Community Reinvestment Emerging from the Housing Crisis

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The Community Reinvestment Act (CRA) has helped to revitalize low- and moderate-income (LMI) communities and provided expanded opportunities for LMI households. Going forward, the CRA could be strengthened in several ways to ensure its continued role in encouraging sound lending, investment, and services in LMI communities. At the same time, the CRA cannot be expected to resolve the range of financial problems facing LMI communities today. We need to clean up the mortgage business, drive out abuses, and develop a system of consumer protection, prudential supervision, capital requirements, and transparency that restores trust and confidence in our financial system.

The Community Reinvestment Act

The CRA encourages federally insured banks and thrifts to meet the credit needs of the communities they serve, including LMI areas, consistent with safe and sound banking practices. Federal banking agencies periodically examine and rate the CRA performance of banks. Regulators consider a bank's CRA record in determining whether to approve its application for mergers with, or acquisitions of, other depository institutions. 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.

Modifications to CRA regulations issued in 1995 changed the focus of evaluations from process-oriented factors to objective performance.[1] These regulations require large banks and thrifts to disclose information about their small-business, small-farm, and community-development lending. The regulations provide for examinations of Large Banks, Small Banks, and Wholesale or Limited-purpose institutions tailored to the business strategies of each institution type. Large banks are evaluated on a three-part test of their lending, investments, and services, while small banks undergo a streamlined review of lending.

Since its enactment and to the present day, the CRA has been the subject of extensive debate. Many scholars vigorously questioned the theoretical and empirical claims that originally motivated the CRA, and some advocated eliminating the law altogether.[2] Critics argued that the CRA is trying to address a nonexistent problem, and that even if intervention is warranted, the CRA is an inappropriate avenue. Others have also suggested that the CRA has had little, if any, positive effect, and at a high cost. However, in earlier work, I have systematically rebutted these prior criticisms of the CRA and laid a solid theoretical and empirical foundation for the act.[3] Those findings are summarized here.

The CRA Reasonably Addresses Market Failures in Low-Income Communities

At its core, the CRA helps to overcome market failures in low-income communities. By fostering competition among banks in serving low-income areas, the CRA generates larger volumes of lending from diverse sources and adds liquidity to the market, decreasing the risk of each bank's loan. Encouraged by the law, banks and thrifts have developed expertise in serving low-income communities and have created innovative products that meet the credit needs of working families and low-income areas with manageable risks.

These market innovations have taken several forms. Banks and thrifts have engaged in special marketing programs to targeted communities; experimented with more flexible underwriting and servicing techniques to

1 *See 12 CFR 25 (applying to nationally-chartered banks), 12 CFR 228 (applying to state-chartered banks), and 12 CFR 563e (applying to thrifts).*

2 *See, e.g., Jeffery W. Gunther, "Should CRA Stand for 'Community Redundancy Act?'" Regulations 23 (3) (2000): 56-60; Jeffrey M. Lacker, "Neighborhoods and Banking." Economic Quarterly 81 (2) (1995): 13–38; Jonathan R. Macey and Geoffrey P. Miller, "The Community Reinvestment Act: An Economic Analysis." Virginia Law Review 79 (1993): 291-348; Lawrence J. White, "The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction." Fordham Urban Law Journal 20 (1993): 281-291.*

3 *Michael S. Barr, "Credit Where it Counts: The Community Reinvestment Act and its Critics." New York University Law Review 80 (2) (2005): 513-652.*

serve a broader range of households; and funded credit counseling for borrowers. Many larger institutions have developed specialized units that focus on the needs of LMI communities. Others have formed partnerships with community-based organizations and Community Development Financial Institutions (CDFIs), which provide local expertise and financial education and assume portions of risk that banks do not want to bear. Spurred in part by the CRA Investment Test, banks have invested in CDFIs in record numbers, improving their ability to serve low-income markets.

The CRA also facilitates coordination among banks to reduce information costs. Because the law requires all insured depositories to lend in their communities, it reduces "free rider" problems. It has spurred the development of multi-bank community development corporations and loan consortia to serve LMI communities more effectively. Moreover, banks get CRA consideration for both originating and purchasing loans, creating a trading system. Institutions can also get credit under the CRA Investment Test for purchasing loan securities. The development of this secondary market has increased liquidity and transparency.

A positive lending cycle thus began in many communities once ignored by mainstream lenders. Under the CRA, lenders know that other banks will be making loans to a community, reducing all institutions' liquidity risk, speeding the gathering and dissemination of information, and producing information that can be used by all lenders. Lending by responsible originators to low-income communities has increased under the CRA, and such responsible lending has not led to the kind or extent of excessively risky activity undertaken outside of the CRA's purview.

Studies have found that the CRA improved access to home mortgage credit for low-income borrowers during the 1990s as its regulatory intensity increased.[4] Between 1993 and 1999, depository institutions covered by the CRA and their affiliates made over $800 billion in home mortgage, small business, and community development loans to LMI borrowers and communities.[5] The number of CRA-eligible mortgage loans increased by 39 percent between 1993 and 1998, while other loans increased by only 17 percent. Even excluding affiliates, banks increased their lending to LMI borrowers and areas by ten percent over this period, while these lenders saw no growth at all in their other markets. As a result, mortgage lending by CRA-covered institutions and their affiliates to these borrowers and areas increased from 25 to 28 percent of their overall mortgage lending.

Beyond the CRA, a series of other factors also contributed to these gains. Strong economic growth and low inflation during the 1990s led to rapid income growth, low unemployment rates, and low real interest rates. Innovation helped drive down the costs of lending. Consolidation in the financial services sector enhanced competition among national players with economies of scale and scope. In addition, fair lending enforcement and affordable housing goals of the government sponsored enterprises also increased during this period.

Controlling for the effects of these other factors, however, CRA-regulated lenders increased their CRA-eligible home purchase lending faster than unregulated lenders from 1993 to 1999.[6] The Joint Center for Housing Studies at Harvard University concluded: "CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if CRA did not exist."[7] One estimate by the Joint Center found that the CRA's effect on increasing home mortgage lending to low-income borrowers was equivalent to a 1.3 percentage point decrease in unemployment. Another

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4 See Michael S. Barr and others, "The Community Reinvestment Act," in C. Guene and E. Mayo, eds., Banking and Social Cohesion: Alternative Responses to a Global Market (Charlbury, Oxfordshire: Jon Carpenter, 2001); Robert B. Avery and others, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act." Federal Reserve Bulletin 85 (1999); Robert B. Avery and others, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages." Federal Reserve Bulletin 82 (1996); Douglas D. Evanoff and Lewis M. Siegal, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending." Economic Perspectives 20 (1996); Michael LaCour-Little, "Does the Community Reinvestment Act Make Mortgage Credit More Widely Available? Some New Evidence Based on the Performance of CRA Mortgage Credits." Conference paper presented at the Midyear Meeting of the American Real Estate and Urban Economics Association meeting, Washington, May 4, 1998.

5 Robert E. Litan and others, "The Community Reinvestment Act After Financial Modernization: A Baseline Report" (U.S. Treasury Department, 2000); Robert E. Litan and others, "The Community Reinvestment Act After Financial Modernization: A Final Report" (U.S. Treasury Department, 2001). For further analysis of these reports, see Eric Belsky, Michael Schill, and Anthony Yezer, "The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending" (Harvard University Joint Center for Housing Studies, 2001).

6 Litan and others, "The Community Reinvestment Act After Financial Modernization: A Final Report"; Belsky, Schill, and Yezer, "The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending."

7 Harvard University Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System" (2002).

study found that the CRA increases the number of small businesses that can access credit by four to six percent, increasing payrolls and reducing bankruptcies—without crowding out other financing available to small businesses or adversely affecting bank profitability or loan performance.[8] In sum, recent evidence shows that CRA provides important benefits to low-income communities.

Though critics of the CRA assert that it leads to unprofitable lending, the weight of evidence suggests otherwise. In a Federal Reserve Board survey of CRA-covered institutions, most responded that CRA lending was profitable or marginally profitable, and not overly risky.[9] Pushing further into low-income markets under the CRA has not weakened banks' profitability or soundness. In the small "special programs" that serve as banks' CRA laboratories to test new and innovative strategies, most institutions reported low delinquency and charge-off rates. In fact, most institutions surveyed reported a net charge-off rate of zero for these programs.

Reforms put into place in 1995 reduced compliance costs for all banks and streamlined CRA regulations even further for the smallest institutions. Evidence suggests the reforms worked. In 2002, the Independent Community Bankers of America surveyed its membership about the cost of CRA regulation.[10] Although the study was designed to highlight the high compliance costs of the CRA, the data suggest otherwise. The mean employee cost for CRA compliance was about $84,000 per year for small banks (average assets of $216 million) and about $115,000 per year for larger "community" banks (average assets of $666 million). Thus, average CRA employee costs as a percentage of assets were negligible—0.017 percent for larger "community" banks, and 0.039 percent for small banks. These costs seem manageable.

The CRA Should Have Done More to Combat Abuses in the Subprime Market

Despite the fact that the CRA appears to have increased bank and thrift lending in LMI communities, such institutions are not the only ones operating in these areas. In fact, with new and lower-cost sources of funding available from the secondary market through securitization, and with advances in financial technology, subprime lending exploded in the late 1990s, reaching over $600 billion and 20 percent of all originations by 2005. Only 25 percent of subprime loans were made by banks and thrifts, and the Federal Reserve reports that only six percent of subprime loans were CRA-eligible. Although reasonable people can disagree about how to interpret the evidence, my own judgment is that the worst and most widespread abuses occurred in the institutions with the least federal oversight.

The housing crisis we face today, driven by serious problems in subprime lending, suggests that our system of home mortgage regulation, including the CRA, is seriously deficient. We need to mend what my friend, the late Federal Reserve Board Governor Ned Gramlich, aptly termed "the giant hole in the supervisory safety net."[11] Banks and thrifts are subject to comprehensive federal regulation and supervision, their affiliates are far less so, and independent mortgage companies are not at all. Moreover, many market-based systems designed to ensure sound practices in this sector—broker reputational risk, lender oversight of brokers, investor oversight of lenders, rating agency oversight of securitizations, and so on—simply did not work. Conflicts of interest, lax regulation, and "boom times" covered up the extent of the abuses—at least for a while, and only for those not directly affected by abusive practices. But no more.

As has become all too evident, the subprime market has been plagued by serious problems. Some borrowers who could have qualified for loans from prime lenders ended up in the subprime market, paying higher rates. Preliminary research suggests that up to 35 percent of subprime borrowers could have qualified for prime mortgage loans.[12] Some minority borrowers may have been improperly "steered" to higher-cost lenders by brokers or real estate professionals. Even after accounting for neighborhood and borrower

8 Jonathan Zinman, "Do Credit Market Interventions Work? Evidence from the Community Reinvestment Act" (Federal Reserve Bank of New York, 2002).

9 Board of Governors of the Federal Reserve System, The Performance and Profitability of CRA-Related Lending, report submitted to the Congress pursuant to Section 713 of the Gramm-Leach-Bliley Act of 1999, July 17, 2000.

10 Grant Thornton LLP, Independent Community Bankers of America, "The High Cost of Community Bank CRA Compliance: Comparison of 'Large' and 'Small' Community Banks" (2002).

11 Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," Presented in Jackson Hole, Wyoming, Aug. 31, 2007; available online http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/4q07Gramlich.pdf.

12 Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families Chap. 5 (Sept. 1996), available at http://www.freddiemac.com/corporate/reports/moseley/mosehome.htm.

characteristics that influence lending decisions, there is "a strong geographic concentration of subprime lending in those neighborhoods where there is a large population of African American homeowners" and "African-American borrowers, regardless of the neighborhood where they are located, have relatively high likelihood of obtaining a subprime compared to a prime loan."[13]

Other studies have documented abusive practices in the subprime sector.[14] These practices have included "flipping," repeatedly refinancing a loan in a short period of time. Flipping subjects a borrower to high fees, including prepayment penalties, which diminish home equity without providing the borrower significant benefit. Loans have been "packed" with additional products (such as credit life insurance) without the borrower understanding that the products were optional or unsuitable.[15] Loans have included fees unrelated to risk or servicing and were structured to disguise the loans' true costs.[16] Some brokers have made home mortgage loans without regard to the borrower's ability to repay.[17] These so-called "asset-based" loans were often made by brokers who earned high fees up front for getting borrowers to take high-cost loans.[18] In other cases borrowers have testified that "unscrupulous mortgage brokers, lenders, home improvement contractors, appraisers, and combinations thereof" engaged in "outright fraud" as well as "deceptive or high-pressure sales tactics," and often "prey[ed] on . . . the elderly, minorities, and individuals with lower incomes and less education."[19]

While credit risk is a key determinant of whether a borrower receives a prime or subprime loan, "credit risk alone may not fully explain why borrowers end up in the subprime market."[20] For example, borrowers who are older, Hispanic, or search less for low interest rates are more likely to end up in the subprime market.[21] Having a subprime loan is an important determinant of refinancing with a subprime loan, even after controlling for relevant factors related to risk and creditworthiness: Some 60 percent of subprime borrowers who refinanced did so with subprime loans rather than prime ones,[22] indicating that many subprime borrowers get stuck in that market.

The higher price that subprime borrowers pay is a function not only of using a subprime lender, but also of negotiating with mortgage brokers, who dominate the subprime market. Brokers are compensated for getting borrowers to pay rates higher than those for which they qualify. Such yield spread premiums are common.[23] In loans with yield spread premiums, there is a wide dispersion in prices paid to mortgage brokers. Among borrowers paying yield spread premiums, African Americans paid $474 more per loan, and Hispanics $590 more, than white borrowers; thus, even if minority and white borrowers qualified for the same rate, in practice minority borrowers are likely to pay much more.[24]

These problems indicate that the CRA has not yet

13 *Paul S. Calem et al., "The Neighborhood Distribution of Subprime Mortgage Lending," 29 J. Real Est. Fin. & Econ. 393, 407 (2004).*

14 *For a full discussion of such practices, see generally Curbing Predatory Home Mortgage Lending, HUD-Treasury Report (2000). See also Michael S. Barr, Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress, 16 Notre Dame J.L. Ethics & Pub. Pol'y 447, 455–62 (2002) (describing problems in and opportunities for reform of subprime mortgage market).*

15 *See HUD-Treasury Report, supra, at 2.*

16 *Ibid.*

17 *Ibid.*

18 *Ibid at 76–77.*

19 *Ibid at 2.*

20 *Marsha J. Courchane et al., "Subprime Borrowers: Mortgage Transitions and Outcomes," 29 J. Real Est. Fin. & Econ. 365, 373 (2004).*

21 *Ibid at 371–72.*

22 *Ibid at 375, tbl.1.*

23 *See H. Jackson & J. Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (2003) at 127.*

24 *Ibid at 125 (describing differences in "total mortgage broker compensation," which includes both yield spread premiums and their functional equivalents, broker "discount fees"); see also Jack Guttentag, Another View of Predatory Lending 8 (Wharton Fin. Inst. Ctr., Working Paper No. 01-23-B, 2000) ("According to the brokers, [a] major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer."), available at http://fic.wharton.upenn.edu/fic/papers/01/0123.pdf.*

done enough to integrate the prime and subprime markets.[25] In some ways, the CRA is well-positioned to help overcome the separation between the prime and subprime markets by enhancing competition from banks and thrifts. Marrying these two markets would improve market efficiency, and thus reduce racial discrimination and speed the correction of other market failures. Competition from banks and thrifts can help to drive out abusive practices and improve price transparency. However, given the large role played by independent mortgage companies and brokers, bank and thrift competition under the CRA alone is not enough to drive out bad practices. In recent years, there has been intense competition among those mortgage market participants who provide harmful products. Further federal regulation is thus also necessary to combat abusive practices, prevent a "race to the bottom" in bad lending behavior, and restore integrity to our housing markets. We need to ensure that all participants in the mortgage process have the right incentives to engage in sound lending practices and are subject to the right kind of regulatory oversight.

The CRA Performance Context Should Include Affiliates of Banks and Thrifts

Going forward, it is both possible under existing law and desirable as a matter of policy, to take account of affiliate activity while respecting the fact that the CRA applies only to insured depositories. For example, CRA regulations already state that evidence of illegal credit practices will affect an institution's CRA rating.[26] The laws governing such credit practices are equally applicable to banks, thrifts, and non-depository creditors. Illegal credit practices of an affiliate that has been included at the option of the depository institution for purposes of a CRA examination are relevant to the parent's rating, but so too should be the illegal credit practices of affiliates not so included. Given the cost of regularly examining all affiliates for such practices, other credit laws should be enforced through risk-based examinations of affiliates.[27] In addition to direct enforcement of such credit laws, the results of compliance examinations should be taken into account in the performance context under the CRA.

Banks should include the activities of affiliates, and bank regulators should determine whether such activities are serving the credit needs of the community. For example, some borrowers may be ending up in a bank's subprime unit, or subprime affiliate, or obtaining an inappropriate loan, when in fact they could qualify for a mortgage on better terms. Regulators now give the CRA consideration for "promoting" borrowers from the subprime to the prime market.[28] Banks and thrifts should thus have in place procedures to ensure that borrowers with good credit histories get access to their prime mortgage units and products, and that all borrowers get access to the best loan for which they qualify, from whatever part of the company offers the product.

In principle, the Office of the Comptroller of the Currency (OCC) considers a bank's subsidiaries' assets in determining the performance context in which it operates.[29] Similarly, the assets and activities of all of the affiliates of a bank should also be considered in assessing the performance context within which a bank meets its obligations under the CRA. After all, a bank's affiliates are hardly irrelevant to the bank's business decisions, including how to meet the credit needs of their communities.
The Gramm-Leach-Bliley Act made a financial holding company's commencement of newly authorized activities, or its merger with newly authorized entities, contingent on Satisfactory CRA performance by all of its affiliate banks

25 *See, e.g., Board of Governors of the Federal Reserve System, in re Citigroup Inc. & Citifinancial Credit Co., Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent, May 27, 2004 (alleging subprime affiliate engaging in asset-based lending in violation of HOEPA, requiring co-signators to sell more credit insurance in violation of Regulation B, misleading examiners, and assessing civil money penalties of $70 million and securing agreement to pay restitution to borrowers), available at http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20040527/attachment.pdf (last visited Mar. 30, 2005). But see Office of the Comptroller of the Currency, Community Reinvestment Act Performance Evaluation: Citibank, N.A. 7, 11–12 (June 9, 2003) (rating Citibank Outstanding after evaluating performance of bank and its mortgage affiliates, including Citifinancial, and noting that fair lending concerns at another affiliate "did not significantly impact our CRA assessment of Citibank" because affiliate did not constitute significant percentage of institution's low- and moderate-income mortgage lending), available at http://www.occ.treas.gov/ftp/craeval/may04/1461.pdf (last visited Mar. 30, 2005).*

26 *12 C.F.R. § 25.28(c) (2004).*

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

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

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

or thrifts. A bank's affiliates have a strong interest in ensuring adequate CRA performance by all the insured depositories of the holding company.

Holding companies provide scale economies to their subsidiaries in complying with bank regulations.[30] Banks that are part of holding companies face lower regulatory burdens from the same regulation than their non-affiliated counterparts of similar size. Thus, affiliation should generally be weighed, not ignored, in determining tradeoffs between regulatory burdens and benefits. Banks that are part of holding companies have access to the range of expertise of the holding company, which is useful for developing programs to meet community needs under the CRA. The holding company and its subsidiaries can offer a range of services to the bank in helping the bank meet its CRA performance goals, such as innovative loan products, securitization, or expertise in investment and other matters. These affiliates do affect a bank's CRA performance, and the bank should therefore be assessed, taking the expertise and resources of the parent institution into account. The agencies should thus include the assets and activities of affiliates in assessing performance context for CRA examinations of banks and thrifts.

The CRA Should Encourage Innovation And Quality in Lending and Community Investment

The success of the CRA in encouraging home mortgage lending is in part a consequence of the ability of regulators simply to count home mortgage loans to eligible low-income borrowers and areas. However, as such lending became more commonplace, bank and thrift examiners generally failed to take sufficient account of whether financial institutions were truly meeting the needs of LMI communities, beyond the production of more home mortgages. Such an assessment might include a qualitative judgment about whether the home mortgage loans offerred were meeting the needs of low-income households, not just the business goals of investors. Such an assessment might also have taken greater account of the extent to which major institutions developed specialized units to serve low-income communities, giving more weight to innovative and complicated community development lending and investment. Nuanced and qualitative assessments are important to understanding how well a financial institution is serving its whole community. However, as a result of examiners' generally more narrow focus on loan production, these qualitative aspects of financial institutions' performance have been undervalued in recent years, and many major financial institutions have cut back on innovative and sound ways to meet community needs. A renewed focus on truly innovative work and qualitative assessments about sound lending would help restore the CRA's role in fostering a culture and structure of community development in major firms.

The CRA Service Test Should Focus on Innovative Products and Services

The CRA could also help to focus banks and thrifts on opportunities to provide bank accounts to low-income persons.[31] The CRA Service Test, which evaluates bank and thrift performance in meeting transaction, savings, and other community needs, has received inadequate attention from bank regulators in CRA examinations. Michael Stegman has shown that banks rarely receive Needs to Improve ratings on the Service Test, which is often used to increase the overall score of borderline banks.[32] Examiners should focus on the extent to which banks and thrifts are actually attracting low-income customers with innovative retail products and services. Given the importance of technology in serving low-income clients in a cost-effective manner, service examinations should move away from an overwhelming focus on bank branches and towards a more quantitative and qualitative assessment of the extent to which technology-based products are expanding access for low-income persons.[33]

The 1995 regulations provide sufficient flexibility for analysis of an institution's performance, but examination procedures provide insufficient guidance as to how to

30 *See Elliehausen, at 26 (noting economies of scale for compliance with ongoing regulations).*

31 *Elsewhere, I have proposed a new tax credit to encourage banks and thrifts to offer low-cost, electronically based bank accounts with no overdraft or hidden fees. See Michael S. Barr, Banking the Poor, 21 Yale J. on Reg. 121 (2004). I have also proposed a system under which the IRS would directly deposit tax refunds into bank accounts for low-income households who do not or cannot designate such an account. See Michael S. Barr, An Inclusive, Progressive National Saving and Financial Services Policy, 1 Harvard Law & Policy Rev. 161 (2007). Together with the CRA, such policies could help to transform the financial services marketplace for low-income households.*

32 *See Michael Stegman & Robert Faris, Creating a Scorecard for the CRA Service Test (Brookings Inst., Policy Brief No. 96, 2002) (revealing that only fifteen CRA examinations out of nearly 2,000 conducted over five years resulted in a rating of Needs to Improve on the Service Test, and no bank earned a Substantial Noncompliance rating on service activities).*

measure an institution's activities in ways that actually matter to low-income consumers. The Service Test, in practice, has received perfunctory attention from examiners, with public evaluations including little or no analysis of whether low-income consumers actually use bank or thrift products or services. Examinations under the Service Test could be vastly improved by taking three steps.

First, examiners should evaluate the extent to which institutions offer low-cost accounts and other products designed to meet the needs of low-income individuals. Low-cost electronic accounts with direct deposit, no overdraft, and an automatic savings plan may hold special promise in this regard. Regardless of the form of the account, examiners should attempt to make a qualitative judgment about the range of product offerings of the institutions, based on research into low-income consumer needs, and taking into account the costs to institutions of providing accounts and the requirements of sound banking practice.

Second, banks and thrifts should be evaluated based on the number of LMI account holders at their institution, and whether they hold traditional or more innovative accounts. Quantitative measures should portray an institution's performance under the Service Test, and relevant data collection should not be burdensome.

Third, the agencies should give negative consideration to activities that undermine the provision of quality services to low-income customers. For example, participation by banks or thrifts in arrangements with affiliates or other parties that do not provide adequate consumer protection, or raise compliance, operational, or other risks, should receive negative consideration.[34] As they have with payday lending, agencies should ensure that banks and thrifts are not merely "renting" their charters to these firms, but are appropriately monitoring and supervising their practices. This may require targeted, risk-based compliance examinations of these parties or affiliates.

A Range of Responses is Needed to Restore Integrity and Stability to Financial Markets

The housing crisis we face today stems from serious systemic problems in the subprime and alternative lending markets that reveal our system of home mortgage regulation to be seriously deficient and in need of reform. Along with maintaining and strengthening the CRA, Congress ought to enact a range of complementary policies to address this crisis.

The new administration, Congress, and the bank regulators could do much to restore integrity to mortgage markets and reduce the likelihood of another such crisis. Federal regulation is necessary to combat abusive practices and restore integrity to our credit markets. We need to ensure that all participants in the mortgage process have the right incentives to engage in sound lending practices and are subject to regulatory oversight.

In 2008 the House of Representatives passed important legislation to clean up the mortgage process and regulate mortgage brokerage to drive out abuses, but the Senate has not followed suit.[35] While improvements could certainly be made in the legislation, it forms a sound basis for the new administration and Congress to enact mortgage reform early in the next Congressional session. In addition, the Federal Reserve's new rules designed to prevent unfair and deceptive mortgage practices and to improve disclosures should be implemented immediately while the Fed works to strengthen them further. In addition, to increase transparency, all borrowers need to be able to obtain firm price quotes on loans and settlement services in order to compare lenders accurately.

Congress also should develop a new standard for truth in lending so that mortgage brokers and lenders do not have incentives to get around disclosure rules. Under this approach, an agency could determine whether a creditor's disclosure was objectively unreasonable, in that the disclosure would fail to communicate effectively the key terms and risks of the mortgage to the typical borrower. A new disclosure approach should require brokers and lenders to disclose all information favorable to the borrower; that would help prevent borrowers from being steered into loans that cost more than the loans for which they would qualify. The new law also needs to increase public disclosure of broker and lender conduct and regulatory monitoring of credit standards.

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33 *See Michael S. Barr, Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress, 16 Notre Dame J.L. Ethics & Pub. Pol'y 447, 452 (2002); see also Michael S. Barr, Comment Letter of October 26, 2001, Community Reinvestment Act Joint Advance Notice of Proposed Rulemaking (OCC Docket No. 01-16, Board Docket No. R-1112, FDIC Re: 12 CFR 345, OTS Docket No. 2001-49), available at http://www.ots.treas.gov/docs/95338.pdf.*

34 *For example, OTS gave Crusader Bank a Needs to Improve rating in 2000 in part because of its payday lending operations; Crusader abandoned its payday lending relationship in 2001.*

35 *The Mortgage Reform and Anti-Predatory Lending Act of 2007, HR 3915, 110th Cong., 1st sess.*

To repair the broken trust and realign good incentives in our system, brokers should not be permitted to earn so-called yield spread premiums for steering borrowers into higher-cost loans. Instead, we need a system under which brokers are accountable to borrowers. Over the long run, we could shift to a system under which borrowers pay for mortgage-broker services and brokers owe a fiduciary duty to borrowers, similar to the extant system under which financial advisers owe such duties to their investment clients. In the meanwhile, enhanced disclosures and barring yield spread premiums could help to reduce abuses.

Moreover, we need to ensure that our capital market regulations—across all financial sectors—provide for transparency, appropriate capital adequacy standards, and rules regarding conflicts of interest. Congress and the new administration need to reform our secondary market regulations as well as our tax and accounting rules so that securitizations enhance liquidity and transparency even in crises, rather than serving as obstacles to crisis resolution.

In addition to reforming the mortgage market by addressing bad practices, we should take this opportunity fundamentally to rethink our approaches to regulation based on insights from behavioral economics. Harvard economist Sendhil Mullainathan, Princeton psychologist Eldar Shafir, and I have argued for a new, opt-out mortgage plan.[36] While the causes of the mortgage crisis are myriad, a central problem is that brokers and lenders offered loans that looked much less expensive than they really were because of low initial monthly payments and hidden costly features. As Ned Gramlich asked, "Why are the most risky loan products sold to the least sophisticated borrowers?"[37] Many borrowers took out loans that they did not understand and could not afford, with predictable results.

In retirement policy, behavioral research led Congress to promote opt-out plans under which employers sign workers up for retirement benefits unless the worker chooses not to participate. This policy has significantly increased overall retirement savings. Under an opt-out home mortgage plan, borrowers would be offered a standard mortgage or set of mortgages, with sound underwriting and straightforward terms. They would get one of these standard mortgages, unless they opted out after clear disclosures. To make the opt-out program "sticky," lenders and brokers would face increased scrutiny and potential liability if they provided alternative loans without reasonable disclosure that later failed. An opt-out system would mean borrowers would be more likely to get appropriate loans, without blocking beneficial financial innovation.

Conclusion

Now, after more than 30 years, the Community Reinvestment Act has helped to expand access to responsible credit to low- and moderate-income households, a laudable achievement. CRA regulations should now focus on encouraging innovative ways to continue to provide sound credit to such households, invest in the development of communities, and offer retail services that meet the needs of those who have been left out of the financial services mainstream. At the same time, Congress should undertake other initiatives to end abusive practices and to restore integrity and stability to our financial markets. Among these, Congress should consider using the insights of behavioral economics to develop opt-out policies that make it less likely that households will make predictable but costly mistakes. Innovation is a hallmark of America's financial system, and with the appropriate set of governmental policies, we can expect our financial system once again to be vibrant, strong—and inclusive. ■

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36 *Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation, " Working Paper (Joint Center on Housing Studies, November 2007).*

37 *Gramlich, "Booms and Busts."*