COMMUNITY REINVESTMENT ACT AND EFFICIENT MARKETS DEBATE: OVERVIEW

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ABSTRACT

This paper integrates two existing lines of research. On the one hand, there is the literature on the community reinvestment act (CRA), and on the other there is the literature on the efficient markets hypothesis (EMH). The paper first provides an overview of each line of research, and then discusses how they might be related. A major portion of the paper is devoted to the introduction of the CRA, its relation to the relevant laws, its development over time. The paper reviews the phases of the CRA and the major factors which have contributed to its wide-ranging effects. Since the EMH is a relatively well-known topic, the paper briefly re-introduces the issues involved. Finally, the paper discusses what the implications of the CRA might be for the EMH.

INTRODUCTION

This paper integrates two existing lines of research. On the one hand, there is the literature on the community reinvestment act (CRA), and on the other there is the literature on the efficient markets hypothesis (EMH). The paper first provides an overview of each line of research, and then discusses how they might be related. A major portion of the paper is devoted to the introduction of the CRA, its relation to the relevant laws, its development over time. The paper reviews the phases of the CRA and the major factors which have contributed to its wide-ranging effects. Since the EMH is a relatively well-known topic, the paper briefly re-introduces the issues involved. Finally, the paper discusses what the implications of the CRA might be for the EMH. This paper sets the foundation for two other papers dealing with the theoretical debate and empirical evidence on the Community Reinvestment Act (Ardalan 2006a and 2006b).

COMMUNITY REINVESTMENT ACT AND RELATED LAWS

The Community Reinvestment Act (CRA) was enacted in 1977 based on the concern that commercial banks and savings associations were engaging in "redlining" practices that were accelerating the decline of many inner-city urban areas. Redlining referred to the practice whereby depository institutions literally or figuratively drew a red line around certain neighborhoods on the basis of the racial composition, age of housing stock, or other factors regardless of the creditworthiness of individual loan applicants, and declined to make loans in those neighborhoods. The perception was that these practices were resulting in the disinvestment and decline of many older, central city, and typically low-income and minority neighborhoods and a shift of jobs to suburban areas. The CRA addressed this problem by requiring the banking regulators to encourage the institutions to help meet the credit needs of the communities in which they are chartered to do business. The hope was that by encouraging depository institutions to look for profitable lending opportunities in their local communities, the CRA would be helpful in revitalizing inner-cities at a time when investment was moving to distant money centers or to more affluent and outlying communities.

The extant literature reveals the following two trends. First, home mortgage lending to low- and moderate-income and minority neighborhoods during the 1990s has increased at rates that far exceed the increases in lending to other neighborhoods. These increases have been attributed in part to the influence of the CRA and fair lending laws.

Second, the CRA has helped create a community development infrastructure among the banking industry, the bank regulatory agencies, the secondary market organizations, and in inner-city communities that has increased CRA compliance. The CRA has increased collaboration among bankers, local and state governments, and community-based organizations in arrangements such as loan consortia and public/private enterprise partnerships. Further, the CRA has resulted in the creation of financial instruments designed to make the private capital more accessible to low- and moderate-income borrowers and minority neighborhood, be represented by banks as CRA commitments, and bring CRA activities into the financial mainstream.

The principle underlying the CRA, that depository institutions must serve the "convenience and needs" of the communities in which they are chartered to do business consistent with safe and sound operations, is one that federal law governing deposit insurance, bank charters, and bank mergers had included before the CRA was enacted. The Banking Act of 1935 states that banks should serve the convenience and needs of their communities. The Bank Holding Company Act of 1956 requires the Federal Reserve Board (FRB), in deciding on acquisitions by banks and bank holding companies, to assess how well a bank meets the convenience and needs of its communities consistent with safe and sound operations. Under CRA, the concept of "convenience and needs" includes the extensions of credit.

CRA and the fair lending laws, while separate, have related objectives. The primary purpose of CRA was to prohibit redlining. The Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA) prohibit lending discrimination based on certain characteristics of potential and actual borrowers. The FHA, enacted as title VIII of the Civil Rights Act of 1968, prohibits discrimination in residential real estate-related transactions on the basis of an applicant's race, color, religion, gender, handicap, familial status, or national origin. These actions include denying a loan or fixing the terms and conditions of a loan based on discriminatory criteria. The ECOA, enacted in 1974, prohibits discrimination with respect to any aspect of a credit transaction based on race, color, religion, national origin, gender, marital status, age, receipt of public assistance, or the exercise, in good faith, of rights granted by the Consumer Credit Protection Act.

The Home Mortgage Disclosure Act (HMDA) was enacted in 1975 to establish a reporting obligation for depository institutions in order for regulators and the public could determine whether depository institutions were serving the credit needs of their communities. It required depository institutions with total assets of more than $10 million to compile data on the number and total dollar amount of mortgage loans originated or for which the institution received completed applications or purchased during each fiscal year by geographic area and make that data available for public inspection. In 1989, HMDA was amended to require collection and reporting of data on race, gender, and income characteristics of mortgage applicants to help identifying discriminatory lending practices and enforcing fair lending laws. Amendments to HMDA in 1988 and 1991 expanded the reporting requirements to most mortgage banking subsidiaries of banks and thrift holding companies and independent mortgage companies not affiliated with depository institutions. In 1992, HMDA was amended to require the financial institutions to make available to the public, upon request, their loan application registers, which contain data for loans covered by HMDA.

HMDA is a large data source at the individual loan application level. Among data sources, it provides the best opportunity to analyze lending patterns and trends by borrower income, race/ethnicity or gender in such detail. Furthermore, the loan data are geo-coded to census tracts, allowing the analysis of the impact of CRA on lending in lower-income, minority, or other historically underserved neighborhoods.

Both HMDA and CRA were enacted to address the regulators' perceived lack of lending by banking institutions to the communities in which they were chartered to do business. Where available, HMDA data are to be used by examiners when assessing compliance with CRA, FHA, and ECOA.

Garwood and Smith (1993), and Litan, Retsinas, Belsky, and White Haag (2000) have discussed aspects of the CRA. The present study has extensively benefited from Belsky, Lambert, and von Hoffman (2000), Ford Foundation (2002), General Accounting Office (1995), and White Haag (2000),

DEVELOPMENT OF THE COMMUNITY REINVESTMENT ACT

Concerns that banks and savings institutions did not adequately respond to credit needs of the communities they served prompted the passage of title VIII of the Community Reinvestment Act (CRA) of 1977. The act mandates federal bank and thrift regulators – the Comptroller of the Currency (OCC) for federal banks; the Board of Governors of the Federal Reserve System (FRB) for State-chartered banks that are members of the Federal Reserve System and bank holding companies; the Federal Deposit Insurance Corporation (FDIC) for state-chartered banks and savings banks that are not members of the Federal Reserve System and the deposits of which are insured by the FDIC; and the Office of Thrift Supervision (OTS) for savings associations with deposits insured by the FDIC, and savings association holding companies, to use their authority to encourage institutions to help meet the credit needs in all areas of the community the institution is chartered to serve, consistent with safe and sound operations. CRA does not cover credit unions and independent mortgage companies. According to the CRA the federal banking regulators have the primary responsibility for the examination of CRA performance and enforcement of the act.

The act requires the regulators to periodically assess institutions' community lending performance and to take it into account when evaluating an institution's application for a deposit facility. Where an "application for deposit facility" is defined as an application to the appropriate supervising regulator for (1) a charter for a national bank or federal savings and loan (S&L); (2) deposit insurance in connection with a newly chartered bank, savings bank, S&L, or similar institution; (3) the opening of a domestic branch or other facility with the ability to accept insured bank or S&L deposits; (4) the relocation of a home office or branch; (5) the merger or consolidation with, or acquisition of the assets, or assumption of the liabilities of an insured depository institution; or (6) the acquisition of shares or assets of an insured depository institution requiring approval under the Bank Holding Company Act or the National Housing Act.

Growing concern about the effectiveness of CRA's implementation and its regulatory burden on institutions led to a few revisions, and a final revision in May 1995.

CRA was amended by the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to require that the regulator's examination rating and a written evaluation of each assessment factor be made publicly available. FIRREA also established a four-point qualitative rating scale so that the CRA ratings would be different from the five-point numerical ratings assigned based on the safety and soundness examinations.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended CRA to require public discussion of data underlying the regulators' assessment.

The Housing and Community Development Act of 1992 amended CRA to require that the regulators give CRA credit to institutions who cooperate in activities and investment involving minorities- and women-owned financial institutions and low-income credit unions.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 amended CRA to require that depository institutions with interstate branching be assigned a separate rating and evaluation for each state and a separate evaluation where they have branches in two or more states within their metropolitan area.

According to the pre-1995 version of the CRA, an examiner is to evaluate depository institutions' technical compliance with a set of specific rules, and to qualitatively evaluate the institution's efforts and performance in serving the credit needs of its entire community. In assessing compliance with the technical requirements of CRA the examiner works through the CRA checklist. However, assessing compliance with the qualitative requirements of CRA is more difficult and subjective. The qualitative aspect of an institution's performance is to be assessed according to 12 factors. To allow examiner sufficient flexibility the regulators have not assigned a relative weighing to the factors. However, regulators have stated that compliance with antidiscrimination laws and regulations, including ECOA and FHA, is a significant factor in determining the CRA rating. Moreover, regulators have stated that examiners are to weigh CRA performance over process, i.e., how well an institution helps meet the credit needs of its community over documentation showing how the institution ensures CRA compliance.

The CRA assessment factors are grouped under five performance categories as published in the Federal Register on May 1, 1990. Table 1 shows the categories and their corresponding factors.

A compliance examination generally results as well in a CRA rating. The CRA scale is a four-part descriptive scale as follows: "outstanding," "satisfactory," "needs to improve," and "substantial noncompliance."

FRB and FDIC also approve applications with commitments. OCC and OTS do not do so, instead they conditionally approve applications. The conditions may be similar to commitments; however, the depository institution must meet the conditions before the final approval.

Table 1: CRA Assessment Factors Performance categories and related assessment factors
1. Ascertainment of community credit needs
Assessment factor A: Activities to ascertain credit needs and efforts to communicate with the community, including the extent of the institution's efforts to communicate with members of its community regarding the credit services being provided by the institution.
Assessment factor C: The extent of participation by the institution's board of directors in formulating the institution's policies and reviewing its performance related to CRA.
2. Marketing and types of credit offered and extended
Assessment factor B: The extent of the institution's marketing and special credit-related programs to make members of the community aware of the credit services offered by the institution.
Assessment factor I: The institution's origination of residential mortgage loans, housing rehabilitation loans, home improvement loans, and small business or small farm loans within its community, or the purchase of such loans originated in its community.
Assessment factor J: The institution's participation in governmentally insured guaranteed or subsidized loan programs for housing, small business, or small farms.

Table 1: CRA Assessment Factors Performance categories and related assessment factors
3. Geographical distribution and record of opening and closing offices
Assessment factor E: The geographic distribution of the institution's credit extensions credit applications, and credit denials.
Assessment factor G: The institution's record of opening and closing offices and providing services at offices.
4. Discrimination and other illegal credit practices
Assessment factor D: Any practices intended discourage applications for types of credit set forth in the institution's CRA Statement(s).
Assessment factor F: Evidence of prohibited discriminatory or other illegal credit practices.
5. Community development
Assessment factor H: The institution's participation, including investment, in local community development and redevelopment projects or programs.
Assessment factor K: The institution's ability to meet various community credit needs based on its financial condition and size, legal impediments, local economic conditions, and other factors.
Assessment factor L: Any other factors that, in the regulatory authority's judgment, reasonably bear upon the extent to which an institution is helping to meet the credit needs of its entire community.
Source: FRB, FDIC, OCC, and OTS compliance manuals.

Any depository institution wishing to expand must be prepared for the potential for a protest by community groups or other members of the public. Regulators must consider protests in their approval process. Historically, these protest groups have exercised their right over institutions wishing to expand. Regulators encourage the parties at odds to come together before an application is submitted to a regulator for approval. The amendments to CRA enacted by FIRREA in 1989 and FDICIA in 1991 have strengthened the public role in enforcing CRA in both the application review process and the CRA examination process.

Many community groups voiced their concern that although over 90 percent of all depository institutions receive satisfactory CRA rating or above, there are large geographic areas that do not obtain credit from these institutions. These groups demanded an examination process that is based on actual lending "performance" rather than "process." On July 15, 1993, the President called for a revision to the CRA regulation that would make CRA examination a performance-based system based on results rather than process and paperwork. Especial emphasis was placed on results in low- and moderate-income areas of depository institutions' communities.

In May 1995, FRB, OCC, OTS, and FDIC released the revised CRA regulations which had a more quantitative orientation and was based on actual performance relative to the following three tests: the lending test, the service test, and the investment test. These replaced the qualitative CRA examination system, including the 12 assessment factors. The three tests under the revised CRA regulations are described as follows:

> *Lending test:* The lending test is the examination of an institution's lending record, including originations and purchases of home mortgages, lending to small businesses and small farms, and, at the institution's option, consumer loans throughout the institution's service area, including the low- and moderate-income areas; the distribution of loans to borrowers in its service area(s); the distribution of loans to borrowers of various income levels; and the like.
>
> *Investment test:* The investment test is the examination of an institution's investments in community development activities. The examiner takes into account the amount, innovativeness, or complexity of the investment as well as the degree to which it responds to community credit and economic development needs.
>
> *Service test:* The service test is the examination of an institution's systems for delivering retail banking services and the extent and innovativeness of its community development services. The examiner reviews information regarding branching, alternative service delivery mechanisms such as banking by telephone, mobile branches, loan production offices, automated teller machines (ATM), etc., in low- and moderate-income areas and for low- and moderate-income individuals. The focus of the test, however, is on the institution's current distribution of full-service branches.

In general, the regulators rate an institution's performance with respect to each of the three tests, but the lending test rating carries more weight than the other two. An institution must receive at least "low satisfactory" rating on the lending test to receive an overall CRA rating of satisfactory. However, ratings on the other two tests have considerable effect on the overall rating.

The revised regulation allows a streamlined examination for small institutions. A small institution is defined as an independent retail institution with total assets of less than $250 million and holding company affiliates with total assets of less than $1 billion. The streamlined examination method focuses on an institution's loan-to-deposit ratio, degree of local lending, record of lending to borrowers and the geographic distribution of different income levels, and record of responding to complaints.

The revised regulation also gives all depository institutions the option of having their CRA performance examined according to a regulator-approved strategic plan. The strategic plan should be developed with community input detailing how the institution proposes to meet its CRA obligation.

The most recent changes to CRA occurred as a result of the Gramm-Leach-Bliley Financial Modernization Act (GLBA) of 1999. GLBA requires that depository institutions must have satisfactory CRA ratings before the institution, or its holding company, affiliates or subsidiaries, can engage in any of the expanded financial activities permitted under the law. GLBA's "sunshine" provision requires that agreements entered into by depository institutions and community organizations or other entities in fulfillment of CRA obligations must be publicly disclosed.

EFFECTS OF THE COMMUNITY REINVESTMENT ACT

The CRA, which was passed in 1977, had limited effect on lending until the late 1980s when the amount of such lending increased significantly (Evanoff and Siegal 1996).

To understand the reasons for this increase and determine the impact of the CRA on lending in low- and moderate-income neighborhoods, during the first half of 2000 the Joint Center for Housing Studies of Harvard University convened a series of discussion groups comprised of individuals who have studied or have direct knowledge of lending in low- and moderate-income neighborhoods. This was then reflected in Belsky, Lambert, and von Hoffman (2000), a summary of which is as follows.

After the passage of the CRA depository institutions made few loans in low- and moderate-income neighborhoods. Regulators enforced the CRA inconsistently. Depository institutions were not worried about receiving CRA approval because almost all of them passed their CRA exams. A major progress started when a few banks and mortgage consortia began to organize departments and assign staff to carry out low- and moderate-income lending, setting the stage for future activity.

In the 1990s, depository institutions substantially increased the amount of loans extended to low- and moderate-income borrowers and neighborhoods. By the late 1990s, regulators had created more consistent and rigorous examination processes. Depository institutions took the regulatory examinations more seriously, worked harder to improve their CRA performance, and expanded their community reinvestment operations. Depository institutions introduced new methods of mortgage lending and offered novel loan products to the low- and moderate-income market. Depository institutions and community advocates began to work together as partners. In general, regulatory officials, community advocates, and officers of a significant number of depository institutions took the CRA seriously and acted together to fulfill its goals.

Several factors that emerged in the late 1980s led lending institutions to increase their lending in low- and moderate-income communities. These factors fall into three categories: (1) collection of new mortgage data; (2) enforcement of CRA; and (3) changes in mortgage market.

Collection of New Mortgage Data: The Financial Institution Reform and Recovery Act (FIRREA) required financial institutions to collect and report information about loan applications and borrowers, including their race, sex, and income. FIRREA also required government officials to release expanded HMDA data and the CRA ratings to the public.

Accordingly, during the early 1990s, the Federal Reserve Board started to release aggregated HMDA data. Consultants and financial institutions then began to disseminate the data in computerized formats, which make the data widely accessible.

Community groups and the local news media analyzed the HMDA race and loan data and concluded that there were discriminatory lending patterns in certain communities.

In 1988 and 1989 the Atlanta Journal-Constitution published “The Color of Money,” a series of reports by reporter Bill Dedman that described lending in the Atlanta region as favoring whites over blacks. This series, which won a Pulitzer Prize in journalism, prompted community organizations to protest, increased media coverage of racial discrimination in lending, and led depository institutions to increase the number of loans to African-Americans and other minority groups.

Another highly publicized study by Munnell et al. (1992), Mortgage Lending in Boston: Interpreting HMDA Data, issued by the Federal Reserve Bank of Boston, had a similar impact. The study found that the rate of denial of loan applications for blacks was much higher than for whites with similar qualifications.

Depository institutions were afraid that criticism on racial grounds would hurt their standing in the community and their ability to expand their operations. These institutions began to analyze the new HMDA data in order to set lending targets for the number and location of their community loans. Depository institutions used this information to size up themselves against competitors regarding penetration into the low- and moderate-income lending market and formulated strategies for expanding the number of customers for CRA-type loans.

Enforcement of CRA: In the late 1980s, federal government officials stepped up their oversight of the CRA thereby pressuring depository institutions to increase the number of loans to low- and moderate-income borrowers and neighborhoods.

In 1989 the Board of Governors of Federal Reserve Bank denied a merger application by the Continental Illinois National Bank and Trust Company of Chicago on the grounds that the bank had not met its CRA requirements. This was the first time that regulators had denied a depository institution's merger application because of non-compliance with the CRA.

As a result, depository institutions worried that federal regulators would deny merger applications unless they complied with the CRA. Therefore, depository institutions' consolidation and merger strategy had an enormous impact on CRA lending. In contrast, for those institutions who were not interested in merger, there was little or no competition for CRA type lending.

In 1989 again, the U.S. Department of Justice sued the Decatur Federal Savings and Loan Association of Atlanta for violating the fair lending laws (mostly the Fair Housing Act and the Equal Credit Opportunity Act). In 1992, Decatur agreed to pay $1 million in damages for discriminatory lending practices and improve its lending practices.

Consequently, depository institutions interpreted the Decatur law-suit as the federal banking regulators' tough new policy in the area of fair lending. As a result, depository institutions became more aggressive in approving low- and moderate-income loan applications.

Over the years, the Congress pushed federal officials to tighten their regulation of the CRA. In response, regulators systematized and increased their supervision of low- and moderate-income lending. In 1989, for the first time regulators released to specific depository institutions the detailed results of the CRA examination with respect to the twelve standard assessment factors. In 1991, regulators started the public release of the results of their examinations of depository institutions' compliance with the CRA. After this, they enforced the act more strictly.

In 1995 and 1996, regulators adopted new ways to examine the lending practices of depository institutions. Examinations were now dependent on the size of the depository institution. For larger banks, the examination was based on three tests: lending, investment, and service. Each test measured innovation and access to financial products. Depository institutions were also now required to disclose their loans outside metropolitan areas. The depository institutions then responded by setting lending goals in order to earn high grades on CRA examinations.

Changes in Mortgage Market: The banking and mortgage industries underwent some changes which encouraged depository institutions to increase their loans to low- and moderate-income borrowers and neighborhoods.

The savings and loan crisis of the late 1980s indirectly played a role because depository institutions had an incentive to merge. This is because, after many savings and loans associations closed, larger institutions hoped to survive by merging with other institutions. The Reigle-Neal law facilitated this process because it eased restrictions on interstate banking. But as described above, when depository institutions applied for merger, regulators enforced the CRA, by which they required depository institutions to have extended enough CRA loans.

The expansion of secondary mortgage market also helped increase the low- and moderate-income lending. Two government-sponsored mortgage corporations, Freddie Mac and Fannie Mae, are major purchasers in the secondary mortgage market. In 1992, in conformance with the recently passed Federal Housing Enterprises Financial Soundness and Safety Act, Freddie Mac and Fannie Mae started to increase their purchases of mortgages to low- and moderate-income borrowers, borrowers in underserved areas, and borrowers for affordable housing projects. This encouraged depository institutions to increase their volume of loan to low- and moderate-income borrowers and neighborhoods which they could then sell to Fannie Mae and Freddie Mac. Such sale of the mortgages freed depository institutions' capital to make more loans to low- and moderate-income borrowers. Nonetheless Fannie Mae and Freddie Mac do not purchase CRA loans as below-market-rate mortgages, requiring the lending institutions to hold them in their portfolios.

The mergers in the banking industry resulted in larger lending institutions that had greater ability to extend CRA loans. These larger banks benefited from economies of scale and specialized in certain markets. Therefore, during the 1990s, these larger banks had more funds to lend to people in low- and moderate-income communities. Although these larger banks have more funds than previous smaller institutions, they may be less responsive to the needs of their communities and they may be less likely to meet their responsibilities in certain communities due to their larger size.

In issuing mortgages to low- and moderate-income borrowers, depository institutions gained experience and became more efficient in issuing CRA loans. Depository institutions were able to lower the costs of issuing CRA mortgages by improving their mortgage originations process and using improved technologies in their operations. Depository institutions learned more about the low- and moderate-income market and how to more accurately assess the risks of potential loans and reduce their own risk of default. Depository institutions took advantage of the insurance provided by private companies when they were extending loans to low- and moderate-income borrowers, which usually are loans with higher loan to value (LTV) and debt to income ratios.

The profitability of CRA loans was regarded as another contributing factor. Depository institutions over time realized that mortgage lending to low- and moderate-income borrowers and neighborhoods could be profitable. At first, depository institutions thought that CRA loans with high LTV, that require extra effort compared to other loans, are not profitable. However, the original assumptions proved to be untrue. Several factors, including the CRA, originally inspired depository institutions to lend in low- and moderate-income areas, but it was the profitability of the loans that induced lenders to continue making them. That is, depository institutions were convinced that there were untapped market opportunities in low- and moderate-income lending. However, some CRA loans are more costly and more risky to the depository institution and hence less profitable.

Finally, the favorable conditions in the national economy encouraged depository institutions to increase the number and amount of loans in low- and moderate-income neighborhoods. The large profits earned in the booming economy made it possible for depository institutions to accept riskier loans and lower interest rates on mortgages.

EFFICIENT MARKETS DEBATE

The debate is based on three major different perspectives: (1) The lending market is efficient, (2) The lending market is inefficient due to illegal "discrimination," and (3) The lending market is socially inefficient as caused by "externalities." The efficient markets view regards the CRA as a "tax" on the banking system, whereas the latter two views mostly support the idea that the CRA benefits lenders as well as low- and moderate-income borrowers and their neighborhoods.

The Efficient Markets Hypothesis (EMH) states that market prices reflect all available information. According to what type of information is available and, therefore, incorporated into market prices, there are three levels of market efficiency:

> *Weak form efficiency* states that all information contained in past price movements is contained in current market prices.
> *Semi-Strong form efficiency* states that current market prices reflect all publicly available information.
> *Strong form efficiency* states that current market prices reflect all pertinent information, whether publicly available or privately held. A good source of information on the EMH is Shiller (2002) and the references therein.

According to the efficient markets view, as long as mortgage credit is extended in a competitive manner the market is best suited to determine which lenders and how many are needed to serve the borrowers.

In the efficient markets view, depository institutions have private incentive to seek all profitable lending opportunities; therefore CRA should have little effect on lending because depository institutions already perform the tasks that the CRA intends to encourage them to do. However, if the CRA forces lenders to make unprofitable loans, then the efficient markets view would regard the CRA as a burden on the banking system. For instance, the CRA may impose substantial compliance costs, such as the costs of training staff to become familiar with the requirements of the CRA and the costs of maintaining records of actions taken to comply with the regulation to be shown to regulators.

The competing views, in turn, note that the CRA itself established and helped maintain the conditions that enabled independent mortgage companies to succeed in reaching low- and moderate-income borrowers and neighborhoods. The CRA accomplished this first by demonstrating that market opportunities existed in serving previously neglected low- and moderate-income borrowers and neighborhoods, and second by enforcing ongoing credit access in low- and moderate-income neighborhoods ensuring that housing markets in these areas remain viable.

The competing views note that as the mortgage lending to low- and moderate-income borrowers and neighborhoods has become more prevalent and more competitive, many lenders introduced products for the CRA-eligible market and used them on a regular basis. Thus, while their CRA lending is mostly extended in their assessment areas, introduction of new products to better serve these areas have likely had positive spillover effects on lending outside of assessment areas, as well as on the lending of non-CRA regulated companies. The fact that many large independent non-CRA mortgage companies have been successful at serving the low- and moderate-income market is an evidence of this process and that a reasonable portion of the CRA-eligible market is being served economically.

The debate preceding the enactment of CRA has continued to this date. The evidence on efficient markets in bank lending seems inconclusive. The controversy will continue for the foreseeable future. An observer with a strong prior belief in the ability of market forces to take advantage of profitable opportunities can easily remain unconvinced by the evidence on the effects of the CRA. On the other hand, an observer with a strong prior belief in the prevalence of market failures in lending will find striking confirmation in such evidence. Between these two extremes lie a range of reasonable assessments.

PREDATORY LENDING

Lately, lending institutions have expanded their operations in the fast-growing area of sub-prime lending. However, many of the companies engaged in this market are not subject to CRA regulations.

HUD-Treasury (2000) reports that recently, too many families are suffering because of the growth of predatory or abusive practices. These practices are concentrated in the sub-prime mortgage market, where most borrowers use the collateral in their homes for debt consolidation or other consumer credit purposes. The interest rates on sub-prime loans are usually higher than that of conventional loans because banks assume that customers run a higher risk of defaulting on their mortgages. This type of lending was and is profitable although it carries higher risks than the prime lending market. Most borrowers in this market have limited access to the mainstream financial sector, yet some would likely qualify for prime loans. Sub-prime lending serves an important role, by providing loans to borrowers who do not meet the credit standards for the prime mortgage market (e.g., impaired or limited credit histories, or high debt relative to their income). Predatory lending practices occur at any stage of the loan process, lenders, mortgage brokers, realtors, and home improvement contractors. In a predatory lending situation, the party that initiates the loan often engages in deception or fraud, provides misinformation, manipulates the borrower through aggressive sales tactics, and/or takes unfair advantage of the borrower's lack of information about the loan terms and their consequences. The results are loans with onerous terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices. The existence of these practices is especially troubling to the extent that sub-prime lending is most heavily concentrated in lower-income and predominantly minority neighborhoods. Predatory lending has contributed to the rapid growth in foreclosures in many inner-city communities, and foreclosures can destabilize families and entire neighborhoods. As a result, the issue of sub-prime and predatory lending are closely intertwined with obligations under the CRA.

Predatory lending in the prime market is avoided by competition among lenders, greater homogeneity in loan terms, greater financial information among borrowers, and the fact that most prime lenders are banks, thrifts, or credit unions, which are subject to extensive federal and state oversight and supervision. This is in sharp contrast to the sub-prime market.

CONCLUSION

CRA was passed in 1977 and has undergone several revisions. Overall, it has increased lending to low- and moderate-income borrowers and communities. The CRA has also made significant changes in the behavior of many federally regulated financial institutions and the financial industry. They have been testing new financial instruments to reach low- and moderate-income markets. They have created bank consortia.

This paper has reviewed the CRA and related legislation, summarized related literature which has assessed the impact of the CRA, and associated these results with the ongoing debate with the Efficient Market Hypothesis. One additional unforeseen consequence of extending the access to finance to low- and moderate-income borrowers, however, is on the supply side: the increasing frequency of predatory lenders. While predatory lending may be profitable, and increase access, its overall impact may be negative on the borrowing community. This might serve as another issue for the efficient markets debate.

APPENDIX: TERMINOLOGY

CRA-regulated lenders refer to federally regulated banks and thrifts as well as their mortgage company and finance company affiliates. CRA-eligible loans refer to loans made to lower-income households and/or households living in lower-income areas. Assessment areas refers to areas where they maintain deposit taking operations.

Lower-income borrowers are defined as having incomes less than 80 percent of metropolitan area median income, and lower-income communities are census tracts with 1990 median family income that was less than 80 percent of their metropolitan area median.

Low- and moderate-income (LMI) borrowers, and borrowers who live in LMI areas, and loans to such persons, are referred to as “CRA-eligible borrowers,” “CRA-eligible loans,” or “CRA-eligible lending”, respectively.

The term minority is used to mean African American or Hispanic and the term white is used to mean non-Hispanic white, even though many Hispanic Americans have European or white racial backgrounds. Black is used as a synonym for African American.

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