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Chapter 9

Modes of Credit Market Regulation

Michael S. Barr

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

In response to these and other concerns, Congress has enacted a wide range of federal laws and subsidy programs that affect the provision of credit (see White, 2003). This chapter provides an

1. This chapter is adapted from Barr (2005) and appears with permission. The chapter focuses on home mortgage lending, which is an important aspect of financial security for low- and moderate-income households, has attracted the greatest attention in the literature, and has different market and regulatory features from other forms of credit. Consumer debt and transactional services are discussed in Barr (2004).

introduction to five types of federal laws that have been enacted to help overcome barriers to credit. These include laws on:

—disclosure (the Home Mortgage Disclosure Act, HMDA, and Truth in Lending Act, TILA);

—affirmative obligation (the Community Reinvestment Act, CRA);

—negative prohibition (the Equal Credit Opportunity Act, ECOA);

—product regulation (the Homeowner's Equity Protection Act, HOEPA);

—and government subsidies (Federal Housing Administration (FHA) home mortgage insurance, and the Government Sponsored Enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system).

I first set out a short theoretical framework, then compare these modes of credit market regulation with one another. I also suggest cross-modal strategies to enhance enforcement of the norms underlying these laws. By cross-modal strategies, I mean initiatives undertaken under one regulatory authority to advance norms of another regulation. For example, disclosure can be used to enhance negative prohibitions regarding racial discrimination. Cross-modal strategies hold out the promise of improving how these different modes of credit market regulation can be mutually reinforcing. Given the scope of the topic, this brief treatment is necessarily tentative and suggestive.

[1]Theoretical Foundations[end]

The theoretical support for governmental home mortgage credit market policies derives from three bases. First, market failures from imperfect information, collective action problems, agency costs,

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2. Subprime refers to 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 specialize in lending to such borrowers.

and neighborhood externalities are more acute in low-income neighborhoods and for low-income borrowers than in credit markets generally. Second, regulations seek to combat discrimination against minority borrowers and communities, both directly and by overcoming market failures that plague low-income communities, given the significant correlation between race and income, and between the race of homeowners and the racial composition and income of neighborhoods. Third, regulations could help to break down inefficient barriers between the bifurcated prime and subprime credit markets by enhancing competition and by helping to complete the mortgage market.[3]

[2]Market Failures[end]

Credit market imperfections impede lending in low- and moderate-income communities. First, information externalities and asymmetries may lead to credit rationing that excludes credit worthy borrowers and causes banks to overlook profitable loans (Ordover and Weiss, 1981). Information asymmetries can result in credit rationing of credit-worthy borrowers (Stiglitz and Weiss, 1981). Information externalities can produce credit constraints in low-income communities because the efficiency of bank lending is in part a function of "market thickness" (Lang and Nakamura, 1993).[4] Second, collective action problems exacerbate information externalities and inhibit entry into these communities (Petersen and Rajan, 1995). CRA and other regulation could help to mitigate these credit constraints by providing "an effective commitment device to coordinate lending…." (Zinman, 2002). Third, agency costs make it difficult to align corporate interest in profitable lending with the behavior of

3. Some regulations are pursued in order to foster housing consumption more generally, in the belief that homeownership is good for society, but as this aim is not focused on low- and moderate-income households, I discuss it only in passing.

4. Market thickness refers to the amount of economic activity in a market.

loan agents. Lastly, neighborhood externalities provide grounds for governmental intervention (for example, Guttentag and Wachter, 1980; Galster, 1987). Government policies designed to increase access to credit and homeownership can help to turn neighborhoods around, increasing property values for adjacent properties and neighborhoods (Ellen and others, 2001; Schill and others, 2002).

[2]Racial Discrimination[end]

The standard view is that, in the long run, in a perfect market, discrimination will disappear (Becker, 1971). Competition undoubtedly puts pressure on racial and other forms of discrimination. Yet this model assumes that only racial animus is illegal, while statistical discrimination, in which lenders use factors correlated with race as proxies for creditworthiness, in fact violates ECOA (see Federal Financial Institutions Examination Council, 1999). Moreover, credit rationing and segmented markets mean that discrimination in loan denials and price can persist in competitive markets. If credit rationing occurs, identical marginal applicants will be treated differently, and lenders will not charge differential prices to sort borrowers by risk. The single-price model accurately describes the prime credit market dominated by banks and thrifts, while the subprime market differentiates by risk. Since lenders in credit-rationing models do not provide loans to all members of a class of identical loan applicants, they could discriminate without losing profits (absent legal liability under antidiscrimination laws). Statistical discrimination could be profitable if race is correlated with an aspect of creditworthiness that is costly to observe directly. Still, statistical discrimination will be less accurate than a direct measure of creditworthiness. As technological innovation drives down the costs of obtaining such measures, one would expect even statistical discrimination to diminish in competitive markets over the long term (Greenbaum, 1996).

The evidence on discrimination in credit markets is hotly contested (Ross and Yinger, 2002). Disparities in the rates at which whites and African Americans are denied home mortgage loans continue to be large. Controlling for creditworthiness and other factors that legitimately affect lending decisions, economists at the Federal Reserve Board of Boston found that African Americans were nearly twice as likely as whites to be denied home mortgage loans (Browne and others, 1992, 1996). The study has come under a barrage of attacks, but rebuttals have affirmed the study's central findings (Ross and Yinger, 2002). Matched pair testing has also found differential treatment (for example, Turner and Skidmore, 1999). These disparities suggest disparate treatment of, or disparate impact on, minorities (Ross and Yinger, 2002, p. 211). In sum, "extensive underwriting discrimination existed in 1990, and there is no more recent evidence to show that this discrimination has gone away" (Ross and Yinger, 2002, pp. 367–68).

In addition to discrimination in loan denials, price discrimination can also occur because of market fragmentation (for example, Ayres, 2002). Prime lenders offer a single price to borrowers who meet their criteria and ration credit among the others. Subprime lenders offer differential pricing of loans based on risk and other factors. Although the growth of risk-based pricing in the subprime market has broadened the eligible pool of borrowers, differentiated pricing may also result in racial discrimination. Using credit scores, creditors can determine the price at which they would be willing to lend to a particular borrower, but the subprime market's fragmented nature prevents all potential borrowers from learning about lenders' pricing schemes. This permits lenders to distinguish among similar borrowers in pricing loans. Creditors price loans based on factors other than risk, including a borrower's willingness to pay. Differential pricing can lead to systematically different prices for minorities than for whites.

Price discrimination occurs in a range of credit markets (for example, Ayres and Siegelman, 1995; Ayres, 2001, 2002; Ross and Yinger, 2002). For home mortgages, studies have focused on overages, the amount by which negotiated loan rates exceed the lender's minimum rates set forth on rate sheets for loan officers. Strikingly, African Americans more often pay overages, and much higher ones, than whites (Ross and Yinger, 2002, pp. 223–27, 307). African Americans fare worse in negotiations with mortgage brokers and loan officers (Buist, Linneman, and Megbolugbe, 1999; Ross and Yinger, 2002, p. 307; Black, Boehm, and DeGennaro, 2003).

[2]Problems in the Subprime Sector[end]

Banks and thrifts have increased their lending to low- and moderate-income borrowers, but subprime lending has grown dramatically at the same time. Subprime lenders specialize in making loans to borrowers with impaired or limited credit history. Most subprime loans are refinance loans. Although refinancing may be used to obtain better rates, subprime refinance loans are usually used for home improvement or consumer purchases, to pay for education expenses, or to consolidate other consumer debt.[5] With new sources of funding available from the secondary market, and advances in information and risk management, subprime lending has grown sevenfold from 1994 to 2002, reaching $241 billion, or 9 percent of the market.[6]

The subprime market is plagued by serious problems. Between 10 and 35 percent of subprime borrowers who could have qualified for loans from prime lenders end up in the subprime market, paying higher rates (Freddie Mac, 2002). While credit risk is a key determinant of receiving a prime or subprime

5. National Home Equity Mortgage Association (2004, www.nhema.org/About/Questions.htm)
6. Remarks by Edward Gramlich at the Texas Association of Bank Counsel, October 9, 2003.

loan, "credit risk alone may not fully explain why borrowers end up in the subprime market" (Courchane, Surette, and Zorn, 2004). For example, borrowers who are older, Hispanic, or search less for interest rates are more likely to end up in the subprime market. Having a subprime loan is predictive of refinancing with a subprime loan, indicating that borrowers get stuck in the subprime market.

In addition, some minority borrowers may have been improperly steered to higher cost lenders. Moreover, studies have documented abusive practices in the sector (U.S. Department of the Treasury and U.S. Department of Housing and Urban Development [Joint Report], 2000; Barr, 2002). These practices have included flipping—repeatedly refinancing a loan in a short period. Loans have been packed with additional products (such as credit life insurance) without informing the borrower that the products were optional or unsuitable. Loans have included disguised fees. Brokers have made home mortgage loans without regard to the borrower's ability to repay. In other cases, "unscrupulous mortgage brokers, lenders, home improvement contractors, appraisers, and combinations thereof" engaged in "outright fraud" as well as "deceptive or high-pressure sales tactics," and often "prey[ed] on . . . the elderly, minorities, and individuals with lower incomes and less education . . . ." (Joint Report, 2000, p. 2).

The price that borrowers pay is a function not only of using a subprime lender, but also of negotiating with mortgage brokers, who dominate the subprime market. Brokers are compensated through yield spread premiums for getting borrowers to pay higher rates than those for which the borrower would qualify. In loans with yield spread premiums, there is wide dispersion in fees paid to mortgage brokers. Among borrowers paying yield spread premiums, African Americans paid $474 more, and Hispanics $590 more, than whites (Jackson and Berry, 2003, pp. 125–28; see also Guttentag, 2001). Minority and

white borrowers tend to go to different lenders, and the subprime lenders that minorities are more likely to use are also more likely to price aggressively (Ross and Yinger, 2002, p. 344).

Moreover, borrowers in the subprime market form a pool whose risk characteristics are worse and more widely dispersed than borrowers in the prime market (Pennington-Cross and Yezer, 2000). Although there is rough risk-based pricing in the subprime market, defaulting borrowers create an externality that raises interest rates on all subprime borrowers. Regulation of the subprime sector is in part a response to the problem of incomplete contracts. Borrowers cannot contract with one another to allocate the costs of the negative externality of default, which raises the cost to all borrowers, and foreclosures concentrated in low-income neighborhoods can also cause negative externalities to neighboring property owners.

Lending by subprime specialists does not replace lending by banks.[7] First, subprime creditors specialize in refinance loans rather than in home purchase originations. Subprime lenders free ride on the information generated by firms engaged in home purchase lending. Second, subprime lenders have failed to report credit scores for sound borrowers in order to capture the informational benefits from their investment. Therefore, the positive externalities from increased lending in low-income areas are not realized. Third, borrowing from a subprime lender signals to prime lenders that a borrower is a bad credit risk. Rather than increasing access to prime lending, subprime borrowing helps to keep borrowers in the subprime market, where borrowers pay more for credit. Fourth, minority households are much more likely to pay higher fees and to remain stuck in the subprime market even after accounting for creditworthiness.

7. For the remainder of this chapter, the term bank refers to banks and thrifts.

[1]Modes of Credit Market Regulation[end]

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 (for example, Stiglitz, 2000, pp. 8–10). The extent of these problems cannot be assessed in the abstract. One needs to compare systems for redressing market failures.

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 ECOA,[8] bar discrimination against minority borrowers. Third, disclosure laws may be thought of as having two subtypes. Some laws, such as the HMDA,[9] assist in the enforcement of other legal rules or social norms by requiring public disclosure of lending data. Other disclosure laws, such as the TILA,[10] rely on providing information to consumers to ensure a well-functioning market, backed by enforcement of the disclosure requirement. Fourth, Congress enacted substantive regulation of loan products in the HOEPA.[11] Fifth, government subsidies are pervasive in the housing credit market. (White, 2003). I focus

8. 15 U.S.C. 1691–1691f.

9. 12 U.S.C. 2801. The Federal Reserve Board implements HMDA under Regulation C, 12 C.F.R. pt. 230.1.

10. 15 U.S.C. 1601, 1602(aa), 1639(a)–(b). The Federal Reserve Board implements TILA under Regulation Z, 12 C.F.R. pt. 226.1.

11 P.L. 103–325, 151, 108 Stat. 2190 (1994).

here on the GSEs and FHA. Further comparative institutional analysis based on empirical research will be critical to understanding the relative efficiency of these laws.

[2]Affirmative Obligation[end]

The Community Reinvestment Act of 1977 (CRA),[12] enacted in response to concerns about redlining of minority and low-income areas[13] and market failures in low-income communities, 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. Federal banking agencies examine banks periodically on their CRA performance and rate the institutions. Regulators consider a bank's CRA record in determining whether to approve that institution's application for a deposit facility, which encompasses mergers with or acquisitions of other depository institutions. Such applications also provide the public with an opportunity to comment on the CRA performance of the institution.

CRA has strengthened over time, particularly during the 1990s, because of both legal and market developments. Legislative changes to CRA enacted in 1989 required regulators to disclose publicly the institution's rating and performance evaluation.[14] Also in 1989, a bank regulator denied for the first time, on CRA grounds, an application for merger.[15] Changes to the regulations implementing CRA issued in

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

13. See, for example, 123 Cong. Rec. 17, 604 (1977) (statement of Senator 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 market failures and discrimination are intertwined.

14. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, P.L. 101–73, 103 Stat. 183 (1989).

15. Continental Bank Corporation, 75 Fed. Reserve Bull. 304 (1989).

1995[16] focus CRA evaluations on objective performance measures rather than more process-oriented factors that regulators had previously used. These regulations require banks to disclose information about their small business, small farm, and community development lending. Under the 1995 regulations, large banks, small banks, and wholesale or limited-purpose institutions have tailored examinations. Large banks are evaluated on a three-part test of lending, investments, and services. Institutions are rated outstanding, satisfactory, needs to improve, or substantial noncompliance.

These changes occurred during a time of increasingly intense consolidation in the banking industry, providing greater opportunities for community organizations and regulators to evaluate bank performance under CRA in merger applications. With the passage of the Gramm-Leach-Bliley Financial Modernization Act of 1999,[17] CRA was again strengthened. 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.[18]

CRA has been since its enactment, and remains today, the subject of extensive debate. Legal scholars question vigorously the theoretical and empirical claims that motivated CRA, and many advocate eliminating the policy (for example, Gunther, 2000; Lacker, 1995; Macey and Miller, 1993; White, 1993). These critics argue that CRA is trying to address a nonexistent problem, and that even if intervention is warranted, CRA is the wrong policy to pursue. Critics suggested that CRA was having little, if any, positive effect, and at a high cost (Macey and Miller, 1993). In a related article, (Barr, 2005) I

16. 12 C.F.R. 228.41 et seq. (2004).
17. P.L. 106–102 (1999).
18. 12 U.S.C. 2903(c) (2000); Id.1843 (l) (2) (2000).

systematically rebut prior criticisms of CRA and lay a solid theoretical and empirical foundation for the act. A summary of those findings follows.

[3]Empirical Evidence That CRA is Effective[end]

With impetus from CRA, lenders have:

—formed multibank Community Development Corporations (CDCs) and loan consortia to reduce risk, overcome collective action problems, and share the costs and benefits of developing information about low-income markets;

—invested in locally based Community Development Financial Institutions (CDFIs) to develop specialized market knowledge, share risk, and explore new market opportunities;

—engaged in special marketing programs to targeted communities;

—experimented with more flexible underwriting and specialized servicing techniques to determine if a broader range of applications could be approved without undue risk;

—and funded credit counseling to improve the creditworthiness of potential borrowers.

Many larger institutions have developed specialized units within their organizations that focus on the needs of low- and moderate-income communities. A positive lending cycle has begun in many communities: once lenders know that others will be making loans to a community, they face less liquidity risk, gather and disseminate information more quickly, and produce positive information externalities. Experience suggests that increased lending to low-income communities has occurred, and that such lending has not led to the kind or the extent of unprofitable, excessively risky activity predicted by critics.

Studies have found evidence that CRA improved access to home mortgage credit for low-income borrowers during the 1990s, as CRA enforcement increased (Evanoff and Siegal, 1996; Avery and others,

1999).[19] Brookings-Joint Center on Housing research that I directed at the Treasury Department found that between 1993 and 1999, depository institutions covered by the CRA and their affiliates made nearly $800 billion in home mortgage, small business, and community development loans to low- and moderate-income borrowers and communities (Litan and others, 2000, 2001).[20] The number of CRA-eligible mortgage loans increased by 39 percent between 1993 and 1998, while other loans increased by only 17 percent (Litan and others, 2000, p. ES-3). Even excluding affiliates, banks increased their lending to low- and moderate-income borrowers and areas by 10 percent, compared with no growth at all for these lenders in their other markets (Litan and others, 2000, p. 46). Over this period, the portfolio share of CRA-covered lender and affiliate loans to these borrowers and areas increased from 25 to 28 percent (Litan and others, 2000, p. ES-4).

In the prime market, banks and their affiliates increased their market share of lending to low- and moderate-income borrowers and areas from 66 percent in 1993 to 71 percent in 1998 (Litan and others, 2000, p. ES-7). Yet the dramatic expansion of the subprime refinance market meant that banks lost 2 percentage points in market share overall among low- and moderate-income borrowers and communities (Litan and others, 2000, p. 43). Banks increased their home purchase lending, while others focused on subprime refinance loans.

A series of factors 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 other households. Real interest rates for mortgages were at low levels during much of this period. Second, innovation helped

19. See also Barr and others (2001), Canner and Smith (1991), Avery and others (1996), and LaCour-Little (1998).
20. For further analysis of these reports, see Belsky, Schill, and Yezer (2001).

drive down the costs of assessing creditworthiness, offering mortgage products, effectuating transactions, and funding loans through securitization. Third, consolidation in the financial services sector heightened the importance of CRA on major transactions, and enhanced competition for the delivery of credit in low-income communities. Fourth, CRA, HMDA, ECOA, FHA, and the GSE Affordable Housing Goals, all operated in intensified ways during this period.

Controlling for the effects of these factors, however, research found that CRA lenders increased their CRA-eligible home purchase lending faster than those not regulated by CRA from 1993 to 1999 (Litan and others, 2000, p. ES-4). Similarly, analysis of CRA lending across metropolitan areas reinforces the view that CRA helps expand access to home mortgage credit for low- and moderate-income borrowers (Litan and others, 2000, p. 36). Analysis controlling for economic, demographic, and market factors found that CRA increased access to credit (Belsky, Schill, and Yezer, 2001, p. 22). The Joint Center for Housing Studies report concluded:

[blockquote]CRA-regulated entities still lead the market in the provision of mortgage capital to lower-income people and communities, especially lower-income minorities. Detailed multivariate analysis confirms that CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if CRA did not exist (2002, p. 135).[end]

Evidence from small business markets reinforces the view that CRA has been effective (Zinman, 2002, p. 2). One study suggests that CRA increases the number of firms that can access credit by 4 to 6 percentage points (Zinman, 2002, p. 20), providing benefits to the real economy—increased payrolls and reduced bankruptcies—without crowding out other financing available to small businesses or adversely affected bank profitability or loan performance (Zinman, 2002, p. 3).

Changes in financial services industry may mean that CRA covers less of the financial services world. Banks' and thrifts' share of financial assets has declined dramatically since the end of World War II, from 60 percent to about 25 percent today. Although assets subject to CRA are declining as a share of financial assets, such assets continue to grow in absolute terms. Moreover, as CRA-covered institutions develop new products, train employees, and alter organizational structures to meet the credit needs of low-income communities, such changes influence affiliates. 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 2001–02, has picked up again, and long-term forecasts suggest that more will likely come (McKinsey, 1997). Furthermore, the Gramm-Leach-Bliley Act made expansion into new activities contingent on banks' CRA performance. Banking organizations will have to pay attention to their CRA performance for many years to come, as they seek to enter new financial markets. In sum, recent evidence shows that CRA provides important benefits to low-income communities, and these benefits are likely to continue. Other factors undoubtedly contributed to the growth in lending to low-income communities during the 1990s, but careful studies have found support for an independent and important role for CRA.

[3]Costs of CRA Have Been Overstated[end]

A Federal Reserve Board report issued in 2000 found that most institutions responded that CRA lending was profitable or marginally profitable (Board of Governors, 2000, pp. xvii, chart1a; xix, chart 3a; xxi, chart 5a; xxiii, chart 7a.). CRA loans appear not to be overly risky (Board of Governors, 2000, table 3c). Pushing further into low-income markets has not weakened banks' profitability and soundness. In the small special programs serving as banks' laboratories, employing new and innovative strategies, 61

percent of respondents still found CRA special programs to be profitable (Board of Governors, 2000, table 14a). Moreover, most institutions reported low delinquency and charge-off rates; the median charge-off rate on these programs was zero (Board of Governors, 2000, table 14c).

[3]CRA Reasonably Addresses Market Failures[end]

CRA helps to overcome market failures in low-income communities. Fostering competition among banks in serving low-income areas leads to larger volumes of lending from diverse sources add liquidity to the market that decreases the riskiness of each bank's loan. CRA has helped banks in developing specialization in serving low-income communities, including innovation in developing products that meet the credit needs of low-income areas with manageable risks, and specialization in serving particular areas through partnerships with community-based organizations and CDFIs. CDFIs demonstrated the possibility of lending in low-income communities, provide local expertise and financial education, and take portions of risk that banks do not want to bear. In turn, banks have invested in CDFIs in record numbers, largely spurred by the CRA investment test. Investments in CDFIs strengthen the ability of banks to serve low-income markets. As banks offer services once only offered by CDFIs, the local institutions move further downstream, reaching lower-income or harder-to-serve borrowers, and developing new approaches that mainstream institutions may later find cost effective.

CRA also provides a precommitment device that helps banks coordinate lending to reduce information costs. Because CRA requires all insured depositories to lend in their communities, it reduces free rider problems. CRA has spurred the development of loan consortia to serve low- and moderate-income communities more effectively. Moreover, banks get CRA consideration for both originating and purchasing eligible loans, creating a trading system. Institutions can rely on the origination expertise of

others by purchasing 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 about the performance and profitability of CRA lending.

CRA permits banks to respond to local needs based on their own organization, market assessments, and business plans, without being judged on the basis of national norms. Banks help to shape the content of the standard, not merely through the notice and comment rulemaking process, but also in CRA's application to their local context. CRA also permits greater citizen participation in the application of the rule. This enhances local organizations that in turn improve the performance of loans made in their community. While public involvement adds to the costs of CRA, these benefits of civic engagement, including its expressive benefits (see Anderson and Pildes, 2000), should be weighed also.

The form of CRA's legal directive, as a standard, rather than as a rule, is also desirable for other reasons. CRA's broad standards and public enforcement mechanisms provide for an interplay, a conversation, between banks and communities that is one of CRA's chief virtues. A rule setting forth lending requirements would cut off this dialogue. It would also send a message that banks are to disregard creditworthiness, business strategy, and local context, which is not the goal of CRA. Moreover, 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.

[2]Negative Prohibition[end]

ECOA prohibits creditors from discriminating in the provision of credit based on "race, color, religion, national origin, sex or marital status, or age."[21] For home mortgage lending, that prohibition is also reinforced by the Fair Housing Act of 1968.[22] Both intentional discrimination (as measured by disparate treatment) and statistical discrimination (as measured by disparate impact) are prohibited by ECOA. ECOA's rule that statistical discrimination is prohibited, as opposed to a rule that subsidized creditors for deciding not to engage in such discrimination, is based on our deeply rooted sense that distinctions based on race, even if rational in the short run, are wrong. Thus the law prohibits the conduct rather than subsidizing adherence to the rule.

Disparate treatment can be proved using direct evidence that the lender considered the race (or other prohibited factor) of the applicant. Disparate treatment may also be proved using comparative evidence based on statistical inferences of differential treatment on a prohibited basis that cannot be explained by valid factors. Given the complexity and proprietary nature of credit scoring systems, and the difficulty of proving that any two applicants are similarly situated except for their race, disparate treatment proof is hard to make out. Lower courts and commentators have assumed that, as with employment discrimination, credit discrimination may also be proved using disparate impact analysis (Kushner, 1995; Ross and Yinger, 2002, p. 314; Mahoney, 1998). The text, history, structure, and purposes of Title VII and the Fair Housing Act are similar. Moreover, in amending the Fair Housing Act in 1988, Congress discussed the disparate impact standard then well developed under Title VII, and assumed that it would apply to the Fair Housing Act without the need for explicit provisions.

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21. 15 U.S.C. 1691.

Disparate impact analysis is essential for combating disparate treatment. Disparate impact analysis is also designed (or ought to be designed) to ferret out policies that create unnecessary "headwinds" toward the full inclusion of racial minorities in society.[23] Disparate impact analysis permits regulators to eliminate the use of credit factors that are correlated with race when factors that are less correlated with race but just as predictive of creditworthiness could be used. Unfortunately, current regulatory practice, which focuses on file review and post review regressions, is not designed to address problems of disparate impact (Ross and Yinger, 2002).

ECOA does seem to help increase lending to minorities. For example, the share of bank and thrift lending to low- and moderate-income borrowers and areas that went to minority borrowers increased from 21 percent in 1993 to 28 percent in 1999. Most of the increase occurred during a period of intense Justice Department focus on enforcing fair lending laws, from 1993 to 1995 (Litan and others, 2001, p. 27).[24] HMDA data also show improvements in lending to minority and low-income borrowers, although HMDA data need to be treated with caution (Joint Center for Housing Studies, 2002). From 1993 to 1999, the

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22. 42 U.S.C. 3605. The Fair Housing Act also covers other forms of discrimination in residential real estate transactions beyond fair lending violations.

23. See *Griggs* v. *Duke Power*, 401 U.S. 424, 432 (1971).

24. The Justice Department cases resulted in important consent decrees. See Consent Agreement, *United States* v. *Long Beach Mortgage Company*, CV-96-6159 (C.D. Cal., Sept. 5, 1996); Consent Agreement, *United States* v. *First National Bank of Vicksburg*, 5-94-CV-6(B)(N) (S.D. Miss., Jan. 21, 1994); Consent Agreement, *United States* v. *Shawmut National Corporation*, 93-CV-2453 (D. Conn., Dec. 13, 1993); Consent Agreement, *United States* v. *Decatur Federal Savings and Loan Association*, 1-92-CV-2198-CAM (N.D. Ga., Sept 17, 1992).

number of home purchase loans made to Hispanics increased 121.4 percent; to Native Americans, 118.9 percent; to blacks, 91.0 percent; to Asians, 70.1 percent; and to whites, 33.5 percent.[25]

Other laws help to enforce ECOA's norms. For example, CRA may help to remedy some practices with discriminatory effects that both disparate treatment analysis and disparate impact analysis as they are currently formulated have a hard time detecting or remedying, such as discriminatory overages, or segmented markets in which whites and minorities tend to go to different lenders with significantly different lending practices.[26]

Moreover, relying on ECOA lawsuits alone to advance antidiscrimination norms has 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 them 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 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 (Ross and Yinger, 2002).

25. HMDA data are available at www.ffiec.gov/hmcrpr/hmda03.pdf.

[3]Cross-Modal Strategies[end]

ECOA's weaknesses do not necessarily imply that it should be abandoned. ECOA itself sets out important antidiscrimination norms, and should be strengthened. Still, some credit market barriers affecting minority borrowers may be remedied more readily using cross-modal strategies under affirmative obligation, product regulation, and disclosure. Building on the strength of HMDA, Congress could enact a disclosure law requiring creditors to disclose the borrower's credit score and the creditor's rate sheet to help address price discrimination. Brokers could be required to disclose prominently that they represent the creditor, not the buyer. A new law on product regulation could bar the payment of yield spread premiums, which disproportionately fall on minority borrowers, and which consumers are ill-positioned to understand or monitor (Jackson and Berry, 2003).

Furthermore, CRA plays an important role in reinforcing the antidiscrimination principles underlying ECOA and in expanding access to credit for minority borrowers. Minority households are disproportionately represented among low- and moderate-income households and in low- and moderate-income communities. CRA has encouraged banks to increase their lending in such communities, and minority households now constitute a larger share of such lending than they did a decade ago. CRA's focus on low-income neighborhoods may address structural inequalities facing African Americans and other minorities more effectively than ECOA's disparate impact standard, which is hemmed in by equal

26. See, generally, Ross and Yinger (2002). But see *Cason* v. *Nissan*, 3-98-0223, (M.D.T.N. May 25, 2001) (ECOA suit based on discriminatory overages in automobile market leading to settlement order).

protection jurisprudence and the business necessity defense.[27] Moreover, CRA goes beyond ECOA's focus on credit discrimination to address broader market failures affecting low-income communities.

[2]Disclosure[end]

HMDA requires most home mortgage creditors annually to disclose to the public information about home mortgage loans made or purchased, as well as loan applications denied.[28] Regulations require disclosure of race, ethnicity, sex, and income of borrowers. Unlike TILA,[29] HMDA is not designed to enhance borrower information. Rather, HMDA is designed 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. 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 undoubtedly helped to spur changes in creditor practices.

Disclosure laws are perennial favorites in the legal literature (for example, Jolls, Sunstein, and Thaler 1998; Camerer and others, 2003). I agree that disclosure can help to improve the home mortgage credit

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27. See, for example, Primus (2003) (lamenting "the growing tendency of equal protection jurisprudence to obscure the dynamics of group hierarchy and to truncate the memory of historical discrimination").

28. 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.

29. TILA was designed to help consumers compare the costs of credit offered by requiring the disclosure of the Annual Percentage Rate (APR), the finance charge, the amount financed, and the total of all payments. The theory was that enhanced disclosure would improve price information and thereby enhance competition. See Schwartz and Wilde (1979) arguing for disclosure rather than product regulation. Unfortunately, TILA is extraordinarily complex. See, for example, *Emery* v. *Am. Gen. Fin., Inc.*, 71 F. 3d 1343, 1346 (7th Cir. 1995) (Posner, J.) ("So much for the Truth in Lending Act as a protection for borrowers.").

market. However, I take issue with disclosure advocates on three grounds. First, disclosure serves a broader set of purposes than usually posited. Second, I have a healthier dose of skepticism about the effectiveness of disclosure in helping households than legal scholars have recently espoused.[30] Third, I argue that disclosure is no substitute for CRA or the underlying substantive prohibitions contained in ECOA.

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 toward compliance with social norms. TILA represents the first type, requiring disclosures to individual consumers regarding the cost of loans that they negotiate, calculated as an APR.[31] This type of disclosure seeks to remedy asymmetric information and improve market competition and efficiency.[32]

HMDA represents the second type of disclosure, requiring information not only for the consumer but also for regulators and the market generally. These broader disclosures reinforce positive social norms, promote market efficiency, and enhance the regulatory effectiveness of other laws.[33] The collection and public disclosure of information is the essential underpinning of CRA, ECOA, and HOEPA in expanding

30. See Camerer and others (2003) suggesting that disclosures respond adequately to consumers' need for information about loans.

31. 12 C.F.R. pr. 226.18(e), 226.4(a).

32. See Congressional Findings and Declaration of Purpose for TILA, 15 U.S.C. 1601; Engel and McCoy (2002); Schwartz and Wilde (1979, p. 635) "Because more consumers will become informed if information acquisition costs are decreased, reducing these costs is thought to be the preferable response to the problem of imperfect information."

33. The Federal Reserve Board amended its HMDA regulations to require lenders to report certain price information about high-cost loans. HMDA reporting could be improved further by requiring information on interest rate and fees.

access to credit. Public debate over this performance likely contributed to increased lending to minorities in the 1990s.

The form of the legal directive can enhance compliance because the law helps to create social norms and to reveal instances in which actors transgress those norms. 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 is taken under ECOA, and even if no mergers are denied under CRA, HMDA data can change creditor behavior. That may be so because the public cares, in general, about the social norm of equal access to credit, and because the creditors care about their reputation with the public. Conversely, the social norm may push behavior beyond what is efficient or fall short of what was intended by the promulgators of the standard.

Although TILA (and HOEPA's disclosure requirements) facilitate comparison shopping by consumers, in some cases too much information is provided for consumers to use, and in other cases too little. Even outside of the subprime market, there is little reason to think that consumers understand most aspects of mortgage transactions (Board of Governors and HUD, 1998; Willis, 2004). Decision theory suggests a need for simplicity: individuals faced with complex problems simplify them to one or two major decisions (Hogarth, 1987; Plous, 1993; Baron, 2000). In addition, mortgage brokers can take advantage of borrowers, who trust mortgage brokers to provide them with full and accurate information and to provide them with the best loan product. Yet it is in the broker's interest to provide the borrower with the highest-rate loan that the broker can convince the borrower to accept. Brokers can earn higher yield spread premiums for placing borrowers into more expensive loans than ones for which the borrower could qualify. Unlike retail consumer markets in which commodities are more difficult to price

differentially for each consumer (for example, Cheerios in supermarkets), individual transactions for home mortgages present the possibility for price discrimination based on sophistication and willingness and ability to shop for better terms (Jackson and Berry, 2003, p. 63).[34] With credit scoring, creditors know whether borrowers qualify for a less expensive loan, while most borrowers do not.[35]

The efficacy of disclosures is diminished by inadequacies in their nature and timing (Eskridge Jr., 1984; Landers and Rohner, 1979),[36] and consumers' cognitive limitations. (Renuart, 2003, pp. 421, 432). In one survey, 75 percent of respondents either agreed somewhat or agreed strongly that TILA statements for credit cards are complicated (Durkin, 2002, p. 201, 208). This effect is exacerbated for low-income and minority buyers, for whom alternative credit options are more limited. (Hogarth and Lee, 1999, 2000). Each of these problems is exacerbated in the subprime market, making disclosure laws even less likely to be effective. Consumers in the subprime market tend to be lower-income, have higher debt-to-income ratios, and lower creditworthiness than borrowers in the prime market. These factors leave them vulnerable as they search for creditors who will approve them for a loan (Zigas and Weech, 2001). Older and minority borrowers are disproportionately represented in the subprime pool and may be more susceptible to aggressive broker practices. Consumers in the subprime market may lack financial literacy and have fewer people in their communities that they can turn to for sound financial advice. Loan price and term dispersion is much higher in the subprime market than in the prime market, making it more difficult for consumers to understand the more varied and complicated loan provisions.

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34. Ayres (2002) has documented similar price discrimination in automobile sales and other markets.

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

36. Early disclosure is now required by Regulation Z, 226.19(b), 226.5a, 226.5b.

TILA's costs are difficult to measure. Surveys of banks estimate the cost of compliance with TILA at between 1.73 and 2.26 percent of total noninterest expenses, or $13 per loan. (see Elliehausen, 1998, p. 15 table 2, p. 18 note 38.) The most substantial cost of TILA may be produced by litigation over *de minimis* violations of its technical terms,[37] although consumer rights lawyers contend that TILA provides them with an opportunity to challenge contracts that ought to be challenged on other grounds but as to which there are significant legal hurdles.

Disclosures can and should undoubtedly be improved.[38] Moreover, financial education can play a role in helping consumers understand disclosures better. The problem is that financial education is notoriously hard to do well. Despite the significant consumer financial education that has been offered over many years, consumers exhibit a wide range of behavior in the extent to which they understand loan terms and

37. See, for example, *Rodash* v. *AIB Mortgage Co.*, 16 F. 3d 1142 (11th Cir. 1994) (holding that failure to include $22 express delivery charge and $204 intangible tax in finance charge for loan of $102,000 created right of rescission). Congress subsequently amended the act to deny rescission so long as the finance charge omitted from the APR calculation did not exceed $35. See 15 U.S.C. 1635(i)(2); *Reexamining Truth in Lending: Do Borrowers Actually Use Consumer Disclosures*, 52 Consumer Fin. L.Q. 3 (1998) ("Most of the [TILA] lawsuits we see involve technical mistakes with disclosures that have no practical meaning to the consumer."Statement of Robert Cook).
38. See, for example, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134 (proposed July 29, 2002,proposing significant simplification). But see Comments of the Staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission, Before the Department of Housing and Urban Development, in the Matter of Request for Comment on Proposed Amendments to the Regulations Implementing the Real Estate Settlement Procedures Act, Docket No. FR-4727-P-01 (Oct. 28, 2002) (arguing that HUD's proposal would not assist consumers).

shop for a mortgage (Hogarth and Lee, 1999, 2000).[39] Moreover, expenditures for it lead to positive externalities, so it is difficult to induce market participants to offer financial education to the public at the scale it would take to matter.

[3]Cross-Modal Strategies[end]

Disclosure laws are no substitute for other regulatory approaches. Relying on HMDA alone to overcome market failures and discrimination in theory could 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. Relying on HMDA data alone can lead to dramatic overstatements of lending discrimination. Similarly, HMDA data do not provide any context for understanding creditors' ability to lend in low-income communities, so banks might face undue pressure to make unsound loans. Conversely, relying solely on public disclosure could lead to "underenforcement" of equal protection and community investment norms. Without fair lending laws, HMDA's disclosure might convey less approbation. Without CRA, disclosure under HMDA that a bank did little lending in low-income communities would have little consequence. CRA puts strong incentives on banks, those most able to alter their behavior in response to the problem of information asymmetry and collective action.[40] CRA can enhance competition in fragmented markets where disclosures seem unlikely on their own significantly to affect market structure. CRA also enlists expert agencies to further its goals, rather than relying solely on the public to change creditor behavior in response to HMDA data or TILA disclosures.

39. There is no good data on whether this is because of different preferences as to search costs, see Stigler (1961) or because consumers do not understand that they can search, or how to search, for lower cost mortgages.

[2]Abusive Practice Prohibitions[end]

Congress enacted HOEPA[41] in 1994 to respond to unscrupulous lending practices in the subprime home equity mortgage market. For some high-cost loans, HOEPA imposes restrictions on certain contract provisions, provides for enhanced disclosures, and enhances remedies for violations.[42] HOEPA restricts prepayment penalties, balloon payments, and negative amortization under some circumstances. Lenders are forbidden from engaging in a pattern or practice of making high-cost loans without regard to the borrower's ability to repay from income (rather than from home equity). For any mortgage loan, the Federal Reserve Board has regulatory authority to prohibit acts or practices that the board finds to be unfair, deceptive, or designed to evade HOEPA. The board can also prohibit acts or practices concerning refinance loans that the board finds to be abusive or not in the interest of the borrower.

In addition to product regulation, HOEPA provides directly and indirectly for enhanced disclosures for borrowers facing high-cost loans. HOEPA directly enhances disclosure by requiring creditors to disclose mortgage terms three days in advance of closing. Indirectly, HOEPA product restrictions tend to drive more of the cost of the loan into the APR so that consumers can better understand the costs of the loan and comparison shop.

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40 Compare, for example, Calabresi (1970) discussing the "cheapest cost avoider."

41. P.L. 103–325, 151, 108 Stat. 2190 (1994).

42. HOEPA covers mortgage refinancing loans and closed-end home equity loans with annual percentage rates more than 8 percentage points above the yields on comparable Treasury securities or loans with certain points and fees that exceed 8 percent of the loan amount or an amount adjusted for inflation (just under $500 for 2004). The statute sets a default rate of 10 percentage points above comparable Treasuries, but the Federal Reserve Board has the authority to adjust downward to 8 percentage points or upward to 12 percentage points. The board adjusted the APR

HOEPA's record has been decidedly mixed (Joint Report, 2000). Given the characteristics of the lower-income consumer credit market—high demand from a population with imperfect or limited credit history, many lightly regulated players, and little competition from mainstream lenders—the potential for abuses is ripe. A Treasury-HUD report that I co-directed proposed a four-part approach to curbing predatory lending: improve consumer literacy and disclosure; prohibit harmful sales practices; restrict abusive terms and conditions; and improve overall market structure (Joint Report, 2000; Barr, 2002). 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.[43] This rule takes significant steps toward limiting abusive practices, but congressional action would improve matters further.[44] The board's requirement that creditors document and verify a borrower's ability to repay will help deter asset-based lending.[45]

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to 8 percentage points in 2001. Final Rule, Federal Reserve System, 12 C.F.R. Part 226, Truth in Lending, 66 Fed. Reg. 65604, Dec. 20, 2001.

43. Final Rule, Federal Reserve System, 12 C.F.R. Part 226, Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001).

44. Congress could bolster the Federal Reserve Board's action in a number of ways, including: banning the financing at or before closing of single premium credit insurance, products often packed into subprime loans; requiring lenders to report the full credit histories of borrowers to the credit bureaus; requiring lenders to offer the borrower a choice of a loan without a prepayment penalty; and including yield spread premiums in the points-and-fees trigger for HOEPA. See U.S. Department of the Treasury Comment on Regulation Z (Truth in Lending Act; Home Ownership and Equity Protection Act) Proposed Rulemaking Docket No. R-1090. Yield spread premiums permit lenders to pass on the cost of a mortgage broker fee to the borrower in the form of a higher interest rate rather than in the form of a cash payment at closing.

45. Stronger requirements might deter asset-based lending even more. See Joint Report (2000) suggesting documentation of ability to repay be signed by broker and acknowledged as received by borrower three days prior to closing.

Meanwhile, a number of states have experimented with a variety of different approaches to regulation of high-cost loans. This experimentation is leading to valuable data on how and whether one can use product regulation to deter abusive practices without cutting off access to home mortgage credit.[46] In the midst of these state law changes, the OCC announced that it would preempt state laws regulating home mortgage lending, as they relate to National Banks and their operating subsidiaries.[47] State laws as they relate to independent mortgage companies, holding company affiliates, and other banks and thrifts are unaffected.

[3]Cross-Modal Strategies[end]

Cross-modal strategies could help to reduce abuses. For example, enhanced disclosures could use public shaming and competition to reduce the scope for problems. Rule changes made in December 2001,[48] 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.[49] Requiring automatic disclosure of credit scores (and how they are used in conjunction with other borrower, property, and loan

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46. Compare, for example, Litan (2001, 2003) and Elliehausen and Staten (2002), with Quercia, Stegman, and Davis (2002), Stegman, Quercia, and Davis (2003), and Ernst, Farris, and Stein (2002).

47. See Office of Comptroller of the Currency, Notice of Proposed Rulemaking, Aug. 5, 2003, 68 Fed. Reg. 46119; Final rule, Bank Activities and Operations; Real Estate Lending and Appraisals, Jan. 7, 2004, at www.occ.treas.gov/2004-3bPreemptionrule.pdf; OCC Advisory Letter AL 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, Feb. 21, 2003.

48. Federal Reserve System, Home Mortgage Disclosure; Final and Proposed Rule, 12 C.F.R. Pt. 203, 67 Fed. Reg. 7,221 (Feb. 15, 2002).

49. The rule could be strengthened by requiring disclosure of all rate spreads, points, and fees, as well as other loan characteristics. See U.S. Department of the Treasury Comment on Regulation C (Home Mortgage Disclosure Act) Proposed Rulemaking Docket No. R.-1001.

characteristics by the particular lender) and more transparent disclosure of pricing; adopting the TILA and RESPA reforms advocated by the Federal Reserve Board, Treasury, and HUD in earlier reports; and developing a means for tracking loan characteristics and performance by individual mortgage brokers could help to improve consumer shopping, increase regulatory oversight, shame bad lenders, and thus make it harder for abuses to occur.

Yet the most egregious cases of predatory lending often involve broker fraud, deception, or misrepresentation that is hard to detect. While such broker actions are often illegal under state law, state authorities often lack the resources to police the activities of the thousands of mortgage brokers that may be doing business in their state. Thus greater focus needs to be paid to holding lenders liable for broker abuses through enhanced due diligence requirements. As a further example, product regulation through banning yield spread premiums as the dominant form of broker compensation and replacing it with flat fees disclosed in advance could take some of the sting out of broker abuses.

CRA could play an increasingly important role in reducing abuses. Competition from banks can help to drive out abusive practices and improve price transparency in these markets. Low-income borrowers may be ending up in a bank's subprime unit or affiliate when they could qualify for better terms. Regulators now give CRA consideration for promoting borrowers from the subprime to the prime market. Over the last decade, affiliations between insured depository institutions and nonbank subprime specialists have increased. Thus the effectiveness of this approach will depend on adequate supervision of the relationship between the bank and its affiliates to assess whether borrowers with good credit history are upstreamed from subprime affiliates and offered prime products; whether borrowers with poor credit

histories have an opportunity to demonstrate creditworthiness and move into prime products; and whether borrowers are inappropriately steered to higher-cost products or divisions.

As financial institutions increasingly rely on a broad range of affiliations to carry on their businesses, it is both possible and desirable to take account of affiliate activity while respecting the fact that CRA applies only to insured depositories. CRA regulations already provide that evidence of illegal credit practices will affect an institution's CRA rating. The laws governing such credit practices are equally applicable to banks and thrifts as well as nondepository 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 high cost of examining all affiliates for such practices, enforcement of other credit laws should occur through risk-based examinations of affiliates. The results of such compliance examinations should be taken into account in the performance context under CRA.

[2]Subsidies[end]

Finally, there are a series of subsidies to credit. Most housing subsidies are not aimed at improving access to credit for low- and moderate-income borrowers or redressing housing discrimination. Rather, they mostly subsidize "the American dream" of homeownership for all. Subsidies to home mortgage credit include government insurance (through the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie Mae) and government-sponsored enterprises (GSEs),[50] including the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan

50. "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 2001: 1).

Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank (FHLB) system. Tax expenditures and grant programs, including the home mortgage interest and property tax deductions, as well as a wide range of other programs, also affect housing markets. I leave analysis of the housing subsidies in the tax code for others, (for example, Glaeser and Shapiro, 2002; Brady, Cronin, and Houser, 2003), and focus on FHA and the GSEs.

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…." (Pennington-Cross and Yezer, 2000, p. 358). FHA, which operates within HUD, insures home mortgage loans made by private lenders in the event of default. FHA is intended to serve borrowers who cannot qualify for conventional mortgages. Ginnie Mae, also within HUD, provides a credit enhancement to pools of FHA loans and places them for sale on the secondary market. In 2002 alone, FHA insured $150 billion in mortgages for nearly 1.3 million households (HUD, 2003).

The GSEs—Fannie Mae, Freddie Mac, and the FHLBs—were created to "provide liquidity and stability to the home mortgage market (Crippen, 2001). Fannie Mae and Freddie Mac issue debt to buy and hold mortgages in portfolio, and insure mortgage-backed securities issued to investors. Fannie Mae and Freddie Mac are restricted to the market for conventional, conforming loans,[51] and essentially fund all net new loans meeting those criteria (CBO, 2001, p. 28). The FHLBs were created to provide short-term loans (advances) to thrifts in order to stabilize mortgage lending in local markets. Today, FHLB

51. Conventional loans are those not backed by government insurance. Conforming loans are those that are under the dollar limit set annually for GSE purchases.

membership is broad, including the largest commercial banks, and advances can be issued on a variety of collateral and used for any purpose (CBO, 2001, p. 4).

In principle, subsidies should be used "to make marginal private costs equal to marginal social costs, and to make marginal benefits equal to marginal social benefits" (Stiglitz, 2000). In practice, this is hard to do. Substantively, it is difficult to get private market actors to respond to government subsidies unless the subsidies are robust. Politically, it is challenging to prevent the subsidies from becoming too robust.

With respect to Fannie Mae, Freddie Mac, and the FHLBs, the subsidies are large in comparison to the benefits accruing to low-income, moderate-income, and minority borrowers. The GSEs benefit from their relationships with the federal government in a variety of ways. They are exempt from state and local taxation, are exempt from Securities and Exchange Commission (SEC) registration,[52] can borrow from the Treasury, and issue debt that banks and thrifts can hold under capital standards that favor the GSEs over private conduits (CBO, 2001; Treasury, 1996). Unlike privately issued securities, GSE securities are exempt from SEC registration, are treated as government securities under the Exchange Act, and are exempt under the Trust Indenture Act of 1939 and the Investment Company Act of 1940 (MBS Disclosure Report, 2003). Most importantly, the GSEs benefit from the credit enhancement of an implicit guarantee that the federal government will intervene in the event of financial collapse (CBO, 2001; Treasury, 1996). 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

52. Fannie Mae and Freddie Mac agreed in 2002 to begin voluntarily to register their common stock with the SEC.

fail." The implicit guarantee permits the GSEs to issue debt at a lower cost, and to hold less capital than similar private firms (Treasury, 1996).

Measuring the subsidy provided to the GSEs is the subject of intense debate. The Congressional Budget Office (CBO) found that the benefits accorded to the GSEs were worth $13.6 billion, of which Fannie Mae received $6.1 billion, Freddie Mac $4.6 billion, and the FHLBs $3.0 billion (CBO, 2001). CBO estimated that a "little more than half ($7.0 billion) of that total subsidy in 2000 passed through" to mortgage borrowers with lower interest rates on conventional, conforming loans (CBO, 2001, p. 1). CBO estimated that Fannie Mae and Freddie Mac retained $3.9 billion (37 percent) of the subsidy for their shareholders or other stakeholders (CBO, 2001, p. 5). As for the FHLBs, CBO estimated that they passed on only $300 million of their $3 billion subsidy to mortgage borrowers, with 90 percent of the subsidy accruing to the benefit of the FHLB member banks or reducing interest rates on other types of loans borrowed from FHLB members (CBO, 2001, p. 5). These estimates are sensitive to assumptions about the funding advantages GSEs receive and about how to model the pass-through to borrowers (for example, Heuson, Passmore, and Sparks, 2000), and the extent of the subsidy is widely debated. 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 helped to create and sustain a nationally integrated, stable, and liquid mortgage market. Fannie Mae, Freddie Mac, and Ginnie Mae played central roles in creating the secondary market for home mortgage loans (MBS Disclosure Report, 2003, p. 7; Lore and Cowan, 2001). Ginnie Mae guaranteed the first mortgage-backed securities in 1970, and Freddie Mac followed shortly thereafter by issuing mortgage-backed certificates. Fannie Mae followed a decade later (MBS Disclosure Report, 2003, p. 7).

As recently as the 1980s, before the rise of a robust secondary market, severe economic dislocations in one region of the country could cause mortgage defaults to increase (Greenspan, 2004). Today, the GSEs likely contribute to the stability and liquidity of national mortgage markets and lower home mortgage rates. To the extent that homeownership externalities might support a general housing policy in favor of the American Dream, (for example, Glaeser and Shapiro, 2002) the GSEs contribute to housing consumption.

The GSEs also may contribute to access to home mortgage credit for low- and moderate-income households. Fannie Mae and Freddie Mac have sponsored home counseling programs, trained loan originators, and supported community organizations to increase affordable lending. The GSEs have used more flexible underwriting criteria for loan purchases. Fannie Mae and Freddie Mac's performance has surpassed HUD's affordable housing goals since they were first formally promulgated in 1997,[53] and HUD increased those goals for 2001–04, and again for 2005–08 (HUD, 2004, 2001). However, the share of GSE purchases financing affordable housing under the goals lagged that of the primary market during the 1990s (Treasury, 2000, 1996). 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, Ginnie Mae, and depository institutions, both as a share of the GSEs' own activities and as a share of the market (Canner and Passmore, 1995, pp. 989, 1000, 1004). In addition to the affordable housing goals, other factors

53. The GSE definition of low- and moderate-income households, 100 percent of area median income, includes households with higher incomes than as defined for CRA. Under CRA, low- and moderate-income households have incomes less than or equal to 80 percent of area median.

contributed to this activity, such as the GSEs' business strategies and the shift in the primary market toward more lending to low-income borrowers.[54]

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 (CBO, 2001). The FHLBs made $16.9 billion in net advances to members in 2002, with $490 billion outstanding at the end of that year (Board of Governors, 2003). In addition, the FHLBs have begun to experiment since the late 1990s with untargeted secondary market operations in the hopes of competing with the other GSEs and now hold in excess of $100 billion in mortgage pools.

The GSEs pose risks and carry high costs. Fannie Mae and Freddie Mac shareholders and FHLB members retain a significant portion of the subsidy, and the portion passed on to consumers is spread diffusely through the market. The GSE duopoly hinders competition in the secondary market for conventional, conforming loans. Taxpayers would face a large, contingent liability in the unlikely event that the GSEs failed. Moreover, the government faces the difficulty of managing risk from an implicit guarantee, rather than an explicit, budgeted one.

In addition to the GSEs, FHA provides mortgage subsidies through insurance. FHA provided $157 billion in insurance on home mortgage loans to 1.3 million households in 2002. FHA's secondary market counterpart, Ginnie Mae, guaranteed $175 billion in mortgage-backed securities that year. FHA specializes in serving borrowers who make "low down payment[s], have high debt-to-income ratios, and/or have tarnished credit." These borrowers tend to be first-time, minority, or low-income and tend to

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

live in low-income or minority-concentrated neighborhoods. A higher share of FHA lending goes to low-income and minority borrowers and areas, as compared to the GSEs.[55] 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 (Joint Report, 2000). FHA also serves a role in regional markets with falling wages, increasing unemployment, and dropping house prices (Pennington-Cross and Yezer, 2000, p. 362). At times, FHA has competed with conventional lenders. A dilemma for FHA is how to reach further into the market while managing risk. As the conventional market serves the more credit-worthy portion of FHA's pool of borrowers, adverse selection is leaving FHA with higher risk (Wartell, 2002, pp. 17, 21). That problem is exacerbated because FHA lags the private sector in credit scoring and risk management (Wartell, 2002, p. 16; Stanton, 1999).

In sum, government subsidies generate windfalls for the GSE shareholders and others. A large portion of those whose mortgages are purchased by the GSEs would likely have had access to the credit markets in any event, even if at a higher price. GSE subsidies are not transparent, making it difficult for the public to weigh its costs and benefits and required levels of capital and regulatory oversight may be insufficient to minimize taxpayer risk. FHA subsidies are more transparent because the cost of the subsidy appears as user fees and as an item in the federal budget.[56] The cost of transparency is, however, direct taxpayer liability for the FHA. FHA may not have the management capacity and technical expertise to manage risk as effectively as private market participants.

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55. See Wartell (2002, p. 11) regarding the profile of the FHA's borrower. The agency's success in serving first-time home buyers may be overstated, since studies suggest that these households would become homeowners anyway at a later age. See Pennington-Cross and Yezer (2000, pp. 362, 367).

56. GSE activity is noted in federal budget documents, even though the GSEs are not on budget.

[3]Cross-Modal Strategies[end]

Given the tradeoffs involved, the risks and costs of the GSEs ought to be lowered through enhanced supervision by bank-like regulators, significantly improved risk disclosure, and more stringent capital requirements; moreover, the benefits should be increased by raising the affordable housing goals so that government subsidies are better targeted. In addition, cross-modal strategies using the GSEs might also help to enhance other norms. For example, to the limited extent that the GSEs purchase subprime loans, GSE disclosures of such items as LTVs, points paid at settlement, credit scores, debt-to-income ratios, loan purpose, and identification of the originator, seller, and servicer, which have been recommended to reduce risk (MBS Disclosure Report, 2003, p. 45), might also reinforce norms underlying HOEPA by permitting secondary market participants to evaluate the riskiness of loan pools, by permitting regulators to evaluate the extent to which prices track credit risk, and by permitting enforcement officials to track originator behavior regarding high-cost loans. For all loans purchased by the GSEs, such disclosures, coupled with HMDA information on the race of the borrower, could help to evaluate the extent of mortgage lending discrimination. Similarly, HUD could use its supervisory authority over the GSEs for compliance with fair lending laws to review more aggressively GSE underwriting criteria and business practices to ensure that they do not create a disparate impact on minority households, particularly since no agency has supervisory authority over nonbank mortgage originators that sell loans to the GSEs.

Regulation can have important advantages over generalized subsidy approaches. For example, 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. Moreover, banks and thrifts have expertise in

finding creditworthy borrowers and in using extensive risk-mitigation techniques. 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. Thus, to the extent that generalized subsidies have contributed to concentrating risks in the GSEs, greater attention will need to be paid to further developing appropriate safety and soundness regulations, and creating a strong institution to regulate them.

[1]Conclusion[end]

I have briefly introduced and compared five different modes of credit market regulation. Comparing these forms of government intervention reveals hidden strengths and weaknesses of the approaches taken and suggests the important role of comparative institutional analysis in policy reform. Further empirical research should help shed light on the comparative strengths and weaknesses of these regulatory approaches. While deepening our understanding of different modes of credit market regulation, the chapter also suggests innovative, cross-modal techniques for advancing the social norms underlying each mode of regulation. While detailed analysis of these ideas must await another day, these cross-modal strategies could hold important promise in helping to reduce discrimination and overcome market failures affecting underserved communities.

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