra note 6, at 264-65; Macey & Miller, supra note 5, at 303-12; Overby, supra note 4, at 1483-91.
\textsuperscript{59} Much of the literature regarding the "economics of discrimination" is due in large part to the work of Gary Becker. For information on taste-based discrimination, see GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION 16-17 (2d ed. 1977). For a detailed discussion of the taste theory in the context of lending discrimination, see Hylton & Rougeau, supra note 6, at 250-59. A taste-based discriminator is willing to offer a payment, or to bid, to avoid contact with members of the group he dislikes. Thus, suppose a taste-based discriminator plans to see a certain movie – he can choose between two theaters close to his home. One theater, A, is frequented only by members of the group he likes (presumably his own group). The other theater, B, is frequented by members of the group he dislikes. The taste-based discriminator will choose B over A only if the price charged by B is sufficiently lower than the price charged by A to compensate for the disutility of associating with members of the group he dislikes.
\textsuperscript{60} See, e.g., Dennis J. Aigner & Glen G. Cain, Statistical Theories of Discrimination in Labor Markets, 30 INDUS. & LAB. REL. REV. 175 (1977); Edmund S. Phelps, The Statistical Theory of Racism and Sexism, 62 AM. ECON. REV. 659 (papers and proceedings) (1972). For a discussion of statistical discrimination in the
In the context of the lending market, one can subdivide these categories of discrimination further still. A lender could discriminate against an applicant because of information about the applicant or because of information about the intended use of the loan. For example, a lender may be reluctant to extend credit once he finds out that the applicant is black. Alternatively the lender could be indifferent as to the race of the applicant, but unwilling to lend after learning that the loan would enable the applicant to purchase a home in a neighborhood with a high percentage of black residents.

It could be seen as needless hair-splitting to create so many categories for examining discrimination, but these categories are useful in examining the plausibility of the discrimination premise. Let us start by considering the claim that lenders are taste-discriminators who focus primarily on the intended use of the loan. What this means is that a lender simply dislikes extending credit intended to fund activities in minority communities.

This argument has a ring of implausibility. The taste-based discrimination theory is typically applied to the case of an employer who prefers not to associate with workers of a different race. The taste-based theory seems plausible in this setting because people generally come in contact with each other at the worksite. However, a loan officer can approve a loan going to support a business or home purchase in a minority community without ever having to set foot in the community.

Consider the theory that banks are reluctant to lend to individual minority applicants because of taste-based discrimination against the applicant. This is somewhat more plausible than the previous theory because bank employees sometimes come into contact with loan applicants or the holders of bank loans. However, as the lending process becomes increasingly mechanized, and as discretion plays a less important role in the process, even this theory of discrimination begins to look less plausible. In today’s lending market, there are mortgage brokers who shop around an information package on a home mortgage applicant that is largely confined to financial matters. The lenders who accept these packages often know

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context of lending, see Hylton & Rougeau, supra note 6, at 254-59. It should be clear from the discussion in the text that the statistical discriminator has no racial or group-based preferences; he simply uses group-identification as predictor of behavior.

61 See Hylton & Rougeau, supra note 6, at 249-54.

nothing of the non-financial personal characteristics (e.g., race) of the applicant. Credit scoring, and other mechanical processes, have become sufficiently common that the theory of taste-based discrimination in the lending market has become less plausible.

Still, mechanization of the lending process has not reached the stage that the non-financial personal characteristics of borrowers can be assumed to be irrelevant to the lending process. The interesting question is how taste-based discrimination occurs in the lending process. The most persuasive account provided so far was suggested in the Federal Reserve Bank of Boston’s study of residential lending discrimination. The study points out the importance of borderline applicants in the mortgage process: according to the study’s authors roughly eighty percent of mortgage applicants are neither unambiguously good risks nor unambiguously bad risks by traditional standards, and within this large group of borderline applicants the discretion of the loan officer is applied. In this setting, there is room for taste-based discrimination to occur in spite of the existence of rigid assessment standards and laws prohibiting racial discrimination.

The remaining theories of discrimination fall under the statistical discrimination category. We think it is fair to say that the statistical discrimination theory is more plausible in the context of the lending market than is the taste-based theory. The key weaknesses in the taste theory are that it requires the exercise of discretion on the part of the lender and direct contact between the discriminating lender and customers. But both of these features are no longer routine in the mortgage lending process and are becoming increasingly less common.

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63 Scoring systems use data from previous loan applicants and recipients to generate models that rate borrower attributes to determine creditworthiness. For a brief overview of credit scoring usage and a discussion of policy implications, see Warren L. Dennis and Christine DiBacco Bachman, Are DOJ and FTC Poised for Fair Lending Attack Against Credit Scoring? 14 BANKING POL’Y. REP. 1 (1995).

64 Of course, one could argue that mechanical processes in general remain flawed because they incorporate the discriminatory tastes of the programmers of the various mechanical methods. But under the model of taste-based discrimination, the important source of discrimination is the decision-maker’s distaste for dealing with an undesirable group. If that distaste were incorporated directly into some algorithm for determining creditworthiness, the lender would, presumably, still have discretion as to whether to follow the algorithm. If the lender had no taste for discrimination, it (presumably) would deviate from the rules set out in the algorithm.


66 See id. at 12.
Furthermore, there are implications from the economics of discrimination literature that support the lending market statistical discrimination thesis. Perhaps the most important concerns the long run survivability of discrimination. The basic result is that in the long run, taste-based discriminators will earn less than competitive returns.

To see why this holds true, let us step back for a moment and review some basic lessons from the theory of competition. In a competitive market, entry occurs until economic profits—the difference between revenue and the opportunity costs of capital used in production—are driven to zero. Thus, in the long run, firms earn zero economic profits. They earn what economists describe as a "normal" profit, which is just enough to compensate them for the risk and the opportunity cost of capital tied up in the enterprise.

Now consider what happens to the discriminator in an industry in which new competitors can enter easily. The taste-based discriminator demands to be compensated for the distaste or disutility he experiences in having to deal with or come into contact with members of the race he dislikes. In the employment context, the white taste-based discriminating employer would demand a wage reduction (relative to the wage paid to a white worker) in order to employ a black worker. In the lending market, taste-based discriminating lenders will demand a premium, in the form of a higher interest rate or higher up front fees, for dealing with black loan applicants. Because of his demand for compensation, the taste discriminator will of course earn a larger profit in each individual contract with a black loan applicant. However, this demand also puts the taste discriminator at a competitive disadvantage relative to non-discriminating lenders. Because they do not need to receive a premium to compensate for the distaste of dealing with black borrowers, non-discriminating lenders will be able to enter into a larger number of profitable contracts and may underprice discriminating lenders when dealing with black loan applicants. Put another

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68 See Becker, supra note 59, at 39-54.
70 See id.
71 See id.; see also KARL E. CASE & RAY C. FAIR, PRINCIPLES OF MICROECONOMICS, 195-96 (2d ed. 1992) (noting that a normal rate of profit is "the rate that is just sufficient to keep owners or investors satisfied").
way, taste-based discrimination gives rise to opportunities for non-discriminators to make "racial arbitrage" profits.

Suppose, for example, that a taste-based discriminator is willing to make a loan to a black home mortgage applicant only if compensated by an additional quarter of a percent on the interest rate or an up-front fee equal to one percent of the amount borrowed (one "point"). If the lender attempts to disguise the racial surcharge by incorporating it into the interest rate, then his strategy is likely to be undone by competitors in the market for refinancing. Indeed, if it were routine for black mortgage holders to be charged uncompetitive interest rates by taste-based discriminators, non-discriminating lenders would have incentives to target refinancing offers to black home owners. Aware of the constraints in the refinancing aftermarket, the taste-based discriminating lender might demand compensation in the form of an additional point at closing of the sale. But in this scenario the additional cost is so obvious to the borrower that one would think that non-discriminating lenders and mortgage brokers would be keen to exploit this opportunity.

If entry into the lending market by non-discriminators is easy, the profits of taste-based discriminators in the lending market will be driven in the long run below the point at which a normal profit is earned. At this point there would be a potentially mutually-beneficial arrangement where discriminators sell their assets to non-discriminators, or discriminators simply exit the field and re-deploy non-specific capital to some other activity. The long run tendency, then, is for the market to penalize taste-based discriminators. Unless they prefer to discriminate while receiving less than competitive returns, they will tend to exit the field at a higher frequency then non-discriminators, and thus make up a smaller share of the market over time.

In the case of statistical discrimination it is not necessarily the case that the market will penalize discriminating firms. If a firm uses information on race as a cheap proxy for other information that is expensive to discover, the firm may be able to improve its position relative to competitors who do not take race information into account. In other words, statistical discrimination, provided race is a sufficiently accurate and cheap proxy for information on risk, does not necessarily generate potential racial arbitrage profits for non-discriminating lenders.72

These implications for the survivability of discrimination can be applied to the banking context in order to aid our assessment of the plausibility of the discrimination hypotheses. On a superficial level the taste-based discrimination theory seems difficult to reconcile with the fact that

72 See Hylton & Rougeau, supra note 6, at 250-51.
banking is a competitive industry.\textsuperscript{73} It is possible, to be sure, for taste-based discrimination to exist in a competitive industry. There is nothing in the theory of competition to suggest that taste-based discrimination cannot exist in the short run, and even in the long run it may persist if taste-based discriminators are willing to accept less than competitive returns. However, the theory seems implausible in light of the scale of the allegedly discriminatory credit allocation pattern. Given the consistency of the pattern of decaying inner-cities surrounded by relatively wealthy suburbs, one would think that there are enormous profit opportunities if this pattern is in substantial part due to racial discrimination on the part of bank loan officers.

In addition, the empirical evidence does not provide support for the taste-based discrimination theory. Recall that the taste discriminator would demand a premium in order to deal with black borrowers. This generates a racial arbitrage profit opportunity for non-discriminators, who can make money by underpricing discriminators in the market for black borrowers. Although these profits are eliminated in the long run through competition, one should expect in the short run to see a positive relationship between bank profitability and minority lending. A recent study by the Board of Governors of the Federal Reserve System examined the relationship between lender profitability and the minority composition of the neighborhoods in which they made loans.\textsuperscript{74} The report concludes that the "influence of the minority composition of a neighborhood on risk or profitability is weak and inconsistent, when other determinants of risk and profitability are accounted for."\textsuperscript{75}

Direct examination of the behavior of presumptive non-discriminators reveals little evidence that these firms behave differently from the typical lender. Who are presumptive non-discriminators? In many large cities, such as Chicago, there are black-owned banks.\textsuperscript{76} Whatever may be said of them, it is highly unlikely that these banks are taste-based discriminators against black loan applicants. However, among municipal depositories in Chicago, within-city loan to deposit ratios are lower for

\textsuperscript{73} On the competitiveness of banking, see PIERCE, supra note 56, at 79-88.
\textsuperscript{74} See BOARD OF GOVERNORS OF THE FED. RESERVE SYS., REP. TO THE 103D CONG. ON COMMUNITY DEV. LENDING BY DEPOSITORY INSTIT. 39-52 (1993) [hereinafter COMMUNITY LENDING REPORT].
\textsuperscript{75} Id. at 39.
\textsuperscript{76} For example, in Chicago until roughly two years ago, there were three black-owned banks: Drexel National Bank, Independence Bank of Chicago, and Seaway National Bank of Chicago. Drexel and Independence were purchased by the South Shore Bank of Chicago (a white-owned bank) two years ago.
minority-owned than for white-owned banks. In general, minority-owned banks tend to perform less well on CRA evaluations than white-owned banks. A study by Harold A. Black, M. Cary Collins, and Ken B. Cyree presents evidence that black-owned banks are more likely to discriminate against black loan applicants. Thus, black-owned banks seem to be as reluctant to lend to black loan applicants as their white-owned counterparts.

From the foregoing, it seems that the taste-based discrimination theory fails several simple preliminary tests of plausibility when examined in the context of the lending market. This is not to say that there could be no taste-based discrimination; this is an issue that deserves careful empirical analysis. But at this preliminary level of probing, there is little support for the theory that stands at the heart of the CRA's justification.

Recall that the alternative to taste-based discrimination is statistical discrimination, which in the context of lending implies that banks use information on race as a cheap substitute for more detailed information bearing on creditworthiness. To the extent firms have set up mechanized lending processes that do not incorporate information on the race of applicants, there is less room for race to be used even as a proxy for other variables that concern the lender. However, the large category of borderline loan applicants opens up an area for banks to use race information informally as a method of reaching decisions on marginal loan applicants.

Let us return briefly to the process described by the Boston Federal Reserve Bank study. How would statistical discrimination affect lending decisions on marginal or borderline loan applicants? Several commentators have noted the phenomenon of "coaching" or the "thick file" phenomenon. This refers to the fact that some borderline loan applicants receive help from loan officers. In some cases the coaching pays off and a borderline applicant who would otherwise have been rejected receives a loan from the bank. Unsurprisingly, the evidence suggests that white loan applicants are more

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77 See Hylton & Rougeau, supra note 6, at 255.
80 See MUNNEL ET AL., supra note 65, at 12.
81 See, e.g., COMMUNITY LENDING REPORT, supra note 74, at 34; Swire, supra note 6, at 819-20; LAWRENCE B. LINDSEY, BREAKING FREE FROM SOME OUTDATED MYTHS, ADDRESS TO A COMMUNITY REINVESTMENT CONFERENCE 5-6 (Sept. 21, 1992) (transcript on file with author).
likely than black applicants to receive this coaching and to have thicker application files. A loan officer who rationalizes his discriminatory behavior may decide to favor white borderline applicants because he thinks they are more likely to speak favorably of the bank to other desirable customers. Viewed in this sense, the coaching process is similar to advertising. The bank views these expenditures as investment in the firm’s goodwill. If such investments are likely to have higher payoffs when directed toward white applicants, the coaching process is likely to be racially biased.

If this is an accurate description of the main source of racial discrimination in the home lending market, then it is easy to see how it may persist and also be difficult to discern. It may persist because it is profit-maximizing; every bank has an incentive to tolerate a race-biased process as applied to borderline applicants. And since this process does not involve the bank refusing to accept unambiguously good risks because of racial discrimination, it is less likely that the sort of racially-motivated price competition (driven by the existence of racial arbitrage profits) that mitigates the effects of taste-based discrimination will be observed in this setting. Discrimination is difficult to discern because in this case it involves applicants who are not clearly qualified under traditional standards.

In short, there is a plausible discriminatory process at work in the residential lending process. However, the process is considerably narrower than the community disinvestment story envisions. The community disinvestment story fails to take into account the constraining effect of competition on the ability of lenders to discriminate against minority loan applicants. Competition in the lending market makes it costly for banks to practice taste-based discrimination. The discrimination that does occur is most likely of the statistical type and is practiced within the set of marginal loan applicants. In addition, if competition is sufficiently vigorous, the statistical assumptions used by discriminators will have to be reasonably accurate, otherwise the discriminators will be punished by the market.

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82 See Swire, supra note 6, at 819-20.
83 For empirical support, see RAPHAEL W. BOSTIC, THE ROLE OF RACE IN MORTGAGE LENDING: REVISITING THE BOSTON FED STUDY (Division of Research and Statistics, Bd. of Governors of the Fed. Reserve System Working Paper No. 1997-2, 1996). Bostic finds that “significant racial differentials exist only for ‘marginal applicants and are not present for those with higher incomes or those with no credit problems.”
B. Bank Lending Practices Are Major Determinant of Economic Decline in Inner-Cities

The third premise of the community disinvestment story is that discrimination in lending has had a significant impact on the economic decay of minority communities. The most persuasive argument for this claim relies on the economic theory of externalities: lending for community investment purposes has an external effect because each dollar invested into restoring a home in a given block raises property values within the block. Thus, the private value of lending for community investment is likely to fall short of its "social value." Banks will tend to do too little lending for community improvement projects.

This is a general argument that applies to all community investment projects, whether in white or minority neighborhoods. It suggests that in the absence of some subsidization efforts by the government there may be too little investment relative to the social optimum in community improvement projects. Of course, the interest from home equity loans is tax deductible, which suggests that the government already subsidizes some community improvement projects. In addition, there is strong social or peer pressure within many neighborhoods to make investments to maintain one's property. Further, nuisance law prevents people from totally ignoring the interests of others in maintaining their property. With all of these forces, it may well be that the level of community investment by property owners is the same as what would be observed in a world in which investors captured all of the external benefits of their investments.

However, there is a potential under-investment problem, and it may be particularly severe in minority neighborhoods. If banks adopt

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85 Nuisance law does not, in general, protect aesthetic interests. See Mathewson v. Primeau, 395 P.2d 183, 189 (Wash. 1964) (refusing to require defendant to remove swine and rubbish from land because nuisance law does not protect aesthetic interests); Fontainebleau Hotel Corp. v. Forty-Five Twenty-Five, Inc., 114 So. 2d 357, 359 (Fla. Dist. Ct. App. 1959) (stating that nuisance law does not protect claim to sunlight). However, if the defendant's failure to maintain their property creates some disturbance which invades the property of a nearby home owner, that home owner would have a valid nuisance claim against the defendant. If, for example, the defendant's property became infested with rats, creating a danger to nearby home owners, a nuisance action could be maintained against the defendant.
discriminatory lending policies, it may be rational for even non-discriminating banks to refuse to make loans in minority communities. Knowing that the profitability of its loans are dependent on the willingness of other banks to extend credit within a certain neighborhood, a non-discriminating lender may think that there are too few non-discriminators to make up for the shortfall in lending due to discrimination. In this case, the externality problem may give rise to a pattern of disinvestment. In the expectation that no substantial lending will be done within a minority community, lenders may rationally expect property values to decline in general.\textsuperscript{86} In this case, investing in one property may raise its value and those of others, but not enough to offset the sum of declines resulting from the failure to maintain nearby properties.

Although we find this story plausible, it is not entirely persuasive. The fundamental weakness in this account is that it puts the cart before the horse by focusing largely on the role of bank lending in the community investment process. How does the perception arise that there will be too little investment in minority communities? If the perception arises from the fact that within a certain community, there is too little investment by homeowners and residents, then banks cannot be held accountable for the lack of lending within that community.

Many of the social ills that lie at the base of the phenomenon of urban economic decline can be characterized either as lifestyle issues or as macroeconomic issues, and are unrelated to the lending policies of banks. Consider the lifestyle issue. A single parent household, for example, is unlikely to be one in which members of the household have time to do simple home improvement or maintenance projects. A community in which roving gangs paint graffiti on the sides of houses and buildings, and otherwise abuse the property of others, is unlikely to be one in which residents have an incentive to invest in property.

The broader point is that in the communities in which there is no visible under-investment problem, one observes private, low-level individual and coordinated efforts that serve to maintain property values. Neighbors, realizing their common interests in maintaining the property, sometimes share equipment and help each other with maintenance tasks. This level of continual investment and coordination is supported by the expectation that

\textsuperscript{86} See, e.g., Swire, supra note 6, at 823-25 (describing "strategic discrimination" where lenders fail to extend credit because of an expectation of falling property values in the future due to an absence of lending in an area). See also Klausner, supra note 84, at 1569 (stating that information drawn from prior sales in an area helps facilitate transactions in the future).
low-level maintenance efforts are necessary in order to be accepted within the community, or, put another way, to be considered a good neighbor. One also finds, in these communities, a level of family cohesion that permits residents to expect a high degree of stability and public order. But in communities in which a large share of the families have dissolved or are in the process of dissolving, low-level investments to maintain property are almost surely not going to be made. Property values probably will decline in these neighborhoods, whatever banks do. In the absence of private, individual efforts to maintain and improve property it is unlikely that bank lending alone will be sufficient to maintain property values.

Similarly, the macroeconomic changes that have led to economic decline in cities were in some cases the result of international trade, and in other cases the result of poor policies at the level of municipal government, or a combination of both. To the extent that these forces drive private investment decisions, banks enter the picture largely as facilitators, moving the traffic along but not controlling its direction.

IV. PERVERSE INCENTIVES

To this point we have criticized the key assumptions of many proponents and the legislative framers of the CRA. We are, of course, unable to prove that these premises are false; this requires empirical research. Some empirical research has been done on the question of lending discrimination, and for the most part it is inconclusive. However, our aim is not to reexamine the empirical literature; rather our aim to this point has been to suggest a framework from which the empirical evidence should be examined. We think the statute’s premises are sufficiently questionable in today’s climate that in the absence of strong evidence supporting them, there should be a presumption that the statute does not accomplish the goals proponents have set out for it. And even if the evidence could be thought to support the proponents’ assumptions, the question remains whether there are more effective or less costly ways to do this.

87 The most dramatic example is Detroit, Michigan, where the decline in the market share of the U.S. auto industry led to large increases in unemployment over the late 1970s. See JAMES HOWARD KUNSTLER, THE GEOGRAPHY OF NOWHERE 193-95 (1993).

88 For a review which stresses the poor policy decisions, see America’s Cities, ECONOMIST, Jan. 10, 1998, at 17.

89 For a review of the empirical literature, see Hylton & Rougeau, supra note 6, at 268-76.
We shift our focus now to the inadequacies in the incentives created by the statute. Thus, whether or not the premises are false, we ask here whether the statute is likely to accomplish its aims at a reasonable cost.

Several commentators have suggested that the CRA may fail to provide the right incentives for banks to comply with its aims, provided those aims can be stated with sufficient clarity. We consider this issue in more detail here. The incentive problems can be grouped under two headings: inadequate incentives and perverse incentives. Under the former we will consider why the statute may provide insufficient incentives for banks to meet the goals of CRA proponents. Under the latter, we will discuss ways in which the statute actually works against the goals of its framers and proponents.

A. Inadequate Incentives

Under the current enforcement framework, banks and thrifts are examined by one of the relevant federal regulatory bodies for compliance with the CRA and graded according to the level of compliance. Compliance grades become an issue when the bank applies for approval for a merger, the acquisition of a new branch, or some other expansion. To simplify the discussion, we will focus on the merger as the relevant transaction. If the bank has received poor compliance grades, the regulatory body may refuse to approve the bank’s merger application. However, the approval process is not limited to a mere consideration of the bank’s compliance grades. Third parties are permitted to intervene and submit letters protesting the merger because of the bank’s failure to comply with the CRA. The statute permits virtually anyone to intervene in this fashion.

With this background in view, it is possible to see some of the obvious inadequacies in the current set of incentives. It should be clear that

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90 See Macey & Miller, supra note 5, at 295; Lawrence J. White, supra note 6, at 287.
92 Regulations for the examining agencies indicate that “interested parties” may file statements responding to applications for new domestic branches, relocations of main offices, mergers, charters, conversions to national charters, and deposit insurance. See 12 C.F.R. § 25.29(c) (1997) (OCC regulation); 12 C.F.R. § 345.29(c) (1997) (FDIC regulation); 12 C.F.R. § 228.29(b) (1997) (Fed. Reserve Sys. regulation); 12 C.F.R. § 563e.29(c) (1997) (OTS regulation).
banks that do not have expansion plans do not have incentives to comply with the CRA.

One might argue that it is the rare bank that does not have expansion plans. However, banking industry analysts have noted that one by-product of the recent wave of mergers is the expansion of the market's lower end. As banks have merged, casting off redundant facilities and workers, some of the discarded assets and employees have found employment in banks serving small geographic markets. Industry analysts have described the industry as having a "barbell shape," with a mass of large banks serving large geographic markets on one end, another mass of small banks on the other, and relatively few medium-sized banks in between. At the lower end of this barbell, there is virtually no need for managers to be concerned about the CRA. Because these banks are catering to a narrow market and do not intend to expand, they are effectively immune from the CRA enforcement process thus giving them an advantage relative to large banks, partially offsetting the disadvantage of not being able to exploit economies created by size in the banking market.

With respect to large banks, it is not entirely clear that they will have incentives to comply with the CRA. First, if the bank’s managers have no intention to expand, their incentives to comply are weakened. But even if the bank’s managers have expansion plans, or otherwise feel pressured to comply with the statute, they may only comply with the letter rather than the spirit of the statute. Banks no doubt study the methods regulators use to grade compliance. Banks have incentives to adopt the cheapest methods necessary to ensure approval or to avoid being put in an unfavorable public light. That may give rise to compliance stratagems that ensure an adequate compliance record without significantly furthering the goals of community development.

A simple example illustrates this argument. Suppose regulators were to measure compliance by comparing the total volume of loans in lower-income communities to those in upper-income communities. Suppose the bank serves two communities – the largely wealthy Park Place and the low-income neighborhood, Marvin Gardens. The bank, aware that regulators will compare the total amount loaned in these two communities, could construct a good record under the regulator's criterion, either by reducing the amount loaned in Park Place or by increasing the amount loaned in Marvin Gardens. If, for example, Marvin Gardens has a small number of very expensive

94 See Hylton & Rougeau, supra note 6, at 281.
properties, the bank will want to extend credit to those owners. Of course, making loans to a small number of wealthy property owners in Marvin Gardens may enhance the bank's statistical compliance record while doing absolutely nothing to improve the welfare of low-income home owners or home searchers in Marvin Gardens. There are plenty of real world examples in which such a compliance strategy is available to a bank. For example, the "Gold Coast" area of Chicago includes pockets of concentrated poverty such as the Cabrini-Green housing project. A Chicago bank that happens to have one of these pockets of poverty within its service area would have a strong incentive under the statute to lend large amounts to wealthy residents living within the same service area. This does little to advance the goals of the statute. Indeed, it has the perverse effect of providing benefits largely to wealthy property owners in areas designated as "low-income," as banks bid more aggressively for their business.

Since we are talking about cheap methods of avoiding problems under the statute, why not consider what a smart bank manager would do? Again, suppose we are in Chicago. A smart bank manager would call the city council member who represents the residents within the lower-income area of the bank's geographic market, and ask that representative to put her in touch with local interest groups that would most likely file CRA complaints in response to the bank's expansion plans. Having met the concerns of the representative and the local interest groups, the bank would be in a good position to seek expansion. Again, this approach toward compliance may not advance the goals of the statute.

Perhaps the most troubling compliance stratagem revealed to date involved Fleet Financial Bank of Boston. Although the allegations have not been admitted to, reports emerged in the Fall of 1996 that the bank had entered into deals with property speculators to buy homes in at least one low-income area of Boston and to resell the homes to minority and low-income residents at inflated prices. In one case, a house that had been bought for $55,000 by a speculator was sold less than two months later, with no improvements on record, for roughly $169,000. Since no rational bank would approve a mortgage on an inflated house, this left Fleet in the position of being the only bank that would lend to the unsuspecting home buyers. Why would Fleet approve mortgages on inflated houses in a low-income area?

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95 See Bad Credit in Dorchester, supra note 38, at A14.
area? Reports suggested that the bank needed to improve its CRA compliance record in order to carry out its expansion plans.7

One could argue that a desirable result had been achieved: the bank made more loans within a low-income neighborhood. But if the allegations against Fleet are true, there may have been no social gain at all from the bank’s activity. The houses probably would have been sold to someone at a price that could be supported by an independent appraisal. Fleet would not have held as many loans in low-income areas, but other banks would have. And what of the new owners of these inflated houses? They are burdened by high mortgage payments and face the prospect of a large loss if they try to sell.

The examples considered so far assume that the bank regulator uses an objective or statistical test for compliance. Recent reform efforts have attempted to make the compliance review process more objective.8 As these examples demonstrate, objective compliance tests may provide incentives for banks to adopt compliance stratagems that satisfy regulators’ objectives without really advancing the underlying goals of the CRA.

Suppose, however, we consider a more subjective review process which focuses on banks’ efforts to comply with the statute rather than statistical evidence on lending. This is, of course, the traditional method regulators have used to evaluate compliance. Is a subjective review process preferable to an objective one because of the greater ability of regulators under the subjective process to reject compliance stratagems that satisfy an objective criterion while failing to genuinely advance the goals of the statute? The answer probably is no.

Under a subjective review process, banks still have incentives to find the cheapest methods to satisfy compliance examiners. As long as it is cheaper to produce documentation and paperwork (e.g., glossy brochures)
than to take on risky loans, banks will have incentives under the subjective process to invest in the production of paperwork indicating an effort to comply rather than to actually extend loans to people in under-served communities. Further, because of the actual risk efforts to extend loans may not satisfy the examiner’s unspecified concerns, banks have additional incentives to focus exclusively on the production of paperwork. The result of these incentives is a “community development” program in which most of the funds are devoted to administrative salaries and expenses.

B. Perverse Incentives

There are some ways in which the statute may serve to undermine its own aims. While a bank that happens to be within a geographic market that includes low-income residents may have enhanced incentives to work toward the goals of the statute, a bank that does not lie within such a service area has an incentive to stay outside. The statute clearly raises the cost of entering and operating within the very markets which the legislative framers and proponents claimed were under-served by banks. As fewer banks view low-income areas as desirable markets, the remaining banks serving those areas become less constrained by competition, permitting them to charge uncompetitively high fees and to engage in the very discrimination the statute aims to eliminate. This is a point that has been made before. However, the problem of perverse incentives runs considerably deeper. Let us return to the focal point of CRA enforcement activity: the merger.

We noted earlier that the CRA is almost irrelevant to a bank that does not have expansion plans. This happens because compliance grades are important largely because they affect the likelihood of approval by regulators for expansion plans. This particular enforcement convention introduces important costs. We put them in two categories: rent-seeking and transaction costs. We aim to point out below that incentives are created to run these costs very high. There is no reason to think that these costs will not exceed the social benefits from a merger.

1. Rent Seeking Costs

a. Banks

Consider the following example: bank A wants to acquire bank B, where B serves a geographic market that includes a large percentage of low-income residents. Bank A’s merger application is under review by the

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100 See Macey & Miller, supra note 5, at 340; White, supra note 6, at 287.
Federal Reserve Board. Suppose there are competing banks, C and D, who would also like to acquire bank B. Suppose there is another bank, E, who competes against B but has no expansion plans.

Suppose further that the owners of A intend to reduce costs and compete more fiercely after the merger, and the estimated gains to A from this are $10 million ($1 million per year indefinitely discounted at 10% interest rate). E’s losses if this transaction takes place will be $3 million. The competing bidders would each gain $5 million if they were permitted to take over B. Consider their incentives under the merger approval process.

E’s concern is that the merger may make B a stronger player in the local market. C and D would like to knock A out of the competition for acquiring B, though it may not be necessary to knock A out of the competition. It may be sufficient, for their purposes, to delay the process so that time-sensitive benefits from the merger between A and B evaporate.

C, D, and E have strong incentives to file protests under the CRA. The value to each is substantial and the cost of filing a letter protesting the merger is minimal. However, they have an incentive to invest considerably more into the grievance process. E is willing to spend up to the expected value of a successful challenge in order to prevent the merger, which in this example is $3 million multiplied by the probability E’s challenge is successful. C will spend up to the value of $5 million multiplied by the probability that C emerges as the acquirer, and the same is true of D. Let us suppose the probability for either C or D emerging as victor is 1/2, conditional on knocking A out of the game, so that each is willing to invest up to $2.5 million into the protest.101

C and D will help their case by finding evidence that suggests that the acquiring bank A either does not have a good compliance record, or is unlikely to have a good compliance record in this market. They will also have incentives to contact local interest groups and representatives and urge them to protest the merger.

As this example suggests, the stakes involved can be high even in small bank mergers. Because of the merger rents at stake for all of the parties, the grievance process encourages banks to invest large sums into the

101 $2.5 million is the maximum the firms are willing to invest in the grievance process. They will spend less if the probability of excluding bank A from the process is less than one at all levels of expenditure. In general firms will choose a level of expenditure that maximizes the gain from the grievance. Thus, if $G$ is the amount invested into the grievance process and $p(G)$ is the probability of excluding A given an expenditure of $G$, banks C and D will maximize the expression $p(G)\times($2.5 million) $- G$. 
complaint process. Surely bank E, with as much as $3 million at stake, will be able to discover important CRA concerns that should require regulators to delay the merger approval process.

On a more general level, C and D have potential merger rents at stake. E, seeking protection from competition, has a regulatory rent at stake. It should be clear that by changing the numbers slightly the sum of the merger and regulatory rents can easily exceed the total gain to A from the merger, and perhaps all of the social gains from the merger. Thus, competition for merger rents and efforts to protect regulatory rents suggests that the particular enforcement process set up under the CRA may generate costs well in excess of the benefits. In addition, competition for rents drives up the cost of bank entry into the very markets in which additional lending is most desirable.

b. Pressure Groups and Politicians

Several commentators have noted that local pressure groups have incentives to demand payoffs from the merger applicant in order to withdraw CRA protests against a particular merger. They are aware that the merger rents at stake are substantial. The payoffs required to quiet them are small in relation to the merger stakes.

Local politicians are also aware of the opportunities created by the CRA review process. Few things look more impressive to the public than a public servant standing up against a powerful financial institution to force that institution to take the interests of its potential customers into account. Realizing this, the enterprising politico need not wait for the local pressure groups to approach her; she can approach them first. She can volunteer to serve as a mediator between the merger applicant and the local pressure groups. With her guidance, the pressure groups can gain information on the reasonableness of a settlement demand.

These costs are generally small in relation to the merger stakes. However, to the extent this activity delays the merger process it can significantly increase the likelihood that the whole deal will fall through.

2. Transaction Costs

It is obvious that the transaction costs of a merger are increased by the current enforcement framework, and thus fewer bank mergers will occur as a result. Of course, this is true of virtually all regulations that affect

102 See Macey & Miller, supra note 5, at 333-34.
103 See id. at 296.
mergers. One unique feature of the CRA is that it substantially increases the
transaction-specific investments made by the merger applicant.\footnote{104}

Suppose the merger applicant is not discouraged by the prospect of
delay and the costs of responding to CRA complaints. Further suppose the
merger applicant invests large sums of time and money into making peace
with local politicians, pressure groups, local competitors, and all other parties
who raise CRA issues. At the end of this process, the bargaining landscape
between the potential acquirer and target has changed.

The target realizes that the merger applicant has made an enormous
investment in this single transaction. Of course, there are some general skills
that the applicant has learned. The applicant will be better prepared in the
future to negotiate mergers, having seen what is required in this one. But the
deals cut with complainants in this special case have no value to the bank in
future expansion applications in other areas.

For example, suppose at the start of the merger discussions, a price
of $50 million was offered and tentatively accepted by the acquisition target.
Suppose over the course of regulatory review, the value of the bank’s assets
decreases by $5 million. Note that the cost of walking away from the
transaction has increased for the merger applicant. If the target refuses to
lower its price, the applicant can refuse to carry out the transaction.
However, the target probably realizes that the acquiring bank does not want
to forfeit its heavy investment into CRA approval. The target is going to be
less willing to lower its price.

The point here is of course not limited to the CRA. To the extent
mergers have to meet any regulatory approval whatsoever, this creates a
transaction-specific investment which alters the bargaining positions of the
parties over the course of the regulatory review process. However, the CRA
is according to many accounts the most costly and time-consuming
component of the bank merger approval process.\footnote{105} In addition, it involves
making investments that are quite useless in future expansion efforts.\footnote{106}

V. ALTERNATIVES TO THE CRA

We do not know whether the costs of the CRA outweigh the benefits.
However, we have suggested so far that the benefits are considerably
narrower than proponents have envisioned. In addition, the administrative
costs by all accounts are high. What is more important in our view is that the

\footnote{104} See id. at 331.
\footnote{105} See id. at 331-32.
\footnote{106} See id. at 295-96.
enforcement structure discourages banks from entering under-served markets and sets up incentives to waste resources. In particular, parties have incentives to exhaust the rents associated with the merger and regulatory processes, and these costs provide an additional disincentive to entry. Because the sum of these costs is likely to be large relative to the social benefits from enforcement, it is probable that the total costs generated by the statute exceed the benefits.

In this section, we briefly consider alternatives to the CRA. We start with general views on desirable changes in the enforcement method and move on to consider current legislative proposals.

A. Changing Enforcement

It should come as no surprise that our most basic suggestion is that the merger process be removed as a focal point for enforcement of the CRA. In addition, we think there are several reasons for shifting to a subsidization approach under the statute; for example, rather than penalizing banks for having a poor compliance record, regulatory agents should only offer rewards to banks that have strong compliance records. In terms of compliance incentives, a subsidy is capable of achieving the same level of compliance as a penalty. The incentive to comply with the CRA's goals is determined by the difference between the reward for complying and the penalty for failing to comply. Under the current framework, there is no special reward for complying while the penalty is denial by regulators of an application to expand the bank's activity. The same incentives can be achieved by removing the penalty and substituting some reward for proving compliance with the statute's goals.

There are several reasons for a change to a pure subsidy approach. First, although the statute has been viewed by proponents as a useful tool for combating discrimination in the lending market, that is not its sole focus. A bank can prove that it has never discriminated against a lender on the basis of the lender's race or the minority composition of the neighborhood for which the loan is intended and yet still face the problem that its level of lending may be deemed inadequate to meet the credit needs of its service area. As many commentators have noted, banks that choose a conservative strategy, or banks that choose not to make a substantial business of home lending, are penalized.

To the extent that the statute constrains banks from pursuing diversified strategies, it is equivalent to penalizing manufacturers for not

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107 See Guttentag & Wachter, supra note 15, at 3.
108 See Macey & Miller, supra note 5, at 312-13, 317-18.
making a broader range of products. For example, if one were to follow the logic of the statute’s proponents and apply it to the auto industry, luxury car makers should be penalized for not making cars that meet the needs of the average consumer. But diversification in the car market, and most other markets, has benefited consumers by permitting firms to meet consumer needs more cheaply through specializing in narrow areas of the market.

In view of the benefits of specialization and diversification, the proper approach by a government that aims to increase production of a certain item is to subsidize either its production or consumption. The same holds in the markets for lending to finance home purchases and business expansion in inner-city communities.

Another powerful reason for a subsidization approach is observed when we consider the long run effects of the CRA. In spite of the incentive issues noted in the previous section of this article, the CRA may very well encourage banks in the short run to do more lending in their service areas. However, there is little doubt that the statute discourages banks from moving into areas in which they will incur greater scrutiny under the statute. While penalties discourage banks from moving into inner-city, minority communities; subsidies would encourage them to move into these areas. Banks would incur expenses in efforts to prove compliance with the CRA, but this is not a concern under a subsidization scheme because the banks would do so voluntarily in the expectation that the future rewards would outweigh the compliance costs. If no bank attempted to comply with the statute, then the government could infer that the costs of compliance were too high relative to the subsidies.

Although we think a subsidy approach is superior to the existing enforcement framework, it is not perfect. In particular, two general problems are connected with a subsidy scheme. First, if the subsidy is provided directly to banks – in the form of relaxed regulatory constraints, a reduction in taxes, or an outright transfer payment – then the problems of inadequate and perverse compliance incentives remain. Banks will be encouraged, as they are now, to find cheap or fast methods of proving compliance with the statute. Some of these methods, such as the scheme allegedly masterminded by Fleet Financial Bank,109 may do nothing to enhance community development and leave borrowers worse off.

The second general approach to subsidization is to offer the reward directly to borrowers who meet certain qualifications, perhaps in terms of income or in terms of the neighborhood of the residence for which the loan is

109 See supra text accompanying notes 95-97.
intended. However, direct subsidies to consumers can also have some undesirable incentive effects.

Suppose, for example, the subsidy is in the form of mortgage insurance, such as that provided by Federal Housing Authority ("FHA"). Such insurance schemes may weaken the incentives of borrowers to protect the value of the underlying asset, a problem generally known in the insurance literature as moral hazard. Certainly one of the reasons a homeowner makes investments in maintaining and improving one's property is to maintain or enhance its value to a prospective buyer. If the homeowner's mortgage payments are insured by the government, the option of stopping payments and forfeiting the property will probably be less costly. As the costs of letting the property decline in value fall relative to the costs of upkeep, one should expect to see less effort put into maintaining the property. In addition to the potential effect on the incentives of homeowners, an insurance scheme has the more familiar moral hazard problem affecting banks: to the extent that lenders are shielded from the consequences of default, they have incentives to pass poor risks on to the public treasury.

Some of the problems outlined earlier in connection with the merger process might reappear if a subsidy approach were used in connection with expansion applications. Suppose, for example, the merger process is streamlined for a bank with high CRA ratings. If third parties are allowed to intervene and contest the bank's CRA performance, then some of the rent-seeking behavior currently associated with the statute's enforcement would remain. Although firms whose real reason for opposing the merger of two rivals is fear of competition would no longer be able to use the CRA to block the merger, they would still have incentives to file CRA protests in order to delay the merger.

110 The FHA sponsors a number of mortgage insurance programs. For single family mortgage insurance, the FHA uses the value of the property to determine eligibility. Maximum property values are set according to a percentage of the median home price in an area, or according to the figures given in the Federal Home Loan Mortgage Corporation Act. The FHA also has guidelines for maximum loan to value ratios. FHA programs require an up-front mortgage premium payment, and the term cannot exceed 30 years. See 24 C.F.R. § 203.18. The low cost and moderate income mortgage insurance program sets eligibility according to income levels and restricts the program to properties worth less than a given dollar amount. See 24 C.F.R. pt. 221 (1998). For information on the development of government mortgage insurance programs, see Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 394-96 (1994).
These problems suggest that although a subsidy scheme would be superior to the existing framework, it would not necessarily eliminate all of the undesirable features observed in the present regime. Whatever its form, any subsidy would have the desirable effect of removing the long run disincentive, existing in the present enforcement regime, for banks to move into areas that are currently considered to be under-served. Moreover, any subsidy would remove the private compliance costs of banks as a political issue, allowing a more open discussion of the societal costs of compliance with statute. However, beyond these two significant benefits, the relative merits of alternative subsidy schemes would have to be considered in light of the incentive issues raised in each proposal.

The ideal subsidy would probably go directly to the purchaser in the form of a fixed sum, in order to improve the purchaser’s ability to meet the requirements of lenders. Perhaps the simplest scheme would be a tax deduction for individuals who purchase homes in certain communities. The tax deduction approach could be expanded for money donated to funds or firms that specialize in community development. The fixed-sum subsidy to consumers would avoid the moral hazard issues raised above. In addition, the fixed-sum to consumers, as a substitute to the current enforcement approach, would entirely avoid the rent-seeking behavior described earlier in this paper.

The subsidy to consumers would raise the problem of determining the specific areas in which consumers could qualify for the tax deduction or transfer payment. But this is an issue that can be resolved easily on a statistical basis. Census figures would permit regulators to easily determine the communities in which investment should be encouraged. Indeed, it would be far easier to determine the communities in which investment should be encouraged than to determine whether a particular bank had really made serious efforts to lend in such a community.

B. Comprehensive Community Redevelopment and Current Legislative Proposals

An alternative to the pure subsidy approach outlined above is an attempt to deal directly with the root causes of economic decline in inner-city communities. To date, the one legislative proposal that combines a subsidy approach to CRA enforcement with a comprehensive approach to revitalizing these communities is the American Community Renewal Act of 1997,111

sponsored by Republican representatives J. C. Watts of Oklahoma and Jim Talent of Missouri and Democratic representative Floyd Flake of New York. The bill would create 100 “Renewal Communities” across the country and would also focus on supporting families and rebuilding neighborhood institutions in the areas selected. These communities would be chosen based on the existence of pervasive poverty and economic distress. Incentives such as tax credits, regulatory relief, and low-interest loans would be offered to businesses and individuals who invested in these neighborhoods. By making certain approved types of investments in Renewal Communities, banks would be able to satisfy their obligations under the CRA.

Although the comprehensive-community approach of the Watts-Talent proposal makes the mistake of keeping much of the current CRA enforcement framework intact, it offers the hope of going considerably further than would a subsidy approach in addressing the under-investment problem. As we noted earlier, banks are unlikely to lend to businesses or home purchasers in communities in which the local businesses and property owners themselves are unwilling to invest. By increasing the level of investment in declining communities, the bill would reduce the risk faced by banks considering whether to lend in these communities. This, in turn, should reduce the size of the subsidy needed to induce banks to increase their lending.

Another active legislative proposal that seeks revisions to the CRA is the Community Reinvestment Improvement Act of 1997. Sponsored by Republican representative Bill McCollum of Florida, the legislation sets forth a modified evaluation procedure for certain mid-sized financial institutions that have received CRA ratings of “satisfactory” or better and are in compliance with the Equal Credit Opportunity Act. It also introduces what is

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113 See id. § 102.
114 See id. §§ 2(b), 102.
115 See id. § 403.
116 See supra Section III.B.
known as a "safe harbor" provision, which would prevent the denial of requests for new facilities on CRA grounds if an institution has received a CRA rating of "outstanding" or "satisfactory" in the two years preceding the request. The safe harbor concept has generated a great deal of controversy over the last several years. As proposed in the Community Reinvestment Improvement Act, the safe harbor simply allows institutions that have performed well under the CRA to escape additional CRA scrutiny when they expand.

Safe harbor proposals solve only some of the CRA's problems. To the extent they remove the merger process as focal point for enforcement, they are desirable. However, they do little to affect the long run disincentives for community development created by the statute. To remove the disincentives, a subsidy or abandonment of the current enforcement process is necessary.

VI. CONCLUSION

The CRA, as it is currently enforced, is of doubtful value as a mechanism for encouraging or promoting investment in economically declining inner-city communities. The enforcement framework fails to provide adequate incentives for banks to comply with the goals of the statute and in some cases provides perverse incentives. It is time for Congress and banking regulators to redesign the enforcement process with a view toward subsidizing community investment efforts.

118 See id. § 4.
119 Many opponents argue that safe harbors let financial institutions escape their community lending responsibilities too easily. "Outstanding" and "Satisfactory" CRA ratings are what the vast majority of financial institutions receive, therefore safe harbors can make it very difficult for community groups to challenge an institution's CRA performance. Safe harbor proponents, on the other hand, argue that a bank which meets its CRA obligations should not be held hostage to the threat of community group protests whenever it contemplates expansion.