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## RETHINKING COMMUNITY REINVESTMENT

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*Policymakers have struggled for decades to boost low-income credit access, which is vital for combatting socioeconomic inequality. In 1977, Congress hoped the Community Reinvestment Act (CRA) would fix the problem. The CRA compels banks to lend near their branches—in low- and high-income neighborhoods alike. Still, millions of creditworthy borrowers can’t find affordable loans. What’s the solution?*

*The CRA, this Article argues, should push large banks to support community banks and other small lenders, including through capital provision, joint ventures, technical assistance, or subsidies. Why? While big banks make nearly all CRA loans, small, community-based lenders reach marginalized groups far more effectively. Economic data indicate this so-called “small-lender effect.” But so far, lawyers haven’t gotten the memo.*

*Ample legal scholarship has discussed the CRA—often focusing on whether it is “efficient,” in the law-and-economics sense. This Article makes two interventions in these debates, which are each necessary and together sufficient to compel its prescriptions. First, drawing on past economics scholarship and original empirical work, it demonstrates small lenders’ greater ability to underwrite low-income borrowers. Second, it shows that community lenders are stymied, themselves, by separate market failures that keep them from filling the gaps left by big banks. Enlisting large banks to support community*

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*lenders would therefore expand credit access and fulfill the CRA's goals. Even better, it would do so efficiently. This Article's prescriptions, finally, explain how to refit the CRA for this purpose.*

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## I. INTRODUCTION

In September 2018, bank CEO Marc Stefanski—head of Cleveland’s Third Federal Savings and Loan Association—joined the ranks of the one percent. That is to say, his bank failed its Community Reinvestment Act exam.

Nationwide, roughly ninety-nine percent of banking executives shepherd their firms to at least a “Satisfactory” CRA rating.<sup>1</sup> Stefanski did not. Under his watch, as the Office of the Comptroller of the Currency (OCC) put it, Third Federal had a “weak” track record of lending to low- and moderate-income (LMI) borrowers.<sup>2</sup> Despite recently ranking first among thirty-five Cleveland banks in mortgage originations, Third Federal made *zero* loans to residents in three-fourths of the city’s poorest census tracts.<sup>3</sup> This, and other shortcomings, the OCC determined, violated the CRA’s charge for banks to “meet the credit needs” of their community.<sup>4</sup>

Stefanski and his team said little about the CRA.<sup>5</sup> But analysts speculated that Third Federal would bounce back, once it lifted risk-limiting measures temporarily installed after the 2008 financial crisis.<sup>6</sup> The bank, meanwhile, took steps to improve. It worked to double its LMI share of mortgages,<sup>7</sup> contributed to charitable groups, and ran

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<sup>1</sup> See *infra* note 78 and accompanying text.

<sup>2</sup> OFF. OF THE COMPTROLLER OF THE CURRENCY, CHARTER NO. 704544, COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION: THIRD FEDERAL SAVINGS AND LOAN ASSOCIATION OF CLEVELAND 2 (2018).

<sup>3</sup> *Id.* at 13–15, C-2.

<sup>4</sup> 12 U.S.C. § 2901(a)(3).

<sup>5</sup> See, e.g., TFS Fin. Corp., Annual Report (Form 10-K) (Nov. 24, 2020), 33–34.

<sup>6</sup> See, e.g., *TFS Financial: Mispriced 2-Step Thrift Conversion with 50% Upside*, SEEKING ALPHA (Dec. 21, 2018, 5:00 AM ET), <https://seekingalpha.com/article/4227943-tfs-financial-mispriced-2-step-thrift-conversion-50-percent-upside> [<https://perma.cc/8E5G-UUUV>].

<sup>7</sup> OFF. OF THE COMPTROLLER OF THE CURRENCY, CHARTER NO. 704544, COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION: THIRD FEDERAL SAVINGS AND LOAN ASSOCIATION OF CLEVELAND 13–14 (2021).

financial-literacy programs.<sup>8</sup> Stefanski turned to the press to tout his community credentials.<sup>9</sup> Yet in February 2021, Third Federal failed again. The OCC praised the bank's "excellent responsiveness" to overall community needs, but it chastised Third Federal for failing to reach low-income groups, specifically.<sup>10</sup>

Stroll five miles down the road, to CHN Housing Partners, and Third Federal's struggle to source LMI borrowers might seem downright mystifying. In 2021, as Third Federal's low-income mortgage business stagnated, CHN inaugurated its new lending arm, which will make millions of dollars in small-dollar housing loans annually.<sup>11</sup> Or consider community bank First Federal Savings & Loan.<sup>12</sup> Twenty percent of its Cuyahoga County mortgages fall within the City of Cleveland—a region where over ninety percent of neighborhoods are low- to moderate-income.<sup>13</sup>

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<sup>8</sup> Joe Pagonakis, *CSU Report: African-Americans Denied Home Loans More Often than Whites*, NEWS 5 CLEV. (Oct. 31, 2019, 5:49 PM), <https://www.news5cleveland.com/csu-report-african-americans-denied-home-loans-more-often-than-white-applicants> [https://perma.cc/M7TF-AQKH].

<sup>9</sup> See Grant Segall, *Third Federal, the Biggest Federally Chartered Thrift, Bolsters Slavic Village*, THE LAND (June 15, 2021), <https://www.thelandcle.org/stories/third-federal-the-biggest-federally-chartered-thrift-bolsters-slavic-village> [https://perma.cc/E5V8-X3P5].

<sup>10</sup> OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 7, at 7, 13–14.

<sup>11</sup> Eric Heisig, *Cleveland Nonprofit Launches Low-Dollar Mortgage Wing to Spur Homeownership in East Side, Low-Income Neighborhoods*, CLEVELAND.COM (Apr. 9, 2021, 2:41 P.M.), <https://www.cleveland.com/realestate-news/2021/04/cleveland-nonprofit-launches-low-dollar-mortgage-wing-to-spur-homeownership-in-east-side-low-income-neighborhoods.html> [https://perma.cc/J67P-R5VW].

<sup>12</sup> First Federal's assets as of September 30, 2022 are roughly \$2.6 billion. *First Federal Savings and Loan Association of Lakewood*, US BANK LOCATIONS, <https://www.usbanklocations.com/first-federal-savings-and-loan-association-of-lakewood.shtml> [https://perma.cc/DUK2-KVQJ].

<sup>13</sup> See Frank Ford, *2020 Mortgage Lending in Cuyahoga County*, W. RSRV. LAND CONSERVANCY 23–24 (Nov. 12, 2021), <https://www.wrlandconservancy.org/wp-content/uploads/2021/12/2020-Cuyahoga-Home-Mortgage-Lending.pdf> [https://perma.cc/8KV5-DMQL].

Both these lenders are small. They have far fewer resources at their disposal than Third Federal. CHN's assets amount to a rounding error on Third Federal's \$15 billion balance sheet.<sup>14</sup> Surely Third Federal—a large bank by any measure—has the financial firepower to spruce up its risky-lending business. Why didn't it?

That thinking is misguided. Lower asset bases notwithstanding, small, community-based lenders—like CHN Housing Partners, or First Federal—more easily reach low-income groups than big banks like Third Federal. This Article explains why—and what it means for the CRA.

Credit markets for low-income borrowers are, in short, highly inefficient. Information asymmetries and other market failures abound.<sup>15</sup> The heart of the problem is that, to find creditworthy LMI borrowers, lenders often need *local information*—that is, detailed, hard-to-quantify knowledge about borrowers' earnings prospects, support networks, and broader communities.<sup>16</sup> However, when extending loans, the biggest lenders rely on cookie-cutter,<sup>17</sup> "hard"<sup>18</sup> creditworthiness metrics, like credit scores or income statements.<sup>19</sup> Most low-income applicants fare poorly by "hard" metrics, even when nevertheless able to repay debt.<sup>20</sup> Hard metrics therefore "misprice" these borrowers. Marc Stefanski, sitting at the helm of Third Federal, may then be an outlier in failing his CRA exams outright. But his institution's general struggles with LMI lending apply broadly to its peers.

Large banks' LMI-lending shortcomings pose urgent policy challenges. By some estimates, hard metrics can conclusively

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<sup>14</sup> Segall, *supra* note 9.

<sup>15</sup> See *infra* notes 104–16 and accompanying text.

<sup>16</sup> See *infra* notes 205–08 and accompanying text.

<sup>17</sup> Rebel A. Cole, Lawrence G. Goldberg & Lawrence J. White, *Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks*, 39 J. FIN. & QUANT. ANALYSIS 227, 227 (2004).

<sup>18</sup> See *infra* notes 179–85 and accompanying text.

<sup>19</sup> See *infra* notes 191–97 and accompanying text.

<sup>20</sup> See *infra* notes 198–204 and accompanying text.

gauge the risk of just one-fifth of mortgage borrowers<sup>21</sup>—suggesting that millions are excluded from affordable credit products. Those left behind are disproportionately people of color,<sup>22</sup> entrenching preexisting racial disparities in credit access. Yet affordable credit is vital for consumers to buy homes and essential goods,<sup>23</sup> access services including healthcare,<sup>24</sup> and build wealth.<sup>25</sup> It matters equally for sustaining small businesses,<sup>26</sup> whose prosperity uplifts the communities of their owners.<sup>27</sup> Affordable credit, then, lies at the vanguard of the fight against economic, social, and racial inequality.<sup>28</sup> President Obama himself underscored the challenge at the start of his second term: “[E]ven with mortgage rates near a 50-year low, too many families with solid credit who want to buy a home are being rejected . . . . That’s holding our entire economy back.”<sup>29</sup>

Smaller lenders, thanks to their community relationships and other structural advantages, circumvent the problems facing big banks.<sup>30</sup> Their size lets them cheaply acquire “soft” information about local borrowers.<sup>31</sup> That, in turn, helps them

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<sup>21</sup> See *infra* note 203 and accompanying text.

<sup>22</sup> See BD. OF GOVERNORS OF THE FED. RESRV. SYS., REPORT TO THE CONGRESS ON CREDIT SCORING AND ITS EFFECTS ON THE AVAILABILITY AND AFFORDABILITY OF CREDIT S-2 (2007).

<sup>23</sup> Steven Laufer & Andrew Paciorek, *The Effects of Mortgage Credit Availability: Evidence from Minimum Credit Score Lending Rules*, 14 AM. ECON. REV.: ECON. POL’Y 240, 240–44 (2022).

<sup>24</sup> JACOB S. HACKER, THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM 5–9 (2006).

<sup>25</sup> NICOLAS P. RETSINAS & ERIC S. BELSKY, BUILDING ASSETS, BUILDING CREDIT: CREATING WEALTH IN LOW-INCOME COMMUNITIES 14–20 (2005).

<sup>26</sup> See, e.g., MANTHOS DELIS, FULVIA FRINGUELLOTTI & STEVEN ONGENA, FED. RESRV. BANK OF N.Y., CREDIT, INCOME, AND INEQUALITY 1–8 (2022).

<sup>27</sup> See, e.g., JOYCE KLEIN, ASPEN INST., BRIDGING THE DIVIDE: HOW BUSINESS OWNERSHIP CAN HELP CLOSE THE RACIAL WEALTH GAP 6–9 (2017).

<sup>28</sup> Laufer & Paciorek, *supra* note 23, at 274.

<sup>29</sup> Barack Obama, President of the U.S., State of the Union Address (Feb. 12, 2013).

<sup>30</sup> See *infra* notes 247–64 and accompanying text.

<sup>31</sup> See *infra* notes 260 & 261 and accompanying text.

extend credit where large banks cannot.<sup>32</sup> This insight—that smaller lenders better navigate LMI credit markets—is not wholly new. Policymakers and activists have suggested it before,<sup>33</sup> while some economists have documented the role of local information in lending.<sup>34</sup> Yet it has big implications for legal debates about the CRA, which, I seek to show, have overlooked this so-called “small-lender effect.”

Those implications are as follows. The CRA compels banks, in practice, to allocate portions of their loan portfolios to borrowers near their branches. But while the Act applies to all banks, the largest ones deploy the most CRA loans. This fact, of course, is the logical result of the biggest banks’ controlling the vast majority of banking wealth, enabling them to lend more. Large banks—here, those with assets exceeding \$1 billion—represent a tiny fraction of American banking institutions but hold *ninety* percent of all bank assets.<sup>35</sup> The upshot is that those banks *worst* at LMI lending (i.e., big banks) dictate where nearly all CRA credit goes—and on what terms.

To date, legal scholars have paid this dynamic little mind—though not for lack of writing on the CRA. For decades, academics have debated myriad aspects of the Act, perhaps most significantly the extent to which it is “efficient.” Efficiency, the primary law-and-economics benchmark for evaluating any law or policy, posits that free markets usually maximize social utility.<sup>36</sup> It therefore counsels against most

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<sup>32</sup> See *infra* note 258 and accompanying text.

<sup>33</sup> See, e.g., Benjamin Della Rocca & Nate Loewentheil, *Analysis of the Distribution of Phase I of the Federal Paycheck Protection Program* 2–3, 7–9, 14 (Yale Inst. for Soc. & Pol’y Stud., ISPS Working Paper 20-08, 2020).

<sup>34</sup> See *infra* notes 210–16 and accompanying text.

<sup>35</sup> See *infra* note 313 and accompanying text.

<sup>36</sup> For theoretical discussions of “efficiency,” see, for example, JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 49–53 (4th ed. 2013); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW §1.1 (9th ed. 2014); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 497 (1980). For applications in legal scholarship, see, for example, Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 498 (2007); David A. Weisbach, *Should Legal Rules Be Used to Redistribute Income?*, 70

government distortions.<sup>37</sup> The CRA, of course, distorts lending markets, which would normally violate efficiency's dictates. Critics of the CRA lean on that fact to advocate substantially overhauling the law or abolishing it altogether.<sup>38</sup> Proponents, by contrast, argue that the law *is* efficient.<sup>39</sup> They contend that its distortions help correct “market failures” in LMI credit markets—that is, the information barriers described above.<sup>40</sup> These failures prevent free markets from fostering efficient outcomes to begin with.

This Article makes two analytic claims involving the CRA. First, I argue that the CRA does not, in fact, resolve information-related “market failures” nearly as well as it could. The reason is the small-lender effect, which Part III of my Article evaluates. This point is crucial for the CRA debate, since resolving market failures is what actually justifies the law (on efficiency grounds). To address LMI-credit-market frictions more effectively, lawmakers and agencies should

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U. CHI. L. REV. 438–41, 448 (2003); Benjamin Della Rocca, *Unemployment Insurance for the Gig Economy*, 131 YALE L.J. F. 799, 810–11 (2022). For critiques of efficiency's traditional role in law and economics, see, for example, Richard S. Markovits, *On the Relevance of Economic Efficiency Conclusions*, 29 FLA. ST. U. L. REV. 1, 2–7 (2001); Zachary Liscow, *Is Efficiency Biased?*, 85 U. CHI. L. REV. 1649, 1693–1700 (2018); Daniel Hemel, *Regulation and Redistribution with Lives in the Balance*, 89 U. CHI. L. REV. 649, 649–62 (2022).

<sup>37</sup> See, e.g., GRUBER, *supra* note 36, at 55–57; RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 60–96 (1983); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 667–69 (1994); Alstott, *supra* note 36, at 498; Christine Jolls, *Behavioral Economic Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1655 (1998).

<sup>38</sup> See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 347–48 (1993); Keith N. Hylton & Vincent D. Rougeau, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives*, 18 ANN. REV. BANKING L. 163, 164 (1999).

<sup>39</sup> See, e.g., Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 650–51 (2005).

<sup>40</sup> Cf. Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 549 (1980); Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 822–27 (2000).



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incentivize banks, through the CRA, to scale exponentially their support for local lenders. The intuition driving this prescription is simple: Loans originated by community lenders, dollar for dollar, plug LMI-credit-market gaps more effectively than those by large banks. The Act should therefore empower community lenders to issue more credit.

The CRA, to be sure, carves out some room for large-bank/small-lender collaboration.<sup>41</sup> Large banks sometimes receive CRA credit for financing community groups, running joint ventures with them, or buying loans off their balance sheets. Rather than treating these activities neutrally, though, the CRA should *incentivize* them significantly more than others. This collaboration, the small-lender effect tells us, is the most effective way to overcome the market failures at issue.

This Article's first claim, taken on its own, might therefore seem to offer a promising CRA fix. Funneling support to small lenders might appear to make the law more "efficient." But that conclusion would be too hasty. That is to say, aiding small lenders would mitigate the *particular* information barriers described above. However, it might not raise efficiency *overall*. And in fact, without more, law-and-economics logic gives strong reason to doubt that it would.

A core law-and-economics presumption, after all, is that free markets are efficient. As for LMI credit markets, information barriers undermine that assumption with respect to *large* banks. But not small ones. Indeed, the small-lender effect matters, in the first place, because small lenders can overcome these barriers. Presumably, then, small lenders *restore* efficiency to LMI credit markets. Yet this presents a puzzle. If information barriers aren't holding back local lenders—unlike large banks—why must the CRA intervene to help them at all? Local lenders should already be filling the gaps big banks leave. Put differently, if community lenders are *truly* so effective, why don't they already lend more in the free market? Yet in fact, the nationwide tally of community banks has dwindled for decades, rather than rising. All this

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<sup>41</sup> See *infra* notes 489–96 and accompanying text.

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points to one conclusion: that more local lending would *not* be efficient. Unimpeded by information barriers, local lenders must already underwrite “efficient” numbers of borrowers. Otherwise, they would simply underwrite more. Therefore, so far as efficiency is concerned, the CRA shouldn’t waste resources subsidizing them. And if LMI borrowers cannot find loans, they must be “inefficient” credit recipients.

That objection tees up this Article’s second analytic claim—which rebuts this law-and-economics reasoning on its own terms. As Part IV explains, declining community lending is *not* the product of market efficiency. Other market failures—completely separate from the information barriers restricting LMI credit—have stymied small lenders’ operations. These independent market failures explain why small lenders *haven’t* stepped in to fill each gap left by big banks. Specifically, this Article identifies five such failures: market-power concentration,<sup>42</sup> regulatory distortions,<sup>43</sup> capital-market frictions,<sup>44</sup> LMI-lending transaction costs,<sup>45</sup> and the emergence of “banking deserts.”<sup>46</sup> These market failures—unlike those from Part III—give a robust efficiency justification for laws that support small lenders.

Neither of my two claims alone justifies my prescriptions, which would have the CRA support community lenders more forcefully. Yet each is necessary, and together they are sufficient. The CRA can solve the *LMI-credit-market* failures in Part III—and thereby achieve the law’s stated purpose—by marshalling large-bank capital to ameliorate the *community-lender* market failures in Part IV. This approach can expand credit access for millions of Americans. Moreover, it can do so efficiently.

Having made these claims, my Article lays out a roadmap for the CRA to achieve this goal. It delivers several prescriptions in particular. The first follows straightforwardly from the above: that the CRA should give banks extra credit

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<sup>42</sup> See *infra* Section IV.A.

<sup>43</sup> See *infra* Section IV.B.

<sup>44</sup> See *infra* Section IV.C.

<sup>45</sup> See *infra* Section IV.D.

<sup>46</sup> See *infra* Section IV.E.

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for activities helping local lenders (including some that the law does not now recognize). This Article gives other prescriptions, though, for the CRA to spur large-bank/small-lender cooperation in the most efficient ways possible—while helping the greatest number of LMI borrowers. These recommendations include letting institutions tailor collaborative arrangements to their particular needs; raising the nexus between CRA credit and LMI support; and increasing banks’ flexibility to support lenders in certain regions, like banking deserts, regardless of location.

The rest of this Article proceeds as follows. Part II describes the CRA and the ongoing legal conversations referenced above. Part III makes the case for the small-lender effect—my first “analytic claim.” It first presents the major players in U.S. lending markets. Then, it explains why large banks stumble in LMI markets, while small ones succeed. Section III.C.2, in particular, sheds light on the subject with novel statistical evidence. Its regression analysis finds that smaller lender size predicts higher loan shares, by dollar volume, going to LMI borrowers. The data also suggest that, within a particular region, one lender’s increase in LMI lending begets more such lending by others—validating a central prediction of the legal scholarship explored in Part II.

Next, Part IV argues that policy interventions to aid small lenders—whether or not through the CRA—are efficient. Why? At least five failures, this Part argues, keep markets from sustaining community lending at efficient levels. This is my second “analytic claim.” Part V turns to prescriptions. First, it explains why the CRA, as opposed to other tools, is the right instrument for solving these problems (or one of the right ones). Then, drawing lessons from the previous two Parts, it evaluates a recent (now rescinded) OCC reinterpretation of the CRA as a case study, before offering novel policy recommendations. Part VI concludes.

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## II. THE CRA AND CONTEMPORARY DEBATES

### A. The CRA's History, Purpose, and Mechanics

Congress passed the Community Reinvestment Act in 1977.<sup>47</sup> In broad strokes, the Act requires banks to take steps that meet the credit needs of neighborhoods nearby their physical branches.<sup>48</sup> It tasks the three federal bank-regulating agencies—the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve (Fed), and the OCC—with evaluating how well banks achieve this goal.<sup>49</sup> These agencies examine banks' conduct within "assessment areas"—the specific communities where banks run deposit-taking operations.<sup>50</sup> Banks receive "credit," or "points," in regulators' scorebooks for conducting CRA-eligible activities within assessment areas. Regulators convert banks' total credit into CRA "ratings."<sup>51</sup> Ordered best to worst, the rating tiers are "Outstanding," "Satisfactory," "Needs to Improve," and "Substantial Noncompliance." The CRA requires the FDIC, Fed, and OCC to "take" ratings "into account" when evaluating mergers, acquisitions, or other actions subject to regulatory review.<sup>52</sup>

Legislators had multiple, overlapping motivations for the Act. The CRA's text itself purports to give effect to banks' "continuing and affirmative obligation to help meet the credit needs of . . . local communities."<sup>53</sup> That austere text elides contentious debate over the nature of banks' obligations, their

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<sup>47</sup> Community Reinvestment Act of 1977, Pub. L. No. 103-328, 108 Stat. 1111 (1977), 12 U.S.C. §§ 2901–08. Specifically, the law applies to national banks, savings associations, and state-chartered commercial and savings banks but not credit unions, insurance companies, loan funds, or other securities companies. CONG. RSCH. SERV., R43661, THE EFFECTIVENESS OF THE COMMUNITY REINVESTMENT ACT 2 (2019).

<sup>48</sup> CONG. RSCH. SERV., *supra* note 47, at 1–2.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> 12 U.S.C. § 2903(a)(2).

<sup>53</sup> *Id.* § 2901(a)(3).

source, and how to enforce them.<sup>54</sup> One major concern was community “disinvestment.”<sup>55</sup> By the 1970s, legislators observed, many banks tended to accept deposits in low-income neighborhoods but use them to finance loans elsewhere.<sup>56</sup> CRA proponents considered this unfair. Banks, they felt, should give back to depositors’ communities by investing locally.<sup>57</sup>

Combatting racial redlining was another motivation. For much of the 20<sup>th</sup> century, many banks had categorically refused to lend within low-income minority neighborhoods.<sup>58</sup> Unlike disinvestment,<sup>59</sup> redlining results from lenders’ discriminatory intentions, racial bias, or explicit use of race to proxy for economic characteristics, even *absent* overt racial animus.<sup>60</sup> Owing to this concern, Congress enacted the CRA as part of a trio of laws—along with the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure

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<sup>54</sup> A. Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431, 1431–38 (1995).

<sup>55</sup> *Id.* at 1446.

<sup>56</sup> CONG. RSCH. SERV., *supra* note 47, at 1.

<sup>57</sup> *See, e.g.*, Overby, *supra* note 54, at 1453–55; Kevin O’Connor, Note, *The DOJ’s Reliance on the Community Reinvestment Act to Support Discrimination Allegations Has Negative Consequences for Community Banks*, 44 VT. L. REV. 399, 402 (2019).

<sup>58</sup> *See, e.g.*, Michael Berry & Jessie Romero, *Community Reinvestment Act of 1977*, FED. RSRV. HIST. (May 8, 2023), <https://www.federalreservehistory.org/essays/community-reinvestment-act> [<https://perma.cc/YL29-B4D6>].

<sup>59</sup> Nonredlining patterns of disinvestment, of course, might still create disparate racial impacts or be reinforced by discrimination elsewhere in society.

<sup>60</sup> Overby, *supra* note 54, at 1446–48. Many academics distinguish “rational redlining” from “irrational redlining.” The definition provided above captures “irrational redlining”: decisions not to extend credit on account of race, separated from economic characteristics of borrowing groups. Rational redlining refers to a related practice of lenders, not motivated by racial animus, who explicitly use race as a proxy for economic characteristics of borrowers that are harder to observe. *See id.* at 1446–53; Keith N. Hylton & Vincent D. Rougeau, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives*, 18 ANN. REV. BANKING L. 163, 172–79 (1999) (distinguishing “rational” and “irrational” redlining).

Act (HMDA)—that addressed racial discrimination in credit markets.<sup>61</sup>

The CRA ameliorated *both* disinvestment and redlining, supporters argued, by compelling banks to lend in nearby low-income neighborhoods.<sup>62</sup> These arguments defeated objections that the Act—according to opponents—distorted credit markets, slapped regulatory burdens on banks, spurred unsound lending, and threatened financial stability.<sup>63</sup>

Since 1977, Fed, FDIC, and OCC rulemakings have implemented the statute, with the current rules tracing back to 1995.<sup>64</sup> Broadly speaking, today’s regime works as follows. Regulators evaluate banks’ activities within bank-specific geographic “assessment areas”; banks have some discretion to draw these areas, but they must include all places where they operate branches, maintain deposit-taking ATMs, or hold significant loans.<sup>65</sup> Within each area, regulators subject banks’ activities to three “tests”: the “lending,” “investment,” and “services” tests. The lending test, composing half of a bank’s overall rating, gauges the number and value of banks’ CRA-eligible loans.<sup>66</sup> (Small banks today are evaluated solely under the lending test.<sup>67</sup>) The investment test measures eligible “community development” investments, and the services test scores banks’ retail services, like checking accounts and in-person branch service.<sup>68</sup> Under each test, regulators assign banks a numerical score, but they do not

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<sup>61</sup> Overby, *supra* note 54, at 1446.

<sup>62</sup> Sandra F. Braunstein, *The Community Reinvestment Act*, BD. GOVERNORS FED. RSRV. SYS. (Feb. 13, 2008), <https://www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm> [<https://perma.cc/VZ4S-WXE5>].

<sup>63</sup> *Id.*; Overby, *supra* note 54, at 1457–58.

<sup>64</sup> See Sandra F. Braunstein, *The Community Reinvestment Act*, BD. GOVERNORS FED. RSRV. SYS. (Feb. 13, 2008), <https://www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm> [<https://perma.cc/VZ4S-WXE5>].

<sup>65</sup> O’Connor, *supra* note 57, at 403–04. Assessment areas also may not reflect illegal discrimination.

<sup>66</sup> CONG. RSCH. SERV., *supra* note 47, at 5–6.

<sup>67</sup> *Id.* at 6.

<sup>68</sup> *Id.* at 5–6.

derive that score from strict quantitative quotas.<sup>69</sup> Instead, each test weighs banks' relevant conduct against their capacity constraints, business model, neighborhood composition, opportunities to lend, and peer institutions' performances—that is, each bank's "[p]erformance context."<sup>70</sup>

Notably, in May 2022, the Fed, FDIC, and OCC undertook joint rulemaking to reform numerous aspects of the CRA.<sup>71</sup> The new rule—expected to be finalized in the coming months<sup>72</sup>—would ease some of the CRA's geography requirements. Specifically, to accommodate the rise of mobile banking, it would let banks' assessment areas include certain areas beyond their physical vicinity, while offering discounted "credit" for community-development activities outside banks' assessment areas.<sup>73</sup> The proposed rule would also restructure the above three tests' precise parameters for most banks.<sup>74</sup> In particular, it would start gauging some of these factors according to stricter quantitative benchmarks.<sup>75</sup> That said, the reformulated versions of these tests would appear likely to measure fundamentally similar sorts of activities to today's lending, investment, and services tests.<sup>76</sup>

Under today's rules, then, what activities specifically are "eligible" for credit? The lending test's most significant categories are (1) mortgage loans to LMI individuals, or to *any* individuals in LMI census tracts; (2) loans to small businesses, regardless of LMI status; and (3) loans to small

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<sup>69</sup> *Id.* at 4.

<sup>70</sup> 12 C.F.R. § 228.21(b) (2023).

<sup>71</sup> *See generally* Community Reinvestment Act, 87 Fed. Reg. 33,884 (June 3, 2022).

<sup>72</sup> *See, e.g., Banks Face Avalanche of Data Demands Ahead of CRA, CFPB Final Rules*, WOLTERS KLUWER (Feb. 8, 2023), <https://www.wolterskluwer.com/en/expert-insights/banks-face-avalanche-of-data-demands-ahead-of-cra-cfpb-final-rules> [https://perma.cc/GRG7-K7XT].

<sup>73</sup> Community Reinvestment Act, 87 Fed. Reg. 33,884, 33,889 (2022).

<sup>74</sup> *See id.* at 33,889–91.

<sup>75</sup> *See id.* at 33916–17.

<sup>76</sup> *See id.*

farms.<sup>77</sup> The investment test credits three main activities that advance “community development.” The first is purchases of loans originated by *other* lenders that *would* have generated lending-test credit, had the purchasing bank originated them.<sup>78</sup> Second is “public welfare investments,” which finance services that “primarily benefit LMI individuals,” like affordable housing programs.<sup>79</sup> Finally, the test covers “community development investments” and “economic development investments,” which support public-welfare investments managed by third parties (like nonprofits).<sup>80</sup>

Large banks generally undergo CRA exams every three years, though the interval for smaller banks is longer.<sup>81</sup> Nearly all receive “Satisfactory” or “Outstanding” ratings, with just a handful earning the latter.<sup>82</sup> Only around one percent of banks receive “Substantial Noncompliance” or “Needs to Improve.”<sup>83</sup> Nevertheless, CRA exams are not a

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<sup>77</sup> See OFF. COMPTROLLER CURRENCY, CRA ILLUSTRATIVE LIST OF QUALIFYING ACTIVITIES 1–4; Laurie Goodman, John Walsh & Jun Zhu, *Small Business and Community Development Lending Are Key to CRA Compliance for Most Banks*, URB. INST. (Feb. 7, 2019), <https://www.urban.org/urban-wire/small-business-and-community-development-lending-are-key-cra-compliance-most-banks> [https://perma.cc/4CQN-S9UM].

<sup>78</sup> CONG. RSCH. SERV., *supra* note 47, at 7.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Community Reinvestment Act (CRA) Questions and Answers for Bank Customers*, OFF. COMPTROLLER CURRENCY, <https://www.occ.treas.gov/topics/consumers-and-communities/cra/cra-questions-and-answers.html> [https://perma.cc/G6BV-37XK].

<sup>82</sup> See, e.g., Robert B. Avery, Marsha J. Courchane & Peter M. Zorn, *The CRA Within a Changing Financial Landscape*, in REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE COMMUNITY REINVESTMENT ACT 30, 43–45 (Prabal Chakrabarti et al. eds., 2009); John Alexander, Drew Dahl & Michael F. Spivey, *Effects of Revisions to the CRA in 1995 on Regulatory Enforcement*, 7 J. BUS. & ECON. RSCH. 1, 3 (2009); Adam Witmer, *FDIC & OCC Release List of CRA Performance Evaluations for May 2018*, COMPLIANCE COHORT (June 7, 2018), <https://www.compliancecohort.com/blog/fdic-occ-release-list-of-cra-performance-evaluations-for-may-2018> [https://perma.cc/544R-SYUY].

<sup>83</sup> See, e.g., *supra* note 81.



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rubber stamp. Rather, banks have acquired the regulatory knowledge needed to align LMI-lending practices with their peers'.<sup>84</sup> The consequences of low ratings, further, are widely seen as harmful enough to banks to ensure high compliance.<sup>85</sup> The big question for the CRA, then, is whether its directives are desirable in the first place.

## B. Legal Scholarship on the CRA

Legal scholars debating the CRA typically ask one (or both) of two sets of questions. The first is whether the CRA is efficient (or reasonably efficient) policy, particularly when it comes to solving market failures that afflict low-income credit markets. The second is whether it combats lending discrimination. This Article's main analysis and prescriptions concern the first question.

To be sure, other values might also guide scholarly treatment of the CRA. Broader redistributive goals, for example, could justify the Act even if it is neither efficient nor antidiscriminatory.<sup>86</sup> Scholars focus on efficiency and discrimination, though, likely because they widely accept that the CRA scores well by redistribution metrics.<sup>87</sup> Hardly anyone disagrees with its redistributive aims;<sup>88</sup> the most that naysayers say, typically, is that the CRA is so inefficient that

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<sup>84</sup> See Avery et al., *supra* note 81, at 43–45.

<sup>85</sup> See, e.g., O'Connor, *supra* note 57, at 406–07.

<sup>86</sup> See, e.g., Michael Klausner, *A Tradeable Obligation Approach to the Community Reinvestment Act* 9, 25 (Stan. L. Sch., Working Paper No. 375, May 2009).

<sup>87</sup> See, e.g., Rougeau & Hylton, *supra* note 59, at 163; Michael Gaughan, *FinTech and the Liberation of the Community Reinvestment Act Marketplace*, 19 CITYSCAPE 187, 188 (2017); Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 319 (1993) (“There is undoubtedly truth to the argument that profitable loan opportunities exist in low-income and moderate-income neighborhoods, and that some of these loans would not be made if it were not for the CRA.”); Overby, *supra* note 54, at 1435–36 (observing that even the CRA's harshest critics charge mainly that the Act, in its implementation, is “ultimately self-defeating”).

<sup>88</sup> Rougeau & Hylton, *supra* note 59, at 169 (noting that all parties “probably agree” that banks should lend more to LMI communities).

it is counterproductive for redistribution. Economist Joseph E. Stiglitz, in fact, singles out the CRA as an archetypical economic policy that is obviously distributively just but not necessarily efficient.<sup>89</sup> In any event, even if the CRA's redistributive aims were seriously disputed, other scholars have articulated the basic case elsewhere.<sup>90</sup> Ample scholarship also demonstrates the importance of consumer-credit policies, generally, for advancing equity.<sup>91</sup>

This Article sets these other distributive justice concerns aside. The next two subsections explain the debates on the CRA's antidiscrimination and efficiency value (the latter of which is the focus of the rest of this Article).

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<sup>89</sup> Joseph E. Stiglitz, *Government Failure vs. Market Failure: Principles of Regulation*, in GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 13, 22 (Edward J. Balleisen & David A. Moss eds., 2010).

<sup>90</sup> See, e.g., Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463, 1484–1513 (1994) (expounding the “equality,” “affirmative action,” and “community-empowerment” impacts of the CRA); Christopher A. Richardson, *The Community Reinvestment Act and the Economics of Regulatory Policy*, 29 FORDHAM URB. L.J. 1607, 1613, 1619–20 (2002) (explaining “the CRA’s ability to increase the relative weight of LMI neighborhoods in the social welfare function” and calling its antidiscrimination benefits “certain”); Daniel J. Hutch, *Smart Growth Tools for Revitalizing Environmentally Challenged Urban Communities*, in GROWING SMARTER 345, 360–61 (Robert D. Bullard ed. 2007) (explaining that the CRA promotes equality by means of reinvestment).

<sup>91</sup> See, e.g., John Linarelli, *Equality and Access to Credit: A Social Contract Framework*, 84 L. & CONTEMP. PROBS. 165, 172–80 (2021) (applying John Rawls’s distributive-justice ideals to credit access, to which “[t]he Community Reinvestment Act was a substantial policy response”); Therese Wilson, *Consumer Credit Regulation and Rights-Based Social Justice*, 35 UNSW L.J. 501, 502–14 (2012) (drawing on other philosophers’ works to relate bank-provided consumer credit to distributive justice); Daniel T. Friedson, *Greenlining Toward a Community of Local Entrepreneurship, Home Ownership, and Quality of Life*, 9 J. AFFORDABLE HOUS. & COMTY. DEV. L. 183, 196 (2000) (casting the reversal of disinvestment through the CRA as an “obligation[] of the community to the individual” and a matter of “distributive justice”); Iain Ramsay, *Consumer Credit Law, Distributive Justice and the Welfare State*, 15 OXFORD J. LEGAL STUD., 179, 181–89 (1995) (theorizing the relationship between “[c]onsumer [c]redit [l]aw and [d]istributive [j]ustice”).

## 1. Discrimination

On balance, the CRA's discrimination debate involves fewer areas of dispute than the efficiency one. Just about everyone agrees the CRA gets things *directionally* right. To be sure, scholarly views diverge on the severity of lender discrimination today—and how well the CRA fixes the problem. Still, because scholars widely agree on the importance of combatting discrimination, many of the threshold questions for expanding, contracting, or reforming the CRA center on efficiency. For this reason, after this subsection, this Article takes for granted the CRA's antidiscrimination benefits, and it focuses on efficiency.

As for points of agreement, no one denies that large racial disparities exist in credit markets. Moreover, virtually all condemn explicit lender discrimination by race (“animus-based” discrimination),<sup>92</sup> as well as implicit bias<sup>93</sup> or use of race to proxy for borrowers' economic characteristics (“statistical” discrimination).<sup>94</sup> The CRA counteracts these trends. It pushes banks to lend locally regardless of neighborhood racial composition. For these effects, the law wins praise even from those criticizing it on other grounds.

Quantifying the CRA's antidiscrimination benefits, though, is harder. Not all disparate outcomes stem from lender discrimination, which the CRA can address. Preexisting social inequalities—such as racial disparities in wealth and income, which influence creditworthiness—are also to blame. Disentangling the effects of lender discrimination from these other factors raises challenging empirical questions.<sup>95</sup>

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<sup>92</sup> Vincent D. Rougeau & Keith N. Hylton, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 239 (1996).

<sup>93</sup> Rougeau & Hylton, *supra* note 59, at 178–79.

<sup>94</sup> Rougeau & Hylton, *supra* note 91, at 247–49 (observing widespread condemnation of statistical discrimination within the modern economics literature).

<sup>95</sup> See, e.g., Barr, *supra* note 39, at 548.

That said, the best econometrics research indicates that lender discrimination does exist. “Economic”<sup>96</sup> factors fail to explain why historically disadvantaged groups receive significantly less credit than others.<sup>97</sup> But the exact channel through which discrimination operates (animus-based, statistical, or implicit bias) is less clear. Further, as some scholars argue, certain types of discrimination are difficult to detect and regulate. Take, for instance, the possibility of loan-officer “coaching.” Some scholars hypothesize that loan officers might provide more application assistance—intentionally or not—to “borderline” nonminority borrowers.<sup>98</sup> That extra help could make their applications appear stronger than minorities’, even in the eyes of nondiscriminatory credit analysts.<sup>99</sup>

Beyond debating discrimination’s scope, scholars contest the CRA’s impact on it. Critics say the Act is a blunt tool for combatting discrimination. This is so because the law targets borrowing by income status, not race,<sup>100</sup> and because it only disincentivizes discrimination at the loan-origination stage. It does nothing, by contrast, to stop other potentially abusive practices—like charging overdraft rates,<sup>101</sup> overages,<sup>102</sup> or other fees.<sup>103</sup> Many argue that the ECOA, moreover, renders

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<sup>96</sup> See *id.* at 570; Rougeau & Hylton, *supra* note 88, at 246.

<sup>97</sup> Barr, *supra* note 39, at 547–48.

<sup>98</sup> Rougeau & Hylton, *supra* note 59, at 178–79.

<sup>99</sup> *Id.*

<sup>100</sup> Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1563–64 (1995).

<sup>101</sup> Roberto Quercia & Janneke Ratcliffe, *The Community Reinvestment Act: Outstanding, and Needs to Improve*, FED. RESRV. BANK S.F. 55, [https://www.frbsf.org/community-development/files/cra\\_outstanding\\_needs\\_improve.pdf](https://www.frbsf.org/community-development/files/cra_outstanding_needs_improve.pdf) [<https://perma.cc/2ACA-8WC3>].

<sup>102</sup> Harold A. Black, Thomas P. Boehm & Ramon P. DeGennaro, *Is There Discrimination in Mortgage Pricing? The Case of Overages*, 27 J. BANKING & FIN. 1139, 1159 (2003).

<sup>103</sup> The CRA also does nothing, others point out, to halt *any* discriminatory practices that banks apply to credit applicants outside their assessment areas. See, e.g., O’Connor, *supra* note 57, at 409.

the CRA's antidiscrimination effects moot because the former Act already forbids discriminating against individual borrowers.<sup>104</sup> CRA proponents acknowledge this point about the ECOA. However, some observe the Act still carries force against *neighborhood*-level redlining (at least in theory).<sup>105</sup>

In short, then, legal scholars dispute discrimination's scope and scale, as well as the CRA's effectiveness against it. These debates are important, but scholars largely do not contest that the CRA gets things directionally right. This Article takes for granted that the CRA has meaningful antidiscrimination benefits. The rest of its analysis and prescriptions thus focus on efficiency—the second subject of legal academic discourse.

## 2. Efficiency

In law and economics, efficiency is the primary yardstick for evaluating any policy. Law-and-economics thought takes as its “central tenet” the prescription that laws should be efficient—which economists define as maximizing “social welfare” or “utility.”<sup>106</sup> Utility maximization requires that the government not intervene in free markets—thereby distorting private choices—unless market mechanisms break down, or

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<sup>104</sup> Klausner, *supra* note 99, at 1563–64; Rougeau & Hylton, *supra* note 59, at 163; Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement Is Needed*, 20 FORDHAM URB. L.J. 293, 310 (1993).

<sup>105</sup> Barr, *supra* note 39, at 544–45.

<sup>106</sup> Zachary Liscow, Note, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 YALE L.J. 2478, 2480–81 (2014); *see also, e.g.*, Steven Shavell, *A Note on Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation?*, 71 AM. ECON. REV.: PAPS. & PROC. 414, 414–17 (1981); Louis Kaplow & Steven Shavell, *Fairness versus Welfare*, 114 HARV. L. REV., 961, 966 (2001); Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 103 (1979); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 488–96 (1980); Jolls, *supra* note 37, at 1654; Della Rocca, *supra* note 36, at 810–11.

“fail,” in some way.<sup>107</sup> Barring market failure, the theory goes, free markets produce efficient outcomes.

Under this framework, the big questions for the CRA, then, are whether it is efficient and how to make it more so. Such considerations of efficiency, which wield substantial influence over real policymakers’ economic-policy decisions,<sup>108</sup> are the biggest CRA stumbling block. Despite the law’s redistributive and antidiscrimination benefits—which receive widespread acclaim—its policy justification is murkier if efficiency undercuts them forcefully enough. Conversely, if the CRA *is* efficient (or can be made so), the case for preserving or expanding it is clear.

So where does legal scholarship stand? In broad strokes, the CRA efficiency debate breaks down as follows.

Proponents of the CRA as written contend it ameliorates market failures in LMI credit markets—most significantly, information barriers.<sup>109</sup> CRA reformists acknowledge such failures exist, at least theoretically, but criticize the Act on two grounds. First, they argue that the failures are small, in practice, or that the CRA does little to solve them anyhow.<sup>110</sup> Second, they argue the Act’s other social costs—including costs to lenders—outweigh any (allegedly small) efficiency gains.<sup>111</sup>

Professor Michael Klausner has written most extensively about the CRA and information-related market failures.<sup>112</sup> He identifies two, the first of which is *information asymmetries*. To extend anyone credit, he observes, lenders must acquire information “regarding the likelihood that the borrower will default.”<sup>113</sup> This “entails costs.”<sup>114</sup> Because of these costs,

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<sup>107</sup> See, e.g., Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512–20 (1980).

<sup>108</sup> Liscow, *supra* note 36, at 1688–91.

<sup>109</sup> See *infra* notes 107–23 & 132–37 and accompanying text.

<sup>110</sup> See *infra* notes 129–31 and accompanying text.

<sup>111</sup> See *infra* notes 126–28 and accompanying text.

<sup>112</sup> Klausner, *supra* note 99, at 1566–70; Klausner, *supra* note 85, at 9–15.

<sup>113</sup> Klausner, *supra* note 99, at 1565; Barr, *supra* note 39, at 533.

<sup>114</sup> Klausner, *supra* note 99, at 1565.

lenders will never know as much about borrowers as borrowers do, themselves.<sup>115</sup> And sometimes, thanks to asymmetries, borrowers with low “true” credit risks will appear risky, meaning lenders might not lend to them or might do so on unfavorable terms.<sup>116</sup>

The second failure is that loan markets, operating at levels depressed by information costs, fail to capture “positive information externalities.”<sup>117</sup> What are positive information externalities? Whenever creditors lend, their transactions create “information,” or data, about borrowers, which *future* lenders can use in subsequent underwriting.<sup>118</sup> As examples, new borrowing expands any person’s credit history, and mortgage loans finance transactions that produce price data on houses. Mortgage underwriting “rel[ies] heavily” on appraisals of borrowers’ homes, which in turn depend on “past sales of comparable homes in a neighborhood.”<sup>119</sup> By limiting borrowing, information barriers short-circuit the production of such data—to third-party borrowers’ detriment.

Scholars agree that LMI credit markets are particularly vulnerable to both failures.<sup>120</sup> Each is also frequently self-reinforcing. As information barriers reduce creditors’ lending in a community, the “thickness” of the community’s lending-related information drops further. That makes lending even harder.<sup>121</sup> Moreover, as creditors raise rates commensurately with their lending risk, adverse selection and moral hazard kick in. As for adverse selection, high rates disproportionately discourage stronger borrowers with lower odds of defaulting

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<sup>115</sup> *Id.* at 1564–65.

<sup>116</sup> *Id.* at 1564–67.

<sup>117</sup> *Id.* at 1566.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at 1569.

<sup>120</sup> See, e.g., *id.* at 1567–68; Barr, *supra* note 39, at 533; David C. Ling & Susan M. Wachter, *Information Externalities and Home Mortgage Underwriting*, 44 J. URB. ECON. 317, 318 (1998).

<sup>121</sup> Market “thinness” is one factor that causes rational lenders to charge higher lending premiums. Barr, *supra* note 39, at 537.

from entering credit markets.<sup>122</sup> As for moral hazard, high rates increase debt-service burdens—and hence the likelihood of default—for *all* borrowers.<sup>123</sup> These trends only heighten the risks of lending within particular markets, exacerbating the original problem. Additionally, LMI communities often lack civic institutions that might arrest the vicious cycle. To take one example, homeowners associations—uncommon in LMI neighborhoods, but more frequent in wealthy ones—can backstop residents' mortgage debt and supply lenders useful information to supplement underwriting.<sup>124</sup>

Given these market failures, does the CRA make sense, as written? Answering this question, as Klausner puts it, requires balancing the CRA's information-related benefits with the efficiency costs that "forced lending" imposes on banks.<sup>125</sup> Virtually all scholars acknowledge some such costs exist. These include banks' administrative, compliance, and implementation costs;<sup>126</sup> reduced lending profitability;<sup>127</sup> and potential regulatory roadblocks to efficient mergers.<sup>128</sup> But as for what these costs mean for CRA efficiency, the legal-academic literature divides roughly into three camps.

The first position, which Professors John Macey and John Miller famously took in the 1990s, holds that the CRA's costs are large enough to make it essentially unsalvageable.<sup>129</sup> As

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<sup>122</sup> Klausner, *supra* note 99, at 1566–67 n.15; Barr, *supra* note 39, at 537–38.

<sup>123</sup> Klausner, *supra* note 99, at 1566–67 n.15; Barr, *supra* note 39, at 537–38.

<sup>124</sup> Barr, *supra* note 39, at 540–42; Rougeau & Hylton, *supra* note 59, at 181–82 (arguing, however, that the absence of such institutions is a poor justification for the CRA).

<sup>125</sup> Klausner, *supra* note 99, at 1573–74.

<sup>126</sup> Overby, *supra* note 54, at 1431 n.4, 1434 n.21, 1457, 1468; Macey & Miller, *supra* note 86, at 324–33; Klausner, *supra* note 99, at 1564; Barr, *supra* note 39, at 524, 591; *see also* U.S. GOV'T ACCT. OFF., GAO-96-23, COMMUNITY REINVESTMENT ACT: CHALLENGES REMAIN TO SUCCESSFULLY IMPLEMENT CRA (1995).

<sup>127</sup> *See, e.g.*, Macey & Miller, *supra* note 86, at 320–22.

<sup>128</sup> *Id.* at 322–24; Rougeau & Hylton, *supra* note 59, at 189–90.

<sup>129</sup> *See, e.g.*, Rougeau & Hylton, *supra* note 59, at 165; Macey & Miller, *supra* note 86, at 324; David P. Ely & Kenneth J. Robinson, *Is the*



Macey and Miller contend, the CRA spurs such inefficient lending that it threatens financial stability.<sup>130</sup> Further, by stymying banks' operations and discouraging expansion into LMI neighborhoods, it might *decrease* LMI lending overall.<sup>131</sup>

A second camp, which includes Klausner, believes the CRA's costs outweigh its gains, but, with cost-minimizing reforms, it might be made efficient. For instance, Klausner's main critique is that, thanks to the Act's geographic nexus, CRA lending is at once too concentrated and too dispersed. It is too concentrated with respect to LMI neighborhoods, in that CRA dollars inundate certain communities with many large-bank branches but barely touch other places.<sup>132</sup> That distribution lowers the marginal information benefit of most CRA transactions. Simultaneously, at the individual-bank level, the CRA's requirement to service *all* nearby neighborhoods prevents specialization and keeps costs high.<sup>133</sup> Klausner thus suggests creating tradeable markets for CRA obligations—which would subvert the geographic nexus—and criticizes the Act for not promoting efficient coordination among banks.<sup>134</sup>

Still others, most notably Professor Michael Barr, defend the CRA as is—at least as “reasonable,” if not ideal, policy.<sup>135</sup> Barr argues that others overstate the law's compliance costs—

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*Community Reinvestment Act in Need of Further Reform? Evidence from Equity Markets During the 1995 Reform Process*, 23 J. FIN. SERV. RSCH. 59, 75 (2003).

<sup>130</sup> Macey & Miller, *supra* note 86, at 319–33.

<sup>131</sup> *Id.* at 340–41.

<sup>132</sup> See, e.g., Klausner, *supra* note 99, at 1574, 1576; Gaughan, *supra* note 83, at 192; Ellen Seidman, Sameera Fazili & Brett Theodos, *Making Sure There Is a Future: Capitalizing Community Development Financial Institutions*, URB. INST. 3–5 (May 2017), [https://www.urban.org/sites/default/files/publication/90241/making\\_sure\\_t\\_here\\_is\\_a\\_future.pdf](https://www.urban.org/sites/default/files/publication/90241/making_sure_t_here_is_a_future.pdf) [<https://perma.cc/VX8E-XDDB>].

<sup>133</sup> Klausner, *supra* note 99, at 1574–76.

<sup>134</sup> *Id.* at 1577. Some have argued that the rhetoric surrounding the CRA creates perverse political incentives that *discourage* banks from lending in certain communities. Rougeau & Hylton, *supra* note 59, at 169.

<sup>135</sup> Barr, *supra* note 39, at 541–42.

particularly after the 1995 reforms<sup>136</sup>—and finds that large banks spend just 600 hours annually complying with it.<sup>137</sup> He emphasizes, moreover, that “forced” lending prevents “freeriding,”<sup>138</sup> supports information-producing civic organizations, and spurs self-reinforcing credit growth.<sup>139</sup> And, unlike other scholars, Barr seems to infer that forced loans are efficient, themselves, because they bring LMI markets’ “volume and liquidity” close to their hypothetical levels absent information asymmetries.<sup>140</sup>

Some scholars, including Barr, have claimed the CRA solves inefficiencies separate from information failures. While such claims have support, these other failures still tie fundamentally to information. For example, Barr cites “collective action problems” that “inhibit” lenders’ “entry” into LMI communities, but this dynamic primarily explains why banks do not privately coordinate to capture information externalities.<sup>141</sup> Barr also alludes to agency costs,<sup>142</sup> which—in his account—are reasons banking institutions lose “focus” on expanding LMI credit.<sup>143</sup> This failure, however, mainly provides one specific reason that surmounting information barriers is hard. Finally, numerous authors discuss “neighborhood externalities,” by which loans boost the local economy and make other residents look more creditworthy.<sup>144</sup> While analytically distinct from information externalities,<sup>145</sup>

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<sup>136</sup> *Id.* at 520.

<sup>137</sup> *Id.* at 591.

<sup>138</sup> *Id.* at 541.

<sup>139</sup> *Id.* at 542.

<sup>140</sup> *Id.* at 542–43.

<sup>141</sup> *Id.* at 534–35.

<sup>142</sup> *Id.* at 535.

<sup>143</sup> *Id.* at 562.

<sup>144</sup> Klausner, *supra* note 99, at 1561–62; Barr, *supra* note 39, at 542–43; Rougeau & Hylton, *supra* note 59, at 180–81.

<sup>145</sup> Information externalities improve underwriting accuracy—and thus enhance a neighborhood’s credit-market efficiency—regardless of whether the original loan transaction ultimately produces economic growth. Neighborhood externalities, in order to be positive, depend on the underlying loan spurring neighborhood growth.

this effect, in practice, benefits LMI communities through similar channels.

The remainder of this Article does not seek to resolve the entire debate about CRA efficiency. Rather, following scholars like Klausner and Barr, I take the law's existence as given, and I recommend reforms for the CRA (short of changing it existentially) to make it significantly more efficient—and more likely to represent a “reasonable” response to credit-market failures.

### III. THE TRUTH ABOUT CREDIT MARKETS

The conventional CRA story, as discussed in the Introduction, misses two important points. First, it neglects the fact that large banks, though responsible for deploying most CRA dollars, are ill-equipped to reach LMI borrowers. Second, it overlooks substantial market failures—which the CRA could combat—that keep local lenders from plugging the gap. This Part explores that first insight, and Part IV explores the second. Section III.A first taxonomizes the major providers of capital in U.S. credit markets. Then, Section III.B explains why large banks underwrite LMI borrowers poorly—and how structural forces stop them from changing. Section III.C unpacks the “small-lender effect.” It shows, by drawing on nonlegal scholarship and original empirical analysis, that smaller, community lenders can reach LMI groups more effectively.

Importantly, as stated in the Introduction, this Part does *not* argue that increased small-lender lending would be efficient, overall. Its evidence is not enough to support that claim. Instead, it shows that small lenders, unlike large banks, are effective at circumventing the *particular* market failures seen in LMI credit markets. Small-lender lending volumes above those today, though, might nevertheless be an *inefficient* resource allocation, overall, for any number of reasons. Part IV will show that this is not so.

## A. The American Lending Landscape

Americans borrow from a wide range of lenders, for many purposes. This Section explores who these lenders are. It covers markets specifically for mortgage loans and small-business loans—the main types of CRA-regulated credit. Broadly speaking, the array of lenders breaks down into three umbrella categories: large banks, smaller community lenders (including small banks), and “alternative”/fintech lenders.

Data on *who* originates loans are sparse, particularly for small-business credit. But they show the following. For mortgage debt in 2021, large banks—defined as those with over \$1 billion in assets—originated 22% of the 13 million mortgages reported under the HMDA,<sup>146</sup> though prior to the COVID-19 pandemic the number was closer to 30%.<sup>147</sup> Some sources, like HMDA data, use \$1 billion for the small-/large-bank asset cutoff, but many set the bar higher, at \$10 billion.<sup>148</sup> Small banks originated another 5% of mortgages, nonbank credit unions another 7%, and various affiliates of the foregoing categories 3%.<sup>149</sup> “Independent mortgage companies”—a catch-all category including fintech and online lenders, as well as more traditional nonbank incumbents—accounted for 63% of originations.<sup>150</sup>

The best small-business-borrowing surveys show similar trends. The Fed’s 2020 report on the Small Business Credit Survey finds that, over the prior five years, 44% of firms had borrowed from banks generally, 20% from online lenders, 6% from credit unions, 5% from nonprofits or other “community-

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<sup>146</sup> CONSUMER FIN. PROT. BUREAU, DATA POINT: 2021 MORTGAGE MARKET ACTIVITY AND TRENDS 55 (2022).

<sup>147</sup> See, e.g., CONSUMER FIN. PROT. BUREAU, DATA POINT: 2017 MORTGAGE MARKET ACTIVITY AND TRENDS: A FIRST LOOK AT THE 2017 HMDA DATA 68 (2018).

<sup>148</sup> See, e.g., 12 C.F.R. § 3.12 (2020) (providing the OCC definition for “community banks”); *Community and Regional Financial Institutions*, BD. OF GOVERNORS OF THE FED. RESRV. SYS. (Sept. 15, 2021), <https://www.federalreserve.gov/supervisionreg/community-and-regional-financial-institutions.htm> [<https://perma.cc/UW5H-R85C>].

<sup>149</sup> CONSUMER FIN. PROT. BUREAU, *supra* note 145, at 55.

<sup>150</sup> *Id.*

based” sources, and 1% from Community Development Financial Institutions (CDFIs).<sup>151</sup> (Respondents could select multiple responses.<sup>152</sup>) Importantly, these numbers mean the vast majority of credit-seeking businesses turn to banks, since over half of firms surveyed did not seek loans at all.<sup>153</sup> According to the 2022 report, 43% of credit-seeking firms applied to—but did not necessarily borrow from—large banks, while 36% applied to small banks.<sup>154</sup> Big disparities exist, though, in *which* businesses apply where. Firms identified as higher risk—that is, those with lower credit scores—applied less than low-risk ones to banks, but more to all other credit sources.<sup>155</sup> Application rates to online lenders, in particular, were almost three times higher.<sup>156</sup>

What can we take from the numbers? First, banks overall remain borrowers’ most important credit source. Within that group, small-sized banks punch above their weight. Small banks hold barely five percent of banking-sector assets.<sup>157</sup> Yet they originate almost one-quarter the mortgages of large banks and, strikingly, receive nearly equal small-business loan applications. The roles of other small, nonbank lenders, like credit unions and CDFIs, should not be discounted either. At the same time, new players are gaining ground. Online lenders—a diverse group of nonbanks that extend credit via online platforms—have surged rapidly in recent years. One estimate suggests their lending grew by a factor of ten

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<sup>151</sup> FED SMALL BUS., BD. OF GOVERNORS OF THE FED. RESERVE SYS., SMALL BUSINESS CREDIT SURVEY: 2020 REPORT ON EMPLOYER FIRMS 8 (2020).

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 11.

<sup>154</sup> FED SMALL BUS., BD. OF GOVERNORS OF THE FED. RESERVE SYS., SMALL BUSINESS CREDIT SURVEY: 2022 REPORT ON EMPLOYER FIRMS 20 (2022). The 2020 report finds similar statistics. FED SMALL BUS., *supra* note 150, at 15.

<sup>155</sup> FED SMALL BUS., *supra* note 153, at 20.

<sup>156</sup> *Id.*

<sup>157</sup> Fed. Deposit Ins. Corp., *Insured Institution Performance*, 17 FDIC Q. 11 (2023).

between 2013 and 2018.<sup>158</sup> Loans by independent mortgage companies, which include many online lenders, similarly soared the last decade.<sup>159</sup> Although online lenders have helped drive up the “independent” mortgage-lending share,<sup>160</sup> this category also encompasses larger incumbents which, despite being nondepository institutions, boast underwriting models much like large banks’.<sup>161</sup> Much of the following discussion of large banks, then, would also hold for these “traditional” independent lenders.

These diverse types of lenders can be broken out roughly into three groups, with distinct business models and clientele. The first is large banks. The aforementioned \$1 billion or \$10

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<sup>158</sup> Brett Barkley & Mark Schweitzer, Fed. Rsrv. Bank of Cleveland, *The Rise of Fintech Lending to Small Business: Businesses’ Perspectives on Borrowing*, 17 INT’L J. CENT. BANKING 35, 36 (2021).

<sup>159</sup> See You Suk Kim, Steven M. Laufer, Karen Pence, Richard Stanton & Nancy Wallace, *Liquidity Crises in the Mortgage Market*, 2018 BROOKINGS PAPERS ON ECON. ACTIVITY 347, 359.

<sup>160</sup> Marshall Lux & Robert Greene, *What’s Behind the Non-Bank Mortgage Boom?*, 3, 17 (Harv. Kennedy Sch., M-RCBG Assoc. Working Paper No. 42, June 2015). Other factors, though, have contributed as well. For example, higher regulatory costs; fines, settlements, and penalties from the financial-crisis era; and forward-looking legal risks have raised the costs of banks’ mortgage-lending practices, lowering their originations. Kim et al., *supra* note 158, at 355–57; Lux & Greene, *supra* note 159, at 17.

<sup>161</sup> See, e.g., *Fitch Downgrades Provident Funding to ‘B’; Outlook Remains Negative*, FITCHRATINGS (Oct. 17, 2022, 4:02 P.M.), <https://www.fitchratings.com/research/non-bank-financial-institutions/fitch-downgrades-provident-funding-to-b-outlook-remains-negative-17-10-2022> [https://perma.cc/B26Q-LXXW] (describing Provident Funding Associates’ “focus on higher quality, agency-eligible originations”). Further indications that some independent mortgage companies’ underwriting models resemble large banks’ come from CRA-like evaluations, by state-level agencies, under state laws designed to mirror CRA obligations for nonbank mortgage lenders. See, e.g., MASS. GEN. L. ch. 167 §14. Massachusetts agencies, for example, give several legacy nonbank mortgage lenders poor marks with LMI lending. See, e.g., MASS. DIV. OF BANKS, ML3821, CRA FOR MORTGAGE LENDERS PERFORMANCE EVALUATION: PROVIDENT FUNDING ASSOCIATIONS, LP 3 (2018) (scoring Provident Funding Associates as “Needs to Improve” on the lending test); MASS. DIV. OF BANKS, ML2767, CRA FOR MORTGAGE LENDERS PERFORMANCE EVALUATION: FREEDOM MORTGAGE CORPORATION, LP 3 (2015) (scoring Freedom Mortgage Corporation as “Needs to Improve” on the lending test).

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billion asset cutoffs serve to separate the vast majority of banking institutions—which frequently hold assets below \$25 million—from behemoths like JP Morgan Chase, Bank of America, Wells Fargo, and Citigroup, whose assets total in the trillions.<sup>162</sup> As the data above suggest—and as the rest of this Part explores—large banks’ lending practices differ starkly from others’.

Most small banks belong to a second rough category—community lenders, which focus operations on particular geographies. “Community banks,” in particular, are a subset of “small banks” dedicated explicitly to servicing defined communities.<sup>163</sup> These banks are vital lenders for certain demographics. By some calculations, they account for twenty percent of *all* bank lending but are overrepresented in agricultural loans (three-quarters), commercial real estate (nearly half), and small-business loans (just over half).<sup>164</sup>

Other categories of small lenders also lend at the community level. Credit unions, for instance, are nondepository institutions that function as cooperatives, fully owned and operated by members.<sup>165</sup> Many have small memberships and focus on “microloans” to members; federal laws limit credit unions’ growth by capping their total loans and requiring members to share a “common bond.”<sup>166</sup> Loan

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<sup>162</sup> Alicia Phaneuf, *Top 10 Biggest US Banks by Assets in 2022*, INSIDER INTEL. (Jan. 22, 2023), <https://www.insiderintelligence.com/insights/largest-banks-us-list/> [<https://perma.cc/6GPP-9ARV>].

<sup>163</sup> Like “small bank,” there is no single definition of “community bank.” Historically, agencies and academics have tended define “community banks” as those with under \$1 billion in assets and qualitative criteria regarding regional focus, but others more recently have upped the asset cutoff to \$10 billion. FED. DEPOSIT INS. CORP., *FDIC COMMUNITY BANKING STUDY 1-1* (2012).

<sup>164</sup> Marshall Lux & Robert Greene, *The State and Fate of Community Banking* 9–12 (Harv. Kennedy Sch., M-RCBG Working Paper No. 37., Feb. 2015).

<sup>165</sup> CONG. RSCH. SERV., R46360, *THE CREDIT UNION SYSTEM: DEVELOPMENTS IN LENDING AND PRUDENTIAL RISK MANAGEMENT 1–5* (2021).

<sup>166</sup> *See id.* at 2, 4–5.

funds, by contrast, are largely unregulated community lenders that often provide technical assistance.<sup>167</sup>

Community Financial Development Institutions (CDFIs) are another important local-lender designation. CDFIs come in diverse forms—roughly half are loan funds; one-third are credit unions; others are venture-capital funds, bank holding companies, or other banks or thrifts—and they are certified by the Treasury as having an explicit community-development mission.<sup>168</sup> The certification lets CDFIs apply for various Treasury grants—either direct financial support or technical-assistance funding.<sup>169</sup> Generally speaking, CDFIs provide more flexible financing terms and offer technical assistance, too.<sup>170</sup> Approximately 1,000 CDFIs operate nationwide, with roughly \$7 billion in outstanding loans.<sup>171</sup>

The final umbrella category is “alternative lenders”—a label used overlappingly with “online lenders” (as in the Fed survey), “marketplace lenders,” or “fintech companies.”<sup>172</sup> Definitions of alternative lenders vary. But most agree they interface with borrowers primarily online and use data-

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<sup>167</sup> See *Community Development Loan Funds*, CMTY. ACTION P'SHIP 3 (2012), <https://communityactionpartnership.com/wp-content/uploads/2018/06/loan-fund.pdf> [<https://perma.cc/K3DF-BGJA>].

<sup>168</sup> SEAN LOWRY, CONG. RSCH. SERV., R42770, COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS (CDFI) FUND: PROGRAMS AND POLICY ISSUES 5 (2018).

<sup>169</sup> *Id.* at 8–9. To receive grants, CDFIs must typically demonstrate that the money will fund projects supporting “distressed” areas, where 30% of residents earn less than the poverty line. *Id.* at 8.

<sup>170</sup> For examples of CDFIs, the services they offer, and their propensity to provide flexible financing terms with technical assistance, see generally *Community Development Financial Institutions: Community-Based, Mission Driven*, CDFI COALITION (Mar. 2014), [https://www.cdfi.org/wp-content/uploads/2014/03/20th-Anniversary-Report\\_FINAL1.pdf](https://www.cdfi.org/wp-content/uploads/2014/03/20th-Anniversary-Report_FINAL1.pdf) [<https://perma.cc/9Z6L-JHVV>].

<sup>171</sup> Sean Campbell & Christopher Shin, *Securitization for Social Innovation*, LOC. INITIATIVES SUPPORT CORP. 17 (Jan. 2021), [https://www.lisc.org/media/filer\\_public/ba/44/ba44a346-bb4f-49da-82fd-a11c116db010/011121\\_securitization\\_for\\_social\\_innovation\\_report\\_fin.pdf](https://www.lisc.org/media/filer_public/ba/44/ba44a346-bb4f-49da-82fd-a11c116db010/011121_securitization_for_social_innovation_report_fin.pdf) [<https://perma.cc/228D-A4WH>].

<sup>172</sup> See, e.g., FED. SMALL BUS., BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 150, at 8 n.4 (2020).



driven, technology-based processes to price credit.<sup>173</sup> Typically, alternative lenders receive third-party debt and equity investments, use the capital to extend loans, and repay investors from the proceeds.<sup>174</sup>

Alternative lenders offer firms and consumers a wide range of products,<sup>175</sup> and their business models vary substantially along two “axes.” The first is loan duration. Some alternative lenders (frequently, payments-processing companies) focus on providing short-term loans—often flexible and collateral free—primarily to businesses for use as working capital.<sup>176</sup> Others lend longer term.<sup>177</sup> The second axis is whether alternative lenders hold loans they originate or sell them. Examples of the former include PayPal<sup>178</sup> and

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<sup>173</sup> Kenneth Michlitsch, *An Introduction to Alternative Lending*, MORGAN STANLEY (May 17, 2017), <https://www.morganstanley.com/im/en-us/financial-advisor/insights/investment-insights/an-introduction-to-alternative-lending.html>.

<sup>174</sup> *Id.*

<sup>175</sup> See *The Ultimate Guide to Alternative Lending in 2021*, SARATOGA INVESTMENT CORP. (2021), <https://saratogainvestmentcorp.com/articles/alternative-lending/> [<https://perma.cc/8F36-Y5FJ>].

<sup>176</sup> Payments-processing company Stripe, for instance, focuses its lending operations on providing small businesses cash advances, similar to credit cards. See *The Sound of Small Business USA*, ALLIANCE FUNDING GRP. (July 27, 2021), <https://afg.com/the-sound-of-small-business-usa/>. Other groups, like payment-processing company Fundbox and lending-company Kabbage, focus on drawable lines of credit for businesses, for shorter terms than banks typically extend them. Katie Campbell, *Alternative Lenders: Best Lending and Loan Options*, FUNDERA (September 27, 2022), <https://www.fundera.com/business-loans/guides/alternative-lending> [<https://perma.cc/24CR-H74W>].

<sup>177</sup> OnDeck, for instance, offers both short-term and longer-term instruments, Lauren Ward, *OnDeck Small Business Loans: 2021 Review*, LANTERN (Feb. 8, 2021), <https://lanterncredit.com/small-business/reviews/ondeck>, and has an average maturity of over one year—relatively long for alternative lenders, OnDeck Capital, Quarterly Report (Form 10-Q) (Aug. 7, 2020).

<sup>178</sup> Paul Sweeney, *Online Loans You Can Take to the Bank*, DEBANKED (Apr. 16, 2019), <https://debanked.com/2019/04/online-loans-you-can-take-to-the-bank/> [<https://perma.cc/E9GE-F298>].

OnDeck.<sup>179</sup> Square, by contrast, securitizes loans,<sup>180</sup> and Affirm—a relative newcomer—securitizes some yet sells others directly to lenders.<sup>181</sup>

As suggested by their diverse business models—and rapid growth—alternative lenders cater to certain borrowing needs unmet by large banks. While they can, and do, service LMI groups, the rest of this Article focuses primarily on community lenders. Certainly, there is much to say about alternative lenders, and policymakers reforming the CRA should consider ways to leverage them, too. Broadly speaking, though, community lenders are most effective at reaching marginalized groups, and research documents that alternative lenders do not substitute for them.<sup>182</sup>

## B. When “Bigger” Isn’t “Better”

Underwriting’s central challenge is accurately determining borrowers’ “true” credit risks. This task is hard for the reasons described in Section II.B. No lender can obtain perfect information about borrowers, and information asymmetries are inevitable.<sup>183</sup> Yet with LMI borrowers, large banks do especially poorly. Large banks identify, collect, and analyze information in ways that screen out LMI applicants—even ones who are creditworthy. These shortcomings, further, are not for lack of trying on banks’ part. Rather, structural

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<sup>179</sup> OnDeck Capital, Quarterly Report (Form 10-Q) (Oct. 31, 2018).

<sup>180</sup> Sweeney, *supra* note 177.

<sup>181</sup> Kristin Broughton, *Fintech Lender Affirm Leans on Investors to Fund Rapid Growth*, WALL ST. J. (Sept. 23, 2021, 4:47 PM ET), <https://www.wsj.com/articles/fintech-lender-affirm-leans-on-investors-to-fund-rapid-growth-11632430057> [<https://perma.cc/PZ26-MCUZ>].

<sup>182</sup> See, e.g., Robert DeYoung, William C. Hunter & Gregory F. Udell, *Whither the Community Bank? Relationship Finance in the Information Age*, 2002 J. FIN. SERVS. RSCH. 3; Jeremy Nowak, *CDFI Futures: An Industry at a Crossroads*, OPPORTUNITY FIN. NETWORK 27–30 (Mar. 2016); Matt Hanauer, Brent Lytle, Chris Summers & Stephanie Ziadeh, *Community Banks’ Ongoing Role in the U.S. Economy*, 2020 ECON. REV. 5, 27 (2021).

<sup>183</sup> 1 TEXTBOOK EQUITY EDITION, PRINCIPLES OF ECONOMICS 323 (2014) (“[L]enders cannot be perfectly omniscient about whether . . . potential borrowers will repay loans on time.”).

features of the banking industry entrench large banks' current practices.

Seeing why “bigger” isn’t “better” in LMI lending requires understanding large banks' underwriting models. When any lender underwrites, they rely on “screening devices”<sup>184</sup>—that is, indicators, or proxy variables, which only approximate true credit risk. Some screening devices, of course, capture risk better than others.<sup>185</sup> But better screens typically cost more. The best creditworthiness indicators involve finer-grained, more detailed, or otherwise harder-to-get knowledge about borrowers. All lenders, then, must choose underwriting methodologies that most accurately screen for risk subject to the cost constraints of acquiring borrower information.<sup>186</sup>

What kinds of screens do large banks use? They rely mostly on information with three characteristics. First, they use *hard information*, which economists define as knowledge that easily reduces to numbers.<sup>187</sup> Hard information can be easily observed, verified, stored, and manipulated<sup>188</sup>—such as borrowers' credit scores or income levels.<sup>189</sup> Soft information,

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<sup>184</sup> See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981).

<sup>185</sup> See *Principles for the Management of Credit Risk*, BANK FOR INT'L SETTLEMENTS 11, <https://www.bis.org/publ/bcbssc125.pdf> [<https://perma.cc/5Z49-ZTG5>] (last visited June 2, 2023).

<sup>186</sup> See, e.g., *id.*

<sup>187</sup> See, e.g., José María Liberti & Mitchell A. Petersen, *Information: Hard and Soft*, 8 REV. CORP. FIN. STUD. 1 N.W.U. 1 (Nov. 30, 2018).

<sup>188</sup> Sumit Agarwal, Brent W. Ambrose, Souphala Chomsisengphet & Chunlin Liu, *The Role of Soft Information in a Dynamic Setting: Evidence from the Home Equity Credit Market*, 43 J. MONEY, CREDIT & BANKING 633, 634 (2015); Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized vs. Hierarchical Firms*, 57 J. FIN. 1891, 1893 (2002); Greg Chen & Xavier Faz, *Hype or Hope: Implications of Big Data for Financial Inclusion*, CGAP (Sept. 4, 2014), <https://www.cgap.org/blog/hype-or-hope-implications-big-data-financial-inclusion> [<https://perma.cc/UYT5-F2LY>].

<sup>189</sup> Further examples, in the mortgage-lending context, might include “age . . . occupation, number of TV sets, and the lender's measure of credit quality.” James Wang, *Essays on Information Asymmetries in Lending* (2015) (Ph.D. dissertation, University of Michigan),

by contrast, is harder to quantify and generally costs more to obtain.<sup>190</sup> Lenders relying on soft information often acquire it through repeated, personalized interactions with borrowers they serve.<sup>191</sup> For instance, in the small-business-lending context, such information might include characteristics of a firm's customers, its supply chain, or its executives' managing style.<sup>192</sup> And with subprime-mortgage lending, negotiations between lenders and borrowers are especially common.<sup>193</sup>

Second, large banks lean heavily on *public* information, not *private* information. Public information is simply that which publicly accessible sources report in a "relatively transparent" way.<sup>194</sup> Borrowers' credit scores are public since banks obtain them from credit agencies, while borrowers' incomes are private. (Private information is often soft but, such as with income, can be hard.<sup>195</sup>) Finally, large banks rely on *non-customized information*. The data they collect, in other words, tend to involve fixed parameters that vary minimally with an individual borrower's identity.<sup>196</sup> Income, age, and occupation are non-customized. When borrowers report these data, each borrower's answer takes a similar form, even while differing substantively. Customized information, by contrast, might include freer-form personal narrative or reputational

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[https://deepblue.lib.umich.edu/bitstream/handle/2027.42/111510/jtabw\\_1.pdf](https://deepblue.lib.umich.edu/bitstream/handle/2027.42/111510/jtabw_1.pdf) [https://perma.cc/CKT2-V3NH].

<sup>190</sup> Hirofumi Uchida, Gregory F. Udell & Nobuyoshi Yamori, *Loan Officers and Relationship Lending to SMEs* 4 (Fed. Rsv. Bank of S.F., Working Paper 2008-17, July 2008); Liberti & Petersen, *supra* note 186, at 6.

<sup>191</sup> Uchida et al., *supra* note 189, at 4.

<sup>192</sup> *Id.*

<sup>193</sup> Barr, *supra* note 39, at 557.

<sup>194</sup> Emilia García-Appendini, *Soft Information in Small Business Lending*, SSRN 2 (Aug. 2007), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=968178](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=968178) [https://perma.cc/C5AK-6FXZ].

<sup>195</sup> Liberti & Petersen, *supra* note 186, at 1.

<sup>196</sup> Elena Loutskina & Philip E. Strahan, *Informed and Uninformed Investment in Housing: The Downside of Diversification*, 24 REV. FIN. STUDS. 1447, 1448 (2011); 78 Fed. Reg. 35430, 35435 (June 12, 2013).

information about borrowers, perhaps supplied by references.<sup>197</sup>

What specific data does this mean large banks use? For consumer loans, personal credit scores play a dominant role.<sup>198</sup> Banks typically collect credit reports from a “Big Three” credit-score agency—Equifax, Experian, or TransUnion, which maintain credit files on over 200 million Americans<sup>199</sup>—and use these reports to calculate loan-applicant “scores.”<sup>200</sup> These agencies’ credit reports include various metrics that predict borrowers’ likelihood of default. Borrowers’ past default histories; bill-paying track records; outstanding credit-card debts; and number, length, and quality of outstanding credit lines all feature prominently.<sup>201</sup> Large banks supplement credit scores with borrower-reported information like income, tax returns, bank statements, and property values.<sup>202</sup> When underwriting small-business loans, large banks rely on businessowners’ personal credit scores, too.<sup>203</sup> They also collect data on the firm, including its outstanding debt, debt-service costs, debt/equity ratio, and other financial-statement information.<sup>204</sup>

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<sup>197</sup> 78 Fed. Reg. 35430, 35435 (June 12, 2013).

<sup>198</sup> FINREGLAB, DATA DIVERSIFICATION IN CREDIT UNDERWRITING 2 (Oct. 2020).

<sup>199</sup> *Preserving the Right of Consumers to Access Personal Financial Data*, H. Comm. on Fin. Serv., 117th Cong. 6 (Sept. 21, 2021) (testimony of Chi Chi Wu).

<sup>200</sup> *Id.*

<sup>201</sup> *Credit Scores*, FED. TRADE COMM’N (May 2021), <https://www.consumer.ftc.gov/articles/credit-scores/> [<https://perma.cc/37R3-9747>].

<sup>202</sup> *See, e.g., Home-Buying and Mortgage Process*, U.S. BANK (2021), <https://www.usbank.com/home-loans/mortgage/first-time-home-buyers/mortgage-process.html> [<https://perma.cc/5UEY-TEYT>].

<sup>203</sup> FED SMALL BUS., *supra* note 150, at ii (2020).

<sup>204</sup> *See, e.g., The 3 Biggest Things Banks Look at When Reviewing Small Business Loan Applications*, CADENCE BANK (2021), <https://cadencebank.com/fresh-insights/business/the-3-biggest-things-banks-look-at-when-reviewing-small-business-loan-applications/> [<https://perma.cc/LJ79-GH2E>].

All these data are hard and non-customizable. Many are public, and, for the data that are not (e.g., income), banks collect them easily from loan applicants.

This approach to underwriting—leaning on hard, public (or almost-public), non-customized information—makes sense in many contexts.<sup>205</sup> Collecting such data is far cheaper than soft, private, customized information. Of course, conventional data cannot provide anything close to a “full picture” of repayment ability. Information asymmetries—perhaps big ones—will inevitably exist. But banks do not always *need* the full picture to price credit at scale. For at least two reasons, traditional underwriting works reasonably well for high- and middle-income groups. First, such applicants frequently score well enough by hard metrics to render soft ones immaterial. Even if banks *did* collect soft data, their credit pricing would change little thanks to these borrowers’ low odds of the worst-case outcome—default.<sup>206</sup> Second, wealthy borrowers can often post collateral, whereas low-income ones cannot.<sup>207</sup> Collateral secures banks’ loans even in the *presence* of major information failures.<sup>208</sup>

But for LMI consumers and businessowners, the story is different. Soft, borrower-specific information matters far more for discovering the “true” lending risk of borrowers at the margins of creditworthiness. First, great numbers of “marginal” borrowers lack meaningful hard metrics altogether. Roughly forty-five million Americans—and

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<sup>205</sup> See Barr, *supra* note 39, at 539 (acknowledging, even from the standpoint of supporting the CRA, that “credit scores are good predictors of repayment”).

<sup>206</sup> See Erik J. Mayer, Big Banks, Household Credit Access, and Economic Mobility 3–4 (SMU Cox Sch. of Bus., Rsch. Paper No. 21-04, 2021), <https://ssrn.com/abstract=3816308> [<https://perma.cc/U3JX-NN86>].

<sup>207</sup> Sam Cheung & Suresh Sundaresan, Lending Without Access to Collateral: A Theory of Micro-Loan Borrowing Rates 4 (Sept. 25, 2006) (unpublished manuscript) ([https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/2329/new\\_micro\\_draft.pdf](https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/2329/new_micro_draft.pdf) [<https://perma.cc/C5DU-WZD7>]).

<sup>208</sup> Yu-Lin Wang, Chien-Hui Lee & Po-Sheng Ko, *Do Loan Guarantees Alleviate Credit Rationing and Improve Economic Welfare?*, 12 SUSTAINABILITY 3922, 3922–23 (2020).

disproportionately LMI ones—have too little credit history to generate a credit score.<sup>209</sup> For other LMI borrowers, hard metrics are inconclusive.<sup>210</sup> By hard data alone, one study finds, *eighty percent* of mortgage borrowers are neither unambiguously good nor unambiguously bad credit risks.<sup>211</sup> Assessing such borrowers' risks accurately, therefore, takes granular, information-intensive analysis.

As a matter of theory, this idea is nothing new. Friedrich Hayek, in 1945, stressed the role that “special knowledge of circumstances”—the knowledge of “local conditions”—plays in allocating resources efficiently.<sup>212</sup> Modern economists would refer to Hayek’s “special knowledge” as “local information.”<sup>213</sup> Local information’s significance for capital allocation—at the individual,<sup>214</sup> firm,<sup>215</sup> or societal level—is straightforward. It makes capital allocations better. When investors do not understand “special circumstances,” their portfolios perform worse, on average, and deviate more from expectations. The reason? Investors form expectations—and their ultimate

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<sup>209</sup> *Preserving the Right of Consumers to Access Personal Financial Data*, H. Comm. on Fin. Serv., 117th Cong. 6 (Sept. 21, 2021) (testimony of Chi Chi Wu).

<sup>210</sup> See, e.g., Cheung & Sundaresan, *supra* note 206, at 4.

<sup>211</sup> Alicia H. Munnell et al., *Mortgage Lending in Boston: Interpreting HMDA Data* (Fed. Reserve Bank of Boston, Working Paper Series No. 92-7, 1992).

<sup>212</sup> Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 520–22 (1945); see also Daniel Aronoff, Letter, *Local Lenders Could Help US Banks' Discrimination Problem*, FIN. TIMES (2021), <https://www.ft.com/content/823e37a4-364a-49b8-990a-58250a74946d> [<https://perma.cc/WAT4-P5JB>]

<sup>213</sup> See, e.g., Zhangkai Huang, Lixing Li, Guangrong Ma & Lixin Colin Xu, *Hayek, Local Information, and Commanding Heights: Decentralizing State-Owned Enterprises in China*, 107 AM. ECON. REV. 2455, 2455 (2017).

<sup>214</sup> See, e.g., Cristiana Tudor, *Investors' Trading Activity and Information Asymmetry: Evidence from the Romanian Stock Market*, 9 RISKS 149, 150 (2021).

<sup>215</sup> See, e.g., Daniel Hoang, Sebastian Gatzler & Martin Ruckes, *The Economics of Capital Allocation for Firms: Evidence from Internal Capital Markets* 7–8, 13 (Karlsruher Inst. for Tech., Working Paper No. 115, Jan. 2018) (discussing the competing investment-quality benefits and agency costs associated with hierarchical firms' reliance on local information).

portfolio allocations—without accounting for crucial (local) information that bears on performance.<sup>216</sup> As a result, their *ex ante* risk from investing rises.

The hard, non-customized, widely accessible data of standard bank underwriting is decidedly not local. Soft, private, customized information often is. Moreover, ample research shows empirically that local information, when collected, improves credit pricing, as theory predicts. The legal academic literature, however, has paid these distinctions little mind.

For example, mortgage-lending research finds that loans by “integrated lenders” significantly outperform others.<sup>217</sup> Integrated lenders are ones who gather information about particular characteristics of borrowers’ properties, rather than only regional property data.<sup>218</sup> Other studies show similar results for bank lending generally.<sup>219</sup> Local information also lets banks profitably underwrite “riskier” borrowers. In the mortgage context, borrowers with poor “hard” metrics—that is, credit scores and incomes—make up greater shares of locally knowledgeable banks’ portfolios.<sup>220</sup> Yet such banks charge them lower rates.<sup>221</sup> All this suggests that local knowledge reduces risks, improves credit pricing,

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<sup>216</sup> Hayek, *supra* note 211, at 523 (describing the multiplicity of “changes,” which can occur on a day-to-day basis, that necessitate the “alteration . . . of plans,” which investors cannot account for).

<sup>217</sup> Johannes Stroebe, *The Impact of Asymmetric Information About Collateral Values in Mortgage Lending*, VOXEU (Dec. 13, 2012), <https://voxeu.org/article/asymmetric-information-and-mortgage-lending-understanding-should-precede-fixing> [<https://perma.cc/PMY2-U3CL>].

<sup>218</sup> *Id.*

<sup>219</sup> See, e.g., Viral V. Acharya, Jean Imbs & Jason Sturgess, *The Efficiency of Capital Allocations: Do Bank Regulations Matter?*, RESEARCHGATE 27 (Sept. 19, 2006), [https://www.researchgate.net/publication/228338288\\_The\\_Efficiency\\_of\\_Capital\\_Allocation\\_Do\\_Bank\\_Regulations\\_Matter](https://www.researchgate.net/publication/228338288_The_Efficiency_of_Capital_Allocation_Do_Bank_Regulations_Matter) [<https://perma.cc/GWL8-4BPQ>].

<sup>220</sup> Ozgur Emre Ergungor, *Bank Branch Presence and Access to Credit in Low- to Moderate-Income Neighborhoods*, 42 J. MONEY, CREDIT & BANKING 1321, 1322 (2010).

<sup>221</sup> *Id.*



and helps banks reach riskier customers. Economics literature broadly corroborates these findings,<sup>222</sup> including research showing that borrowers underwritten by physically distant banks have *higher* “hard” creditworthiness.<sup>223</sup> That relationship suggests hard metrics matter more when lenders have lesser (or costlier) access to local knowledge.

Why, then, do large banks rarely collect local information? Simply put, large banks find it more profitable not to lend to borrowers whose creditworthiness hinges on it. Discovering soft information is costly for any lender. Collecting it requires frequent, intensive interactions between borrowers and bank employees.<sup>224</sup> Preparing personnel for these interactions, itself, incurs training costs.<sup>225</sup> And typically, LMI neighborhoods lack dense networks of appraisers and real-estate professionals whose functions help bank employees.<sup>226</sup> For small-business lending, especially, information gathering can mean successive meetings with third parties, like borrowers’ customers and suppliers.<sup>227</sup> “Small business lending” in general, scholars observe, “has historically been very costly, because of the paucity of information . . . and the high costs of the personnel required to obtain even that information.”<sup>228</sup>

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<sup>222</sup> See, e.g., Loutskina & Strahan, *supra* note 195, at 1475–77; Liberti & Petersen, *supra* note 186, at 35.

<sup>223</sup> Mitchell A. Petersen & Raghuram G. Rajan, *Does Distance Still Matter? The Information Revolution in Small Business Lending* 1, 2 (Nat. Bur. Econ. Rsch., Working Paper 7685, May 2000).

<sup>224</sup> Liberti & Petersen, *supra* note 186, at 28; Jim DiSalvo, *Is Small-Business Lending Local?*, FED. RSRV. BANK PHILA. 19 (2021), <https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2021/q3/bt-is-small-business-lending-local.pdf> [<https://perma.cc/PK9N-C9QB>].

<sup>225</sup> Barr, *supra* note 39, at 536.

<sup>226</sup> *Id.* at 536, 540.

<sup>227</sup> Liberti & Petersen, *supra* note 186, at 28. Lending to small businesses is widely understood to be more challenging than lending to larger ones, due to information gathering costs. See Allen N. Berger & Gregory F. Udell, *Universal Banking and the Future of Small Business Lending* 4 (New York Univ., Working Paper FIN-95-9, 1995).

<sup>228</sup> Petersen & Rajan, *supra* note 222, at 1; see also Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru & Vikrant Vig, *Did Securitization Lead to*

Finally, analyzing soft information—even when collected—adds still more underwriting costs. Soft information requires far more loan-officer time to evaluate,<sup>229</sup> transmits less easily across decisionmaking hierarchies,<sup>230</sup> and complicates the processes of banks' non-loan-officer personnel.<sup>231</sup> For some large banks, these “analysis” costs raise underwriting expenses by fifty percent.<sup>232</sup>

Some lenders can overcome these costs and profitably underwrite local-information-dependent borrowers. But large banks have several structural features that inhibit doing so—meaning that their underwriting practices will likely persist.

The first structural factor is large banks' inherent resource constraints. Banks cannot lend infinitely. Government regulations and banks' own concerns about solvency each limit banks' lending-portfolio risks relative to their deposits.<sup>233</sup> Banks, therefore, “optimize” their choices of whom to underwrite given these risk constraints.<sup>234</sup> And the

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*Lax Screening? Evidence from Subprime Loans*, 2010 Q.J. ECON. 309, 310, 321 (2010) (citing the greater “potential for significant soft information” for borrowers seeking “*low documentation loans*”).

<sup>229</sup> See Petersen & Rajan, *supra* note 222, at 7; Ricardo Correa, *Bank Integration and Financial Constraints: Evidence from U.S. Firms* 5 (Bd. of Governors of the Fed. Rsrv. Sys., Int'l Fin. Discussion Papers No. 925, Mar. 2008).

<sup>230</sup> Liberti & Petersen, *supra* note 186, at 23, 42.

<sup>231</sup> *Id.* at 40.

<sup>232</sup> Gerald Chappell, Holger Harreis, Andrés Havas, Theo Papanides & Kayvaun Rowshankish, *The Lending Revolution: How Digital Credit Is Changing Banks from the Inside*, MCKINSEY & CO. (Aug. 31, 2018), <https://www.mckinsey.com/business-functions/risk-and-resilience/our-insights/the-lending-revolution-how-digital-credit-is-changing-banks-from-the-inside> [<https://perma.cc/8ZS5-77NF>].

<sup>233</sup> Ilya Khaykin, Ugur Koyluoglu, Douglass Elliott & Christopher Spicer, *Financial Resource Management*, OLIVER WYMAN 8–9 (2017), [https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/mar/Financial\\_Resource\\_Managment.pdf](https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/mar/Financial_Resource_Managment.pdf) [<https://perma.cc/6RLB-B85N>]; Daniel Paravasini, *Constrained Banks and Constrained Borrowers*, M.I.T. 2–3 (Oct. 2004), <https://www.caf.com/media/29882/danielparavisini-constrainedbanks.pdf> [<https://perma.cc/XN9X-GER8>].

<sup>234</sup> Khaykin et al. *supra* note 232, at 8–9.

imperative of keeping risks manageable often means underwriting lower-risk borrowers in lieu of others. Importantly, banks today have no shortage of low-risk borrowers to choose from. With few geographic restrictions on bank branches today,<sup>235</sup> large banks operate many branches across state lines, overseeing each from a central headquarters.<sup>236</sup> At the same time, banking conglomerates concentrate their *lending* activities in metropolitan areas<sup>237</sup>—with more plentiful creditworthy borrowers.<sup>238</sup> These incentives to focus on lower-risk (higher-information) borrowers make it cost effective for banks to tailor their underwriting processes toward that group.

A second problem, which compounds that trend, is that the costs of (nonlocal-information-dependent) underwriting vary little with loan size.<sup>239</sup> Once banks fix their underwriting method, that is, they spend roughly the same amount to process \$50,000 loans and \$1,000,000 ones.<sup>240</sup> Banks can

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<sup>235</sup> See *infra* Section IV.A.

<sup>236</sup> See CHRISTIAN JOHNSON & TARA RICE, FED. RESERV. BANK OF CHI. ASSESSING A DECADE OF INTERSTATE BRANCHING 22 fig.1 (2007). The three largest banks—JPMorgan Chase, Bank of America, and Wells Fargo—account for roughly one-fourth of U.S. banking branches (and nearly a third of deposits). Rachel Louise Ensign, *Biggest Three Banks Gobble of \$2.4 Trillion in New Deposits Since Crisis*, WALL ST. J. (Mar. 22, 2018, 7:16 PM ET), <https://www.wsj.com/articles/biggest-three-banks-gobble-up-2-4-trillion-in-new-deposits-since-crisis-1521711001> [https://perma.cc/2J3E-733N].

<sup>237</sup> See Seidman et al., *supra* note 131, at 3–5. Almost ninety percent of bank holding companies are headquartered in metropolitan areas. Ross Levine, Chen Lin & Wensi Xie, *Geographic Diversification and Banks' Funding Costs*, ASIAN BUR. FIN. ECON. RSCH. 11 n.5 (Jan. 2017).

<sup>238</sup> See CONG. RSCH. SERV., R46914, AN OVERVIEW OF RURAL CREDIT MARKETS 6 (2021) (explaining that “lower incomes and lower rates of employment” in rural areas “affect the ability of prospective homebuyers to obtain mortgages”).

<sup>239</sup> Klausner, *supra* note 99, at 1568 (“Credit analysis involves substantial fixed costs initially assessing and then monitoring the economic condition a neighborhood and its surrounding area and in becoming fam and maintaining familiarity with the neighborhood’s businesses residents.”).

<sup>240</sup> See, e.g., FINREGLAB, THE USE OF CASH-FLOW DATA IN UNDERWRITING CREDIT 6 (Sept. 2019); Lisa Chen & Gregory Elliehausen, *The Cost Structure of Consumer Finance Companies and Its Implications*

therefore raise profits by issuing large loans instead of small. In practice, many large banks refuse to *consider* credit applications below \$250,000.<sup>241</sup> Loan officers' time is just better spent elsewhere.<sup>242</sup> LMI borrowers, of course, disproportionately demand small loans.<sup>243</sup> This reality gives banks further reason not to adjust their loan-approval processes, collect costly local information, and underwrite LMI groups.

Over time, importantly, large banks' biases toward traditional underwriting have become more entrenched. For one, underwriting methodologies are path dependent. Banks' initial choices to rely on hard information, in other words, have led them to invest heavily in technologies, processes, and infrastructure that support traditional underwriting. These investments lowered traditional methods' costs in future periods.<sup>244</sup> To the same effect, banks' underwriting choices have also stimulated dense networks of third-party firms that

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*for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies*, BD. GOVERNORS FED. RSRV. SYS. (Aug. 12, 2020), <https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.html>.

<sup>241</sup> Karen Gordon Mills & Brayden McCarthy, *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* 6, 12, 40 (Harv. Bus. Sch., Working Paper 15-004, July 2014).

<sup>242</sup> See Barr, *supra* note 39, at 551, 580. These incentives exist on the level of individual loan officers, too, as banks often adopt "reward structures" that favor officers sourcing larger loans. *Id.* at 551.

<sup>243</sup> See, e.g., Karen Gordon Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation* 3 (Harvard Bus. Sch., Working Paper 17-042, 2016) (discussing the small-business context).

<sup>244</sup> Petersen & Rajan, *supra* note 222, at 5–6. Banks' investments in these technologies have occurred alongside exogenous improvements, over the last four decades, in data processing, storage, and collection, which further facilitate conventional underwriting. See, e.g., *id.*; Chappell et al., *supra* note 231.

facilitate hard-data-driven lending.<sup>245</sup> Such service providers include credit-score agencies, data intermediaries, and external credit analysts, which use artificial intelligence or machine learning to predict risk.<sup>246</sup> All this self-reinforcing investment in conventional underwriting methods has, at the same time, created a race to the bottom. Over the past few decades, the banking sector has grown highly competitive,<sup>247</sup> and banks must keep pace with underwriting's ever-evolving technological frontier to stay afloat.<sup>248</sup> For large banks, recalibrating their methods to serve smaller, less-profitable LMI populations risks falling behind.

Entrenching current underwriting practices further are structural forces that push banks *away* from investing in local-information collection. First, thanks to deregulation and technological changes in underwriting, large banks issue increasing loans to borrowers far from their branches (or, at least, their nonmetropolitan branches).<sup>249</sup> The borrower communities nearby particular branches are therefore less important—so banks invest less in learning about them. Additionally, large banks have diversified away from loans altogether, increasing their holdings of derivatives and other financial instruments.<sup>250</sup> Greater portfolio diversity again reduces incentives to invest in costlier forms of lending. Finally, simple organizational inertia plays a role. Incumbent banks inevitably incur costs when replacing legacy systems or

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<sup>245</sup> See, e.g., Petersen & Rajan, *supra* note 222, at 5–6; Xavier Vives & Zhiqiang Ye, *Information Technology and Bank Competition*, IESE 2 n.2 (June 14, 2021).

<sup>246</sup> See sources cited *supra* note 245.

<sup>247</sup> See, e.g., Vives & Ye, *supra* note 244, at 2.

<sup>248</sup> See, e.g., *id.* at 6.

<sup>249</sup> See, e.g., Robert B. Avery, Raphael W. Bostic, Paul S. Calem & Glenn B. Canner, *Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act*, 1999 FED. RES. BULL. 81, 82 (1999).

<sup>250</sup> Allen N. Berger & Loretta J. Mester, *Inside the Black Box: What Explains Differences in the Efficiencies of Financial Institutions?*, 21 J. BANKING & FIN. 895, 929–30 (1997).

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changing their operations, which discourages such investments.<sup>251</sup>

Banks, then, not only lack the local information needed to lend profitably to LMI groups; they are also poorly positioned to collect it. To be sure, all this does not imply that large banks *never* lend to disadvantaged consumers or firms. Some such borrowers fare just fine by credit scores; others leverage existing bank relationships to gain credit.<sup>252</sup> Some banks, further, are more receptive than others to considering forms of soft information. And of course, the CRA itself spurs some LMI lending. Still, the fact remains that many LMI borrowers struggle to find large-bank loans, even when able to repay them.

### C. The “Small-Lender Effect”

Large banks leave sizable LMI-credit-market gaps. Enter community lenders. This Section describes what it calls the “small-lender effect”—the fact that small, community lenders, owing to their size and business models, service LMI borrowers better. Their size facilitates close-knit community relationships, which help them gather local information and underwrite borrowers dependent on it. Moreover, structural forces ensure local lenders will stick to this model—just as the structural forces above keep large banks from usurping it. The subsection below analyzes findings, underappreciated in legal scholarship, which demonstrate the capabilities of small lenders. The following subsection presents original empirical findings on the relationship between lender size and LMI underwriting.

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<sup>251</sup> Erik Feyen, Jon Frost, Leonardo Gambacorta, Harish Natarajan & Matthew Saal, *Fintech and the Digital Transformation of Financial Services: Implications for Market Structure and Public Policy* 16 (Bur. Int’l Settlements, Paper No. 117, July 2021).

<sup>252</sup> See, e.g., Della Rocca & Loewentheil, *supra* note 33, at 13–14 (describing how some large banks prioritized lending to existing customers during early-stage distributions of Paycheck Protection Program loans).

## 1. Lessons from Secondary Literature

Small lenders, in short, have much of what large banks don't. Whereas large banks navigate loan markets with hard, public, non-customizable data and eschew personalized relationships, small lenders leverage local knowledge and connections for pricing credit. When it comes to LMI lending, that gives them an edge.

The hallmark feature of small lenders' underwriting model is that it is "relationship-based." Economists, policymakers, activists, and other commentators widely describe community banks,<sup>253</sup> CDFIs,<sup>254</sup> and other small creditors as "relationship-based lenders." Being "relationship-based" means local connections inform all aspects of small lenders' business models. First and foremost is underwriting. The Government Accountability Office finds, for instance, that interpersonal relationships not only supplement but, in some circumstances, replace hard data like financial statements for community-bank underwriting.<sup>255</sup> When choosing to originate loans, many small banks (unlike large ones) explicitly

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<sup>253</sup> See, e.g., U.S. FED. RESRV. SYS., CONF. OF ST. BANK SUPERVISORS & FED. DEPOSIT INS. PROG., *COMMUNITY BANKING IN THE 21<sup>ST</sup> CENTURY* 30 (2020); Hanauer et al., *supra* note 182, at 7; Brent Lytle, Chris Summers & Stephanie Ziadeh, *Community Banks' Ongoing Role in the U.S. Economy*, 2020 ECON. REV. 5, 7 (2021); Lux & Greene, *supra* note 163, at 7; Meredith Covington & Josh Courtney, *Banking in Rural America: Insight from a Community Development Financial Institution (CDFI)*, S. BANCORP 2 (2014); Kylee Wooten, *Measuring What Community Banks Bring to the Table*, AM. BAR. ASS'N (Apr. 24, 2019), <https://bankingjournal.aba.com/2019/04/measuring-what-community-banks-bring-to-the-table/> [<https://perma.cc/CG2A-UQ2X>].

<sup>254</sup> See, e.g., Campbell & Shin, *supra* note 170, at 25; Nowak, *supra* note 181, at 10–12; Brett Theodos, Sameera Fazili & Elena Seidman, *Scaling Impact for Community Financial Development Institutions*, URB. INST. 7–8. (June 2016), <https://www.urban.org/sites/default/files/publication/81356/2000811-Scaling-Impact-for-Community-Development-Financial-Institutions.pdf> [<https://perma.cc/M3D9-ZMXC>].

<sup>255</sup> GOV'T ACCOUNTABILITY OFF., GAO-12-881, *COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULEMAKINGS* 17–18 (2012).

consider whether they have a preexisting credit relationship with applicants.<sup>256</sup>

Relationships matter beyond initial loan approvals. They also drive community banks' marketing, outreach, and business development. Small businesses, in particular, tend to return to creditors that capitalized them previously.<sup>257</sup> And throughout a loan's duration, local lenders interact more with borrowers. Some commentators therefore label the CDFI approach to credit a "high touch" model.<sup>258</sup> Small lenders visit borrowers physically—especially helpful, again, for small businesses—whereas large banks keep relations impersonal.<sup>259</sup> And if borrowers encounter crises, tight-knit relationships help local creditors provide proactive assistance, which large banks cannot.

What "edge" does the relationship-based model bring? As economists have put it, it gives local lenders two core advantages: greater knowledge of borrowers, and the ability to be flexible.<sup>260</sup>

Small lenders' "greater knowledge," first, covers two types of information—both local. First, creditors know many of their individual customers actually taking out loans.<sup>261</sup> Sometimes, lenders know them personally even before they initially borrow.<sup>262</sup> In other cases, lenders or their employees—for example, loan officers or servicers—develop personal and lasting relationships through the lending process.<sup>263</sup> These relationships strengthen with repeated personal interactions,

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<sup>256</sup> Cole et al., *supra* note 17, at 228.

<sup>257</sup> Lux & Greene, *supra* note 163, at 24; Petersen & Rajan, *supra* note 222, at 8–9.

<sup>258</sup> Nowak, *supra* note 181, at 25.

<sup>259</sup> DiSalvo, *supra* note 223, at 19.

<sup>260</sup> Lux & Greene, *supra* note 163, at 2.

<sup>261</sup> See, e.g., Campbell & Shin, *supra* note 170, at 25.

<sup>262</sup> See, e.g., Caroline Smith Loyas, *A Qualitative Model for the Evaluation of Community Development Financial Institutions*, 2020 COMMUNITY DEV. INNOVATION REV. 61, 74–75 (2021).

<sup>263</sup> See, e.g., *id.*; Lux & Greene, *supra* note 163, at 4–5; Cole et al., *supra* note 17, at 230; García-Appendini, *supra* note 193, at 14 n.17; U.S. FED. RSRV. SYS. et al., *supra* note 252, at 20, 30.



especially for returning clients.<sup>264</sup> As for the second type of knowledge, small creditors have “community expertise,” meaning they know third parties who employ, purchase from, sell to, or otherwise transact with their borrowers.<sup>265</sup> (Knowing these parties, again, often means direct personal relationships.) Additionally, small lenders tend to have deep familiarity with local economic conditions<sup>266</sup> and know community leaders who do as well.<sup>267</sup> Even if small lenders don’t personally know borrowers (though they often do), their connections to the constellations of people and institutions surrounding borrowers work to close information gaps.

The lack of such knowledge, conversely, is why large banks struggle to underwrite applicants without “hard” creditworthiness metrics.<sup>268</sup> Small creditors can therefore succeed where big banks fail. Knowing borrowers directly lowers the cost of obtaining data—particularly soft data—since frequent creditor/borrower interactions facilitate information exchange.<sup>269</sup> For business clients, visiting a storefront or a plant, inspecting operations, and speaking with staff communicates volumes more than reading a loan-

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<sup>264</sup> See sources cited *infra* note 263.

<sup>265</sup> Campbell & Shin, *supra* note 170, at 25.

<sup>266</sup> *What Comes Next? PPP Forgiveness: Hearing Before the H. Comm. on Small Bus.*, 117<sup>th</sup> Cong. 3 (2021) (testimony of Robert Fisher, President and CEO, Tioga State Bank); Theodos et al., *supra* note 253, at 7.

<sup>267</sup> See, e.g., Theodos et al., *supra* note 253, at 7; Loyas, *supra* note 261, at 69, 75.

<sup>268</sup> See *supra* notes 209–223 and accompanying text.

<sup>269</sup> See, e.g., Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351, 351–52 (1995). Empirical evidence also suggests that the length of a lender/borrower relationship can increase these benefits. Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 5–6, 26–27 (1994); see also Allen N. Berger, Anthony Saunders, Joseph M. Scalise & Gregory F. Udell, *The Effects of Bank Mergers and Acquisitions on Small Business Lending*, 50 J. FIN. ECON. 187, 224 (1998) (“Some of the research on relationship lending finds that as a bank-small business borrower relationship matures, the interest rates charged and collateral requirements tend to decline as the bank gains information on the borrower.”).

application questionnaire.<sup>270</sup> Information about third-party actors, further, gives important color and context on the information borrowers themselves supply.

Relationships also lower the cost of collecting customized data, which lets local lenders parse more information, overall, than big banks. Some mortgage originators, for instance, find success letting certain loan applicants supplement poor credit scores with information about rent-payment history.<sup>271</sup> Incorporating these data *ad hoc* can be efficient for smaller mortgage shops, especially if it helps them reach new market segments. But this is less so for large banks, which lack information about—or relationships with—local landlords. Additionally, local knowledge expands the range of ventures small lenders can fund. Soft information matters particularly for financing complex (but profitable) capital expenditures by firms, as judging profitability takes deeper familiarity with companies' business models.<sup>272</sup>

Even when large banks *can*, in theory, collect and analyze soft, customized data, their rigid organizational structures—with many decisionmakers, communications frictions, and potential monitoring problems—make it costly to transmit such information and integrate it into investment processes.<sup>273</sup> Small lenders, whose staffs are leaner, more

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<sup>270</sup> DiSalvo, *supra* note 223, at 19.

<sup>271</sup> See Brett Theodos, Christina Plerhoples Stacy & William Monson, *A New Model for the Provision of Affordable Homeownership*, URB. INST. 4 (Jan. 2015), <https://urban.org/sites/default/files/publication/43281/2000130-A-New-Model-for-the-Provision-of-Affordable-Homeownership.pdf> [<https://perma.cc/D3RY-TN5H>].

<sup>272</sup> See Cole et al., *supra* note 17, at 227–28.

<sup>273</sup> See *supra* notes 229–232 and accompanying text; see also Achraf Mkhahber & Richard A. Werner, *The Relationship Between Bank Size and the Propensity to Lend to Small Firms: New Empirical Evidence from a Large Sample*, 110 J. INT'L MONEY & FIN. 102, 281, 102, 282 (2021) (writing that soft information “is problematic to quantify, verify and transmit through the communication channels of organisationally complex large banks, causing additional expenses and problems . . . due to . . . managerial diseconomies”). For one recent difference-in-differences study finding, in the context of banks in India, that expanding banks' managerial hierarchies decreases the issuance of small loans, see Janis Skrastins & Vikrant Vig,

cohesive, and better coordinated, can apply this knowledge cheaply.<sup>274</sup> Loan officers at small banks, for instance, can more easily communicate soft information to branch managers, with whom they work closely.<sup>275</sup> Small-bank branch managers themselves also collect soft information through client interactions, obviating information-sharing frictions altogether.<sup>276</sup> And small banks' size helps managers oversee loan officers,<sup>277</sup> which, in practice, affords officers more discretion to leverage soft data in underwriting.<sup>278</sup> These phenomena only expand local lenders' universe of *usable* data.

As for small lenders' second advantage, trusting relationships—coupled with understanding of borrowers' conditions—give lenders flexibility to adapt loan terms to changing conditions.<sup>279</sup> For many borrowers, such flexibility

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*How Organizational Hierarchy Affects Information Production*, 32 REV. FIN. STUD. 564, 564–67 (2019).

<sup>274</sup> See, e.g., Mkhiaiber & Werner, *supra* note 272, at 102, 282; *When Smaller Is Better: The Effect of Bank Size on Small-Business Lending*, CHI. BOOTH REV. (Apr. 1, 2004), <https://www.chicagobooth.edu/review/when-smaller-better> [<https://perma.cc/9RRD-AGET>].

<sup>275</sup> See Ross Levine, Chen Lin, Qilin Peng & Wensi Xie, *Communication within Banking Organizations and Small Business Lending*, 33 REV. FIN. STUD. 5750, 5751 (2020) (“[S]oft information obtained by local loan officers [at large banks] is difficult to transmit to higher-level banking officials, and . . . the costs of communicating soft information within large banking organizations hamper lending that depends on soft information . . .”).

<sup>276</sup> Masazumi Hattori, Kohei Shintani & Hirofumi Uchida, *The Repository of Soft Information within Bank Organizations*, 47 J. MONEY, CREDIT & BANKING 737 (2015).

<sup>277</sup> Mkhiaiber & Werner, *supra* note 272, at 102, 282; Allen N. Berger & Gregory F. Udell, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure*, 112 ECON. J. F32, F34, F39 (2002).

<sup>278</sup> Reint Gropp, Christian Gruendl & Andre Guettler, *Does Discretion in Lending Increase Bank Risk? Borrower Self-Selection and Loan Officer Capture Effects* 1–2 (Eur. Banking Ctr. Discussion Paper No. 2012–010, 2012).

<sup>279</sup> See, e.g., Hanauer et al., *supra* note 182, at 53–54. Empirical studies also confirm that small businesses have credit arrangements with explicitly flexible terms more commonly than larger ones. That finding is consistent with this aspect of the “small-lender effect,” given that small firms

is a coveted lifeline. Borrowers commonly choose to work with CDFIs, in particular, for their responsiveness during recessions or other hard times.<sup>280</sup> And they have good reason. Empirical research finds that greater community-bank presence reduces regional firms' overall credit constraints during recessions.<sup>281</sup> Specifically, small lenders can restructure debt in customized, mutually beneficial ways,<sup>282</sup> something especially important in downturns.<sup>283</sup> Borrower knowledge also helps lenders diversify their range of services—demonstrated at the onset of COVID-19, when community banks outpaced peers in connecting clients to emergency financing.<sup>284</sup>

Small creditors offer additional benefits, facilitated by their informational advantages, that lead to better lending outcomes. They can, and often do, provide technical assistance. Technical assistance is easier to deliver in trusting relationships, where transaction costs are low, and it directly improves financed ventures. Lower-income business clients, especially, seek out technical-assistance opportunities when selecting lenders.<sup>285</sup> Nonbusiness customers benefit from assistance, too. For example, community-based mortgage lenders combat affordable-housing defaults with pre- and post-purchase counseling, coaching, and financial education—all of which correlate with lower delinquencies and foreclosures.<sup>286</sup> Separately, small lenders offer complementary, personalized products like budgeting tools and wealth-management services.<sup>287</sup> And they have more

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disproportionately receive credit from small banks. Gabriel Chodorow-Reich, Olivier Darmouni, Stephan Luck & Matthew Plosser, *Bank Liquidity Provision Across the Firm Size Distribution*, 144 J. FIN. ECON. 908, 909 (2022).

<sup>280</sup> See, e.g., Loyas, *supra* note 261, at 74–75.

<sup>281</sup> Hanauer et al., *supra* note 182, at 53.

<sup>282</sup> Nowak, *supra* note 181, at 10.

<sup>283</sup> Chodorow-Reich et al., *supra* note 278, at 908–11.

<sup>284</sup> See, e.g., U.S. FED. RES. SYS. et al., *supra* note 252, at 20–23.

<sup>285</sup> See, e.g., Loyas, *supra* note 261, at 74.

<sup>286</sup> Theodos et al., *supra* note 270, at 5.

<sup>287</sup> See Hanauer et al., *supra* note 182, at 60.

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flexibility to meet with customers outside business hours—helpful during emergencies.<sup>288</sup> Importantly, local lenders’ understanding of community needs elevates the quality of each service above<sup>289</sup>—giving them a systematic edge over larger banks. Thanks to these and other benefits, community-bank customers report higher satisfaction than standard bank clients.<sup>290</sup>

All these findings suggest that community lenders, who forge relationships and collect local knowledge adeptly, can fill market gaps by underwriting hard-to-reach, LMI groups. Legal scholarship, however, takes little heed of this “small-lender effect.” Aspects of this effect receive some treatment in economics scholarship—strengthening this Section’s argument—though economists have done little to test it directly.

The closest work appears to be a 2017 Federal Reserve blog post, which shows that the top-three largest banks cut LMI lending faster than other banks after the financial crisis.<sup>291</sup> However, the post does not unpack structural reasons that large banks broadly conduct LMI lending less effectively; it focuses on the effects of a regulatory change after 2010.<sup>292</sup> Some scholarship also finds that the 2010 Dodd-Frank Act

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<sup>288</sup> U.S. FED. RSRV. SYS. et al., *supra* note 252, at 19.

<sup>289</sup> See, e.g., *Three Reasons to Bank Locally with a Community Bank*, INDEP. CMTY. BANKERS AM., <https://www.icba.org/newsroom/blogs/bank-locally/2021/07/27/three-reasons-to-bank-locally-with-a-community-bank> [<https://perma.cc/Y6YG-HGC2>].

<sup>290</sup> Wooten, *supra* note 252.

<sup>291</sup> Neil Bhutta, Steven Laufer & Daniel R. Ringo, *The Decline in Lending to Lower-Income Borrowers by the Biggest Banks*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Sept. 28, 2017), <https://www.federalreserve.gov/econres/notes/feds-notes/the-decline-in-lending-to-lower-income-borrowers-by-the-biggest-banks-20170928.htm> [<https://perma.cc/F3YK-K66G>].

<sup>292</sup> Specifically, the authors apparently presume that large-bank LMI lending fell comparatively quickly because large banks were discouraged from making loans insured under the Fair Housing Administration—which often go to LMI borrowers—following an uptick in litigation against false mortgage certifications. They do not explore reasons, regulatory or otherwise, why large lenders might lend to LMI borrowers less effectively on an absolute basis. *Id.*

lowered LMI lending at large banks more than small ones.<sup>293</sup> But these works also do not explore small banks' superior abilities as a general matter, nor on an absolute basis.<sup>294</sup>

Other empirical studies shed light on the small-lender effect still more indirectly. The scholarship discussed in Section III.B largely examines *information's* effect on loan quality, though not the effect of *small-lender status*, per se. One economist also finds that when a bank branch closes, small banks and credit unions absorb roughly half of its local mortgage and small-business loans, partially offsetting the overall decline.<sup>295</sup> This result, he reasons, shows that local information helps small lenders underwrite.<sup>296</sup> And another study finds that higher numbers of nearby bank branches lead to cheaper, more frequent LMI loans within a census tract (though it does not tie this finding to bank size).<sup>297</sup>

Analyses of small lenders' portfolio compositions corroborate the small-lender effect, too. For instance, banks' sizes correlate strongly negatively with their share of assets devoted to small-business lending.<sup>298</sup> This finding does not speak specifically to LMI-credit-market gaps. Still, given small-business lending's information intensity,<sup>299</sup> it is

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<sup>293</sup> Pedro Gete & Michael Reher, *Mortgage Supply and Housing Rents*, 31 REV. FIN. STUD. 4884, 4891–93; Francesco D'Acunto & Alberto G. Rossi, *Ditching the Middle Class with Consumer Protection Regulation*, SSRN 1–2 (Sept. 29, 2016), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2846102](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2846102)

[<https://perma.cc/5BPV-HTJU>]; see also Brian S. Chen, Samuel G. Hanson & Jeremy C. Stein, *The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets* 1–2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 23843, 2017).

<sup>294</sup> Chen, Hanson, and Stein do, however, discuss the possibility that large banks decreased small-business lending because—in addition to regulatory changes—their leaders had grown less sanguine about their comparative advantage in that sector, possibly because of information barriers. Chen et al., *supra* note 292, at 1–2, 5, 9.

<sup>295</sup> Hoai-Luu Q. Nguyen, *Are Credit Markets Still Local? Evidence from Bank Branch Closings*, 11 AM. ECON. J. 1, 3–5, 21 (2019).

<sup>296</sup> *Id.*

<sup>297</sup> Ergungor, *supra* note 219, at 1322, 1336–39.

<sup>298</sup> See, e.g., Berger et al., *supra* note 276, at 188.

<sup>299</sup> See *supra* notes 227 & 227 and accompanying text.

suggestive of the small-lender effect, too. Separate research suggests that CDFIs, in particular, see outstanding LMI-lending results. By one estimate, approximately two-thirds of CDFI business loans go to LMI businesses, firms in LMI areas, or companies owned by underserved groups.<sup>300</sup> Half, moreover, go to high-poverty census tracts, versus a quarter of banks' CRA loans<sup>301</sup> (which, typically, are the most LMI-concentrated loans they make). And importantly, small lenders lend this way without sacrificing financial soundness. Community banks' defaults on their own commercial mortgages are one-eighth other banks' rates, and their defaults held steady during the 2008 financial crisis.<sup>302</sup>

The small-lender effect, as a final point, is unlikely to disappear soon. Local lenders have structural incentives to preserve their community-focused models, just as large banks face barriers to usurping them. For one, community lenders inherently serve small geographies. They therefore rely more heavily on income from particular places, making investments in place-based connections more attractive.<sup>303</sup> Moreover, many community lenders could not diversify geographically even if they wanted to. As discussed below, fierce competition for mainstream borrowers, banking-sector concentration,<sup>304</sup> and transaction costs involved with scaling community-lending models<sup>305</sup> preclude overmuch diversification. Finally, community banks hold fewer complex financial instruments, while deriving greater profit shares from loan interest.<sup>306</sup> These dynamics mean local lenders' most profitable use of resources, often, is to focus on developing their relationships.

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<sup>300</sup> Jack Northrup, Eric Hangen & Michael Swack, *CDFIs and Online Business Lending: A Review of Recent Progress, Challenges, and Opportunities*, UNIV. N.H. CAREY SCH. PUB. POL'Y 17 (Nov. 2016), <https://scholars.unh.edu/cgi/viewcontent.cgi?article=1286&context=carsey> [<https://perma.cc/8KLS-UN5S>].

<sup>301</sup> *Id.* at 18.

<sup>302</sup> Lux & Greene, *supra* note 163, at 6–7.

<sup>303</sup> See Hanauer et al., *supra* note 182, at 48–51.

<sup>304</sup> See *infra* notes 349–363 and accompanying text.

<sup>305</sup> See *infra* notes 455–466 and accompanying text.

<sup>306</sup> Hanauer et al., *supra* note 182, at 72.

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## 2. New Empirical Findings

This subsection offers novel statistical evidence of the small-lender effect. It shows, specifically, that the size of lenders' operations, controlling for other factors, correlates negatively with their potential to underwrite LMI debt. This correlation strongly suggests (though cannot conclusively prove, of course) a causal relationship running from lender size to LMI-lending ability. And, ultimately, it helps motivate this Article's overarching prescription for the CRA to put large-bank capital in small lenders' hands.

The statistical analysis here aligns with what some of the aforementioned literature, taken together, already suggests is true. Yet it fills an important gap in that literature. No statistical studies—to my knowledge—have tested the small-lender effect directly. Economics scholarship examines the role of *local information* in lending, and diverse scholarly and non-scholarly sources argue that small lenders acquire local knowledge skillfully. These works largely fall short, though, of explicitly arguing that small lenders—by virtue of being small—more effectively underwrite LMI borrowers than do large lenders.

The first subsection below outlines my methodology and central hypothesis: that the small-lender effect holds. The following three present findings, which, in short, are as follows. First, lender size correlates negatively with lenders' shares of mortgage loans going to LMI lenders. Second, this relationship remains statistically significant after controlling for other factors. (Additionally, this exercise suggests that “information externalities” facilitate LMI lending—as legal scholarship hypothesizes<sup>307</sup>.) Third, the relationship between size and LMI lending has grown *stronger* in recent years.

### a. Methodology, Main Variables, and Hypothesis

To investigate the small-lender effect, I analyzed lender-reported mortgage data publicized per the Home Mortgage

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<sup>307</sup> *Supra* notes 109–111 and accompanying text.



Disclosure Act (HMDA). The HMDA requires many financial institutions—more precisely, bank and nonbank lenders whose assets, and other metrics, exceed threshold levels—to share mortgage-lending data with federal authorities.<sup>308</sup> In part, these data capture the dollar values of lenders’ total annual mortgage originations, at the county level, to borrowers within different income bands.

With these data, I generated two metrics of primary interest. First, I collected the total value of mortgage financing that each lender extends within every county for which they report data. I call this value *intra-county lending*. My analysis uses intra-county lending to proxy for the size of lenders’ operations. Lenders with lower-valued intra-county lending, that is, are deemed “smaller lenders,” for present purposes. This heuristic is not perfect. Some large-bank branches, at least in certain years, will also issue few loans within specific counties. However, given large banks’ strategic orientation toward larger loans,<sup>309</sup> and toward maximizing volume,<sup>310</sup> this proxy reasonably distinguishes community-bank-type lenders from those akin to, say, JP Morgan.

Second, I calculated the share of each lender’s total intra-county lending extended to borrowers with low or moderate income. I call this the *intra-county LMI share*. I take this value to indicate—roughly—a given lender’s capability to underwrite LMI credit. We can expect, in other words, that lenders extending thirty percent of their credit to LMI groups can do so better than those with three-percent LMI shares. This proxy cannot fully capture the idealized concept of LMI-lending “ability” but should indicate it reasonably well.

My main hypothesis is the following: intra-county lending correlates negatively with intra-county LMI share. This finding would be consistent with the small-lender effect. Importantly, to the extent the small-lender effect is *false*—and size did not influence LMI-lending ability—there is good reason to expect the data to correlate *positively*. All else equal,

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<sup>308</sup> See 12 C.F.R. §§ 1003.1, 1003.2, 1003.3, 1003.4, 1003.5, 1003.6 (2022).

<sup>309</sup> See *supra* notes 239–243 and accompanying text.

<sup>310</sup> See *supra* notes 233–238 and accompanying text.

lenders might invest more in local knowledge—which facilitates LMI lending—in counties where they extend most loans (and which therefore most affect profits). A negative intra-county-lending/LMI-share relationship, then, would indicate that the small-lender effect outweighs this countervailing dynamic.<sup>311</sup>

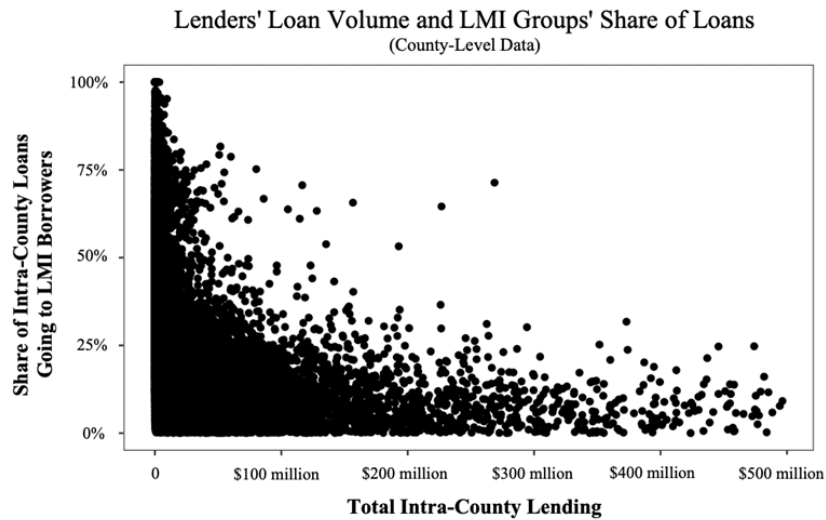
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<sup>311</sup> One dynamic of the U.S. mortgage marketplace worth mentioning is the presence of a robust secondary market, where other entities buy mortgages issued by banks and other lenders. Each year, for example, government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac repurchase hundreds of billions of dollars of mortgage securities. *See, e.g., Monthly Volumes Summary: December 2021*, FREDDIE MAC, <https://www.freddiemac.com/investors/financials/pdf/1221mvs.pdf> [<https://perma.cc/NXC7-NPZN>]. Large banks typically sell most of the mortgages they originate to GSEs, but most community banks retain the majority of their mortgages on their balance sheets. *See* FED. DEPOSIT INS. CORP., *Trends in Mortgage Origination and Servicing: Nonbanks in the Post-Crisis Period*, 13 FDIC Q. at 52 (2019), <https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2019-vol13-4/fdic-v13n4-3q2019.pdf> [at <https://perma.cc/ZXC8-AVR9>]; *Housing Finance: The Community Bank Perspective*, INDEP. CNTY. BANKERS AM. 2 (Mar. 26, 2019), [https://www.icba.org/docs/default-source/icba/advocacy-documents/testimony/19-03-26\\_gsestatement.pdf](https://www.icba.org/docs/default-source/icba/advocacy-documents/testimony/19-03-26_gsestatement.pdf) [<https://perma.cc/T7ZW-WC6H>]. This dynamic, however, should not affect my overall findings. Even when large banks sell mortgages to GSEs, they face the same incentives to underwrite using hard metrics thanks to that underwriting model's low costs and scalability. This is especially true to the extent large banks, which seek to apply uniform underwriting methodologies across their lending practice, retain some originated mortgage securities on their balance sheet. Moreover, GSEs impose hard-metric requirements on the mortgages they buy. *See* Amy Loftsgordon, *FHFA Approves Use of Classic FICO Credit Scores for Fannie Mae, Freddie Mac Mortgages*, NOLO (Nov. 10, 2020), <https://www.nolo.com/legal-updates/fhfa-approves-use-of-classic-fico-credit-scores-for-fannie-mae-freddie-mac-mortgages.html> [<https://perma.cc/6K2T-UKQP>]. That fact would only serve to entrench large banks' disproportionate focus on hard metrics, exacerbating the small-lender effect.

## b. Correlating Intra-County Lending and LMI Share

Lenders' intra-county lending and intra-county LMI share correlate negatively, consistent with my hypothesis, as the chart below illustrates. Specifically, the below chart shows the correlation for 2019 HMDA data—the latest available data coded for borrowers' income status—from over 60,000 lender-county observations.<sup>312</sup>

**Figure 1**



As evident, the loan-volume/LMI-share correlation exists across the entire spectrum of lender size (as measured by loan volume). But the relationship is exponential. Lenders originating small amounts of intra-county mortgages—around ten million dollars or less—display far greater LMI shares. Above the one-hundred-million cutoff, virtually no lender boasts a majority-LMI mortgage portfolio, yet plenty of

<sup>312</sup> Figure 1 excludes lender-county observations for which (1) lenders did not report data necessary to calculate intra-county lending and intra-county LMI share or (2) total intra-county lending equals \$500 million or more. Removing the latter exclusion does not meaningfully affect the correlation. I apply it to show, in graphical form, how the small-lender effect obtains across the entire lender-size spectrum.

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the smallest lenders reach this milestone. Many small lenders, of course, have far *lower* LMI shares. The below-ten-million range, in particular, has significant diversity. Small size is therefore no guarantee of LMI-lending prowess. Yet the data strongly suggest that, as lenders grow, their propensity to lend to low-income groups drops.

Without more, of course, correlation does not imply a particular causal relationship.<sup>313</sup> And here, there are alternative factors—besides the small-lender effect—that could explain these results. An important one is county income or wealth. This variable could independently make intra-county lending and LMI share diverge. In richer counties, for instance, lenders might have higher mortgage-loan volumes because, first, borrowers have stronger economic characteristics and, second, wealthier borrowers demand larger mortgages. Simultaneously, lenders might lend proportionally *less* to LMI groups simply because, in wealthier places, there are fewer of them.

Another possibility is banking *competition* for LMI borrowers. Certain parts of the country have become CRA “hotspots,” where many large banks, which cluster in cities, simultaneously seek to meet CRA obligations.<sup>314</sup> “Clustered” CRA dollars might lower each bank’s total lending to a county (as banks compete for finite borrowers) while raising their LMI shares (as they strive to meet CRA burdens).

I explore these possibilities below.

### c. Regression Analysis

To control for the confounding variables above, I conducted a multivariate regression. I use LMI share as the dependent variable and intra-county lending as the primary independent one. For control variables, I use county per-capita income, counties’ *aggregate* intra-county mortgage loans (that is, loans by *all* lenders) to LMI borrowers, and county population. Per-

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<sup>313</sup> When *X* correlates with *Y*, it might be the case that *X* causes *Y*; that *Y* causes *X*; that a third set of variables, *Z*, causes both *X* and *Y*; or that the correlation is spurious and arises by chance.

<sup>314</sup> See *infra* Section IV.C.

capita income controls for potential income and wealth effects. As for aggregate LMI lending and population, holding these variables constant should account for CRA-credit competition in certain counties (and the lack thereof elsewhere).

The aggregate-LMI-lending control, conveniently, serves an additional purpose. To the extent it *positively* correlates with LMI share—contrary to my confounding-variable concern—it could suggest the existence of information externalities. A positive relationship would indicate that, holding population and incomes constant, one bank’s lending to LMI borrowers raises the share of *other* intra-county creditors’ loans going to LMI groups. Information externalities, captured through greater lending activity, would fit this trend well—though this exercise, of course, would not prove definitively that they are responsible.

A partial summary of the regression results is below.<sup>315</sup> Full results are on file with and available from the author.

**Figure 2**

<b>Independent Variable</b>	<b>Coefficient</b>	<b>P-Value</b>
<b>Lender's intra-county loans</b> (millions of dollars, logged)	-0.129	< 2E-16
<b>County's aggregate CRA-eligible LMI loans</b> (millions of dollars, logged)	0.215	< 2E-16
Observations	67,594	
Adjusted R <sup>2</sup>	0.51	

Two observations emerge. First, even with controls, lenders’ intra-county lending continues to predict their LMI-lending shares negatively and statistically significantly.<sup>316</sup> Second, the aggregate-lending measure *does*, in fact, predict LMI shares positively (and statistically significantly). While

<sup>315</sup> I take the logarithm of intra-county lending and aggregate lending, which relate exponentially to LMI share in bivariate correlations.

<sup>316</sup> As the R-squared value shows, the variables explain about fifty percent of the LMI-share variation, indicating the model’s robustness.

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not conclusive, this corroborates legal scholars' theorized role for externalities.

What are the magnitudes involved? The results imply that, for a lender with intra-county mortgage loans totaling \$50 million, all else equal, moving to \$51 million predicts an LMI-share drop of about 0.11 percentage points (or \$56,100). Downsizing to \$49 million produces a roughly opposite effect. The effects at higher starting values are greater. For a \$200 million lender, by contrast, a jump to \$250 million lowers the share by about 1.3 points (roughly \$3,125,000), whereas falling to \$150 million raises it about 1.6 point (roughly \$2,420,000). These findings' implication is that, all else equal, when smaller lenders deploy capital in large ones' stead, it can mean millions of dollars—or more—being funneled to LMI individuals.

The same-year effects of information externalities, suggested by the aggregate-lending variable, are also important. Boosting counties' aggregate LMI loans from \$20 million to \$25 million, for instance, predicts a 0.2 percentage-point increase in all lenders' LMI shares (about \$70,000 across all lenders), all else equal. And information externalities would bring benefits in *future* years—not captured by the model—assuming that lending-related data persist.

#### d. Changes Over Time

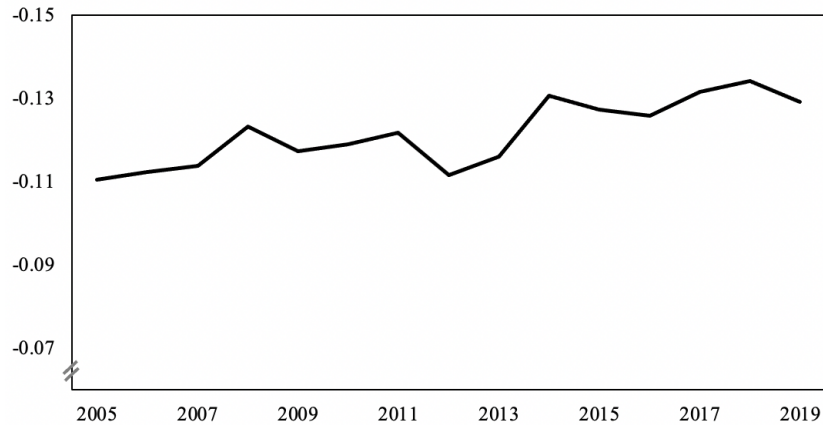
How persistent are these trends? Are they a fluke from the 2019 data? They are not. Conducting the multivariate regression for each year from 2005 through 2018 demonstrates this point. This period, which spans more than ten years, captures a broad range of economic conditions including the financial crisis, its prelude, and its aftermath. And in each year, the intra-county-lending and aggregate-lending coefficients retain their sign and statistical significance.

Year to year, though, the model's results are not identical. Most significantly, the coefficient on intra-county loans *rises*, in absolute value, throughout the sample period and particularly after 2012. The 2019 value exceeds the 2005 one by 18%. The chart below illustrates this trend. The change it

depicts is statistically significant—regressing the coefficient values by measurement year yields a p-value close to zero.

**Figure 3**

**Coefficient on Intra-County Loan Term**  
(Y-axis Inverted)



This finding suggests that small lenders' significance is not disappearing. To the contrary, local creditors are growing more important than ever before, at least in recent memory.

What drives this change is not completely clear—and beyond the scope of this Article to unpack fully. Multiple causes are likely at play. Some point to unequal economic recovery since the 2008 financial crisis,<sup>317</sup> rising lender risk aversion,<sup>318</sup> or potentially laxer Trump administration CRA

<sup>317</sup> See, e.g., Sean P. MacDonald, *Has Stagnant Real Income Growth Contributed to An Uneven U.S. Housing Market Recovery Following the Great Recession?*, CITY UNIV. N.Y. 4–7 (2016), [https://academicworks.cuny.edu/cgi/viewcontent.cgi?article=1213&context=ny\\_pubs](https://academicworks.cuny.edu/cgi/viewcontent.cgi?article=1213&context=ny_pubs) [<https://perma.cc/9WVA-J6MC>] (discussing the mortgage context); Karl Schneider, Chris Stocks & Jason Dietrich, *Data Point: Small Business Lending and the Great Recession*, CONSUMER FIN. PROT. BUREAU (Jan. 2020), [https://files.consumerfinance.gov/f/documents/cfpb\\_data-point\\_small-business-lending-great-recession.pdf](https://files.consumerfinance.gov/f/documents/cfpb_data-point_small-business-lending-great-recession.pdf) [<https://perma.cc/JE5M-2Y68>] (discussing the small-business context).

<sup>318</sup> See, e.g., Michele Lerner, *10 Years Later: How the Housing Market Has Changed Since the Crash*, WASH. POST (Oct. 4, 2018),

enforcement.<sup>319</sup> Nevertheless, whatever the reason for local lenders' growing importance to LMI borrowers, the time has come for the CRA to adapt.

#### IV. OF LOCAL LENDERS AND MARKET FAILURES

Despite their knack for underwriting hard-to-reach borrowers, local lenders are on the decline. In fact, they have been for forty years. Since the 1980s, the United States has seen striking consolidation within its banking sector. Large banks have been buying up small ones at a rapid clip; others have been forced to shutter or scale down, without new entrants replacing them. As measured by number of banking institutions, and by share of total bank assets, community-banking activity has plunged roughly *seventy percent* over thirty-five years, as the chart below illustrates.<sup>320</sup>

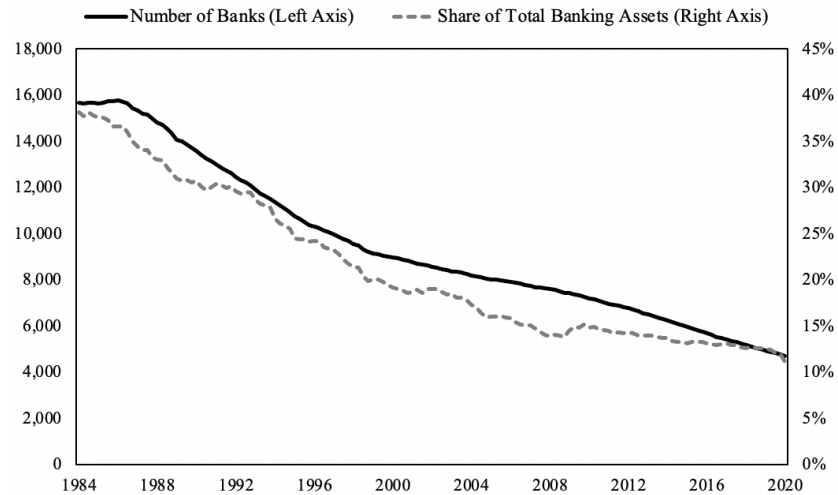
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<https://www.washingtonpost.com/news/business/wp/2018/10/04/feature/10-years-later-how-the-housing-market-has-changed-since-the-crash> [<https://perma.cc/FKG4-HX54>].

<sup>319</sup> See, e.g., Amanda Abrams, *Why Have Banks Stopped Lending to Low-Income Americans?*, TALKPOVERTY (Dec. 5, 2017), <https://talkpoverty.org/2017/12/05/banks-stopped-lending-low-income-americans> [<https://perma.cc/EXV7-LKCA>].

<sup>320</sup> Data come from *FDIC Quarterly Banking Profile*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/bank/analytical/qbp> [<https://perma.cc/ZX2R-JYPB>] (last visited June 3, 2023).



**Figure 4****The Nationwide Decline in Community Banking**

The above data capture banking institutions, specifically, but these trends affect nonbanks as well. As banks exit communities, they cease financing local CDFIs, causing important sources of funding to dry up (though CDFI activity has grown in this period overall).<sup>321</sup> At the same time, credit unions are consolidating.<sup>322</sup> Developments like these have reduced—or entirely eliminated—many LMI communities' access to local lenders.

However, from an efficiency standpoint, are these developments bad? So far, the evidence from Part III has not told us. Part III has *not* shown that small-lender lending is efficient, *overall*. Its findings instead show only that community lenders underwrite LMI groups well—by circumventing specific market failures that otherwise inhibit

<sup>321</sup> Seidman et al., *supra* note 131, at 8.

<sup>322</sup> See Aaron Passman, '\$1 Billion Is Not Enough': Why Credit Union M&A Is Poised to Accelerate, AM. BANKER (Jan. 26, 2021, 11:36 AM), <https://www.americanbanker.com/creditunions/news/1-billion-is-not-enough-why-credit-union-m-a-is-poised-to-accelerate> [<https://perma.cc/V7PJ-7F3T>].

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lending to them. In fact, as discussed in the Introduction, law-and-economics orthodoxy would give us every reason to believe that more small-lender lending might be *inefficient*. Lenders, after all, operate in markets, and markets typically produce efficient outcomes. And small lenders are on the decline *even though* they can surmount LMI-credit-market failures. Why, then, would it be efficient to subsidize them with policies like the CRA?

The answer is simple. When it comes to community lending, markets are not efficient. As this Part explains, significant market failures—of the type widely recognized elsewhere in economic theory—hold small lenders back and bring their activities below efficient levels. In total, this Part describes five major failures (though others may also exist). These failures justify intervention on behalf of small lenders and, in particular, Part V's prescriptions for the CRA.

#### A. Antitrust and Market Concentration

One of the most significant drivers of banking consolidation—if not the primary one—is antitrust's waning reach in banking. With this decline, large banks have gained significant market power. While competition *among* large banks is fierce,<sup>323</sup> large banks' market position, collectively, shuts out smaller banks in many regions and keeps them from gaining market share. Small-lender stagnation, in turn, sidelines LMI borrowers whom large banks cannot service.

Antitrust regulation, by reversing market-power concentration, theoretically enhances efficiency in two ways. First, it keeps monopolists from underproducing, which lets them raise prices—and profits—above competitive levels.<sup>324</sup> Second, it stops them from spending resources to block new entrants, which creates deadweight loss.<sup>325</sup> These rationales hold for financial services, specifically, as with most other

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<sup>323</sup> See Section III.B.

<sup>324</sup> See, e.g., John R. Walter & Patricia E. Wescott, *Antitrust Analysis in Banking: Goals, Methods, and Justifications in a Changing Environment*, 94 *ECON. Q.* 45, 45–46 (2008).

<sup>325</sup> See, e.g., *id.*

industries.<sup>326</sup> Accordingly, as early as the 1950s,<sup>327</sup> the banking sector fully entered federal antitrust law's ambit. In that era, regulation meaningfully restricted banking consolidation.

First, in 1956, the Bank Holding Company Act charged the Fed with overseeing multibank holding companies and blocking acquisitions that would “substantially lessen competition” (unless “clearly outweighed” by the “public interest”).<sup>328</sup> Seven years later, the landmark case *United States v. Philadelphia National Bank* held, for the first time, that Section 7 of the Sherman Act's anticompetitive-merger prohibition covered banks.<sup>329</sup> This opened bank mergers up to DOJ challenge even if they complied with banking-specific statutes.<sup>330</sup> Congress then clarified, in a 1966 law, that the Fed and DOJ were to conduct overlapping antitrust review of merging banks,<sup>331</sup> a role which they share today.<sup>332</sup>

Importantly, all these developments took place in the shadow of significant state-law restrictions on bank mergers—reflecting states' traditional role as banking-sector

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<sup>326</sup> See Samuel N. Weinstein, *Financial Regulation in the (Receding) Shadow of Antitrust*, 91 TEMP. L. REV. 447, 452–53 (2019); Howard A. Shelanski, *The Case for Rebalancing Antitrust and Regulation*, 109 MICH. L. REV. 683, 727–29 (2011).

<sup>327</sup> Congress had attempted to bring bank mergers under federal review with the National Bank Consolidation Act of 1918 and the Federal Deposit Insurance Act of 1950, but these laws suffered from weak standards and loopholes banks used to evade review. Jeremy C. Kress, *Modernizing Bank Merger Review*, 37 YALE J. ON REGUL. 435, 444 (2020).

<sup>328</sup> Walter & Wescott, *supra* note 323, at 48.

<sup>329</sup> *United States v. Philadelphia National Bank et al.*, 374 U.S. 321, 342–44 (1963); *see also* 15 U.S.C. § 7; *United States v. S.E. Underwriters Ass'n*, 322 U.S. 533, 539 (1944).

<sup>330</sup> Kress, *supra* note 326, at 445.

<sup>331</sup> Walter & Wescott, *supra* note 323, at 48; Kress, *supra* note 326, at 446.

<sup>332</sup> Lawrence J. White, *Antitrust and the Financial Sector*, MONEY & BANKING (Jan. 21, 2019), <https://www.moneyandbanking.com/commentary/2019/1/18/antitrust-and-the-financial-sector> [<https://perma.cc/2YY9-FAGA>].

regulators.<sup>333</sup> Most states had tighter standards than federal law,<sup>334</sup> including prohibitions on operating bank branches across state lines.<sup>335</sup> Federal law required banks chartered in one state to respect the limitations of others.<sup>336</sup>

This dual federal/state system persisted, more or less, over the next three decades. And under it, regulators “routinely” challenged mergers.<sup>337</sup>

Yet cracks began to show by the 1970s—which gave rise, before long, to the banking sector’s current concentrated state. First, at the state level, between 1974 and 1994 some thirty-five states axed regulations on interstate branching.<sup>338</sup> With fewer barriers to buying up banks across state lines, mergers soared. And, in many metropolitan areas, banking-sector concentration rose above the levels antitrust regulators usually tolerate. To gauge regional market concentration, the DOJ uses a metric called the Herfindahl-Hirschman Index (HHI), calculated from the market shares of all participating firms.<sup>339</sup> The agency considers HHI scores above 1,800 to be “highly concentrated,” and in such markets, it often moves against relatively small acquisitions.<sup>340</sup> By 1994, the median

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<sup>333</sup> Robert F. Roach, *Bank Mergers and the Antitrust Laws: The Case for Dual State and Federal Enforcement*, 36 WM. & MARY L. REV. 95, 126–27 (1994).

<sup>334</sup> See, e.g., PA. STAT. ANN. tit. 7, § 1604; WASH. REV. CODE ANN. Sec. 30.40.020 (Supp.1973) (repealed 1996).

<sup>335</sup> See Correa, *supra* note 228, at 7.

<sup>336</sup> *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 610 (1974); see also Gary Richardson, Daniel Park, Alejandro Komai & Michael Gou, *McFadden Act of 1927*, FED. RESRV. HIST. (Nov. 22, 1913), <https://www.federalreservehistory.org/essays/mcfadden-act> [<https://perma.cc/U32C-6NFQ>].

<sup>337</sup> Kress, *supra* note 326, at 449.

<sup>338</sup> Correa, *supra* note 228, at 7.

<sup>339</sup> *Horizontal Merger Guidelines*, U.S. DEPT JUST. (Apr. 8, 1997), <https://www.justice.gov/atr/horizontal-merger-guidelines-0> [<https://perma.cc/G99X-HBGF>].

<sup>340</sup> *Id.*

U.S. metropolitan area's HHI score was 1,850, and the seventy-fifth percentile was 2,360.<sup>341</sup>

Normally, numbers like these would make regulators commonly deny mergers—which they did, through the early 1980s.<sup>342</sup> But then, a second long-term shift took root. President Reagan's inauguration shifted federal antitrust priorities, and overall cases brought by federal regulators started plunging.<sup>343</sup> Within banking, federal regulators adopted especially permissive stances. Agencies began “pre-vetting” mergers behind closed doors rather than denying them outright.<sup>344</sup> This arrangement produced a sort of regulatory capture: banks had ample opportunity to engineer market-consolidating mergers around antitrust rules, while regulators had “cognitive biases” disposing them to permit vetted transactions (at least eventually).<sup>345</sup> Owing partly to these trends, the DOJ has not issued a formal bank-merger denial since 1985.<sup>346</sup>

These trends accelerated in 1994. That year, the Riegle-Neal Interstate Banking and Branching Efficiency Act, in an explicit preemption of state law, authorized interstate mergers *regardless* of state restrictions.<sup>347</sup> This nullified 36

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<sup>341</sup> Daniel Bergstresser, *Market Concentration and Commercial Bank Loan Portfolios*, SSRN (Oct. 28, 2008), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1291356](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1291356) [<https://perma.cc/6MSY-H4S2>].

<sup>342</sup> Kress, *supra* note 326, at 453–54.

<sup>343</sup> Many members of the Reagan administration ideologically opposed over enforcing antitrust. Sam Peltzman, *The Decline of Antitrust Enforcement*, 19 REV. IND. ORG. 49, 51 (2001); *see generally* Jonathan B. Baker, *Taking the Error out of “Error Cost” Analysis: What’s Wrong with Antitrust’s Right*, 80 ANTITRUST L.J. 1 (2015).

<sup>344</sup> Kress, *supra* note 326, at 454–59.

<sup>345</sup> *Id.*

<sup>346</sup> *Id.* at 453.

<sup>347</sup> Pub. L. No. 103-328, 108 Stat. 2338 (1994); *see also* GOVT ACCOUNTABILITY OFF., *supra* note 254, at 8–9; Correa, *supra* note 228, at 7–8.

jurisdictions' remaining interstate-branching rules.<sup>348</sup> Following Riegle-Neal, bank mergers across state lines soared,<sup>349</sup> as did nationwide consolidation. In the fifteen years after the Act's passage, the four largest banks' share of all U.S. bank loans climbed from 10% to 40%, and the top ten's share from 20% to 50%.<sup>350</sup> Measured by deposits, these figures are roughly the same.<sup>351</sup> Between 1997 and 2012, further, financial services broadly consolidated more than any other industry, save utilities.<sup>352</sup> The fifty biggest financial firms' combined market share soared nearly 50%, versus a 24% economywide median.<sup>353</sup> This should be little surprise given large banks' economies of scale,<sup>354</sup> which tend to concentrate markets and stifle competition.<sup>355</sup>

The regional-level picture is more nuanced. Some evidence suggests that, in some metropolitan areas, post-1994 market concentration fell—with fintech and continued large-bank entrances offsetting small-bank closures.<sup>356</sup> Scholars like Professor Jeremy Kress, therefore, argue that traditional DOJ “competition” measures cannot adequately protect banks'

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<sup>348</sup> Susan McLaughlin, *The Impact of Interstate Banking and Branching Reform: Evidence from the States*, 1 CURRENT ISS. ECON. & FIN. 1, 1 (1995).

<sup>349</sup> See *supra* note 320 and accompanying text and figure.

<sup>350</sup> Dean Corbae & Pablo D'Erasmus, *A Quantitative Model of Banking Industry Dynamics*, GOOGLGROUPS 2 (Mar. 21, 2013), <https://02e278dc-a-62cb3a1a-sites.googlegroups.com/site/deancorbae/research/bank032113.pdf> [<https://perma.cc/HA54-AKV9>].

<sup>351</sup> *Id.* at 12.

<sup>352</sup> *Benefits of Competition and Indicators of Market Power*, COUNCIL ECON. ADVS. 4 (Apr. 2016), [https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160414\\_cea\\_competition\\_issue\\_brief.pdf](https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160414_cea_competition_issue_brief.pdf) [<https://perma.cc/P7EN-V8YQ>].

<sup>353</sup> *Id.*

<sup>354</sup> See *supra* Section III.B.

<sup>355</sup> See, e.g., Alan J. Meese, *Market Failure and Non-Standard Contracting: How the Ghost of Perfect Competition Still Haunts Antitrust*, 1 J. COMPETITION L. & ECON. 21, 39 (2005).

<sup>356</sup> Kress, *supra* note 326, at 452–53.

customers.<sup>357</sup> Regardless of the precise HHI numbers,<sup>358</sup> though, the evidence shows that consolidation has hurt small lenders and consumers alike, as would be expected for concentrated markets. As the dominant market players, large banks—collectively—have first access to most consumers, and particularly to the most creditworthy ones.<sup>359</sup> The borrowers left for small banks are riskier—evinced by small banks’ disproportionate share of bank-loan defaults<sup>360</sup>—which inhibits scaling and entry. Under these conditions, how do consumers fare? Empirically, bank mergers come with higher credit prices, greater fees, and lower depositor rates.<sup>361</sup> Financial-stability risks have also risen.<sup>362</sup> These results are just what economic theory would predict from consolidation.

It remains true, of course, that in many ways, modern banking is highly competitive.<sup>363</sup> Thanks partly to technological change, large banks compete fiercely among themselves to expand and win borrowers. This dynamic differs from one where a single monopolist firm holds the dominant market position. The salient point, though, is that large banks *collectively* hold enough power to keep other players—that is, small banks—from breaking in. This outcome hurts marginal borrowers whom large banks cannot underwrite cheaply.

Notably, regulators could have taken greater steps, in theory, to forestall the banking sector’s present-day concentration. Federal banking laws—perhaps recognizing

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<sup>357</sup> *Id.* at 451–54, 464.

<sup>358</sup> Kress also points out that regulators’ reliance on the 1,800 HHI threshold may be inappropriate, as a general matter, and that the DOJ defines banking markets to include *both* deposits and loans, which may obscure concentration in either. *Id.* at 450 n.91, 456–58.

<sup>359</sup> See Corbae & D’Erasmus, *supra* note 349, at 32.

<sup>360</sup> *Id.* at 14.

<sup>361</sup> Kress, *supra* note 326, at 459 (summarizing the literature); see also *Letter Calling on Regulators to Halt Bank Mergers*, AMS. FOR FIN. REF. (Dec. 13, 2021), <https://ourfinancialsecurity.org/2021/12/letter-to-regulators-letter-calling-on-regulators-to-halt-bank-mergers/> [https://perma.cc/3BEX-XDZS].

<sup>362</sup> Kress, *supra* note 326, at 449–50.

<sup>363</sup> See *supra* Section III.B.

the sector's special consolidation risks—stipulate that merger review should consider not just competitive effects but a host of criteria. These include the “convenience and need” of the communities that banks serve, as well as other financial and managerial metrics.<sup>364</sup> Yet in practice, antitrust regulators do not apply these. They have instead stuck to antitrust's traditional competitiveness analysis.<sup>365</sup> For decades, then, Congress has supplied ammunition for tackling consolidation's harms. Regulators, drifting from the statutory baseline, have left that ammo on the table.

What does the future hold? Consolidation barriers look likely only to topple further. For one, federally-brought litigation is continuing its downtrend.<sup>366</sup> Today, despite rising U.S. industry concentration,<sup>367</sup> DOJ merger enforcement actions stand at roughly half of 1990s levels.<sup>368</sup> FTC actions have similarly fallen,<sup>369</sup> and actions the FTC does bring, moreover, target narrower markets than they have historically.<sup>370</sup> Another bank-merger tailwind is case law immunizing anticompetitive behavior in highly regulated industries (like banking). In 2004, in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, the Supreme Court opined that—absent an antitrust savings clause—federal enforcement schemes might “impl[y] . . . antitrust immunity” so as to avoid “conflicting” agency “judgments.”<sup>371</sup> Three years later, the Court held in *Credit Suisse Securities v. Billings*

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<sup>364</sup> Kress, *supra* note 326, at 450–51.

<sup>365</sup> *Id.*

<sup>366</sup> Peltzman, *supra* note 342, at 51.

<sup>367</sup> John E. Kwoka, *U.S. Antitrust and Competition Policy Amid the New Merger Wave*, WASH. CTR. FOR EQUITABLE GROWTH, <https://equitablegrowth.org/research-paper/u-s-merger-policy-amid-the-new-merger-wave/?longform=true> [<https://perma.cc/53VK-7L5H>].

<sup>368</sup> *Antitrust Enforcement Data*, YALE SCH. MGMT. (2021), <https://som.yale.edu/faculty-research-centers/centers-initiatives/thurman-arnold-project-at-yale/antitrust-enforcement-data-0> [<https://perma.cc/LW4C-U97X>].

<sup>369</sup> *Id.*

<sup>370</sup> Kwoka, *supra* note 366.

<sup>371</sup> *Verizon Comm'ns Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 406 (2004).



that, when securities laws govern certain conduct, the “risk” of “conflict” between “the securities and antitrust laws” can imply such conduct’s antitrust immunization.<sup>372</sup> For banks, both trends weaken antitrust’s bite.

In short, banking market-power concentration harms consumers and stifles entry (even as large lenders compete fiercely). That concentration, in turn, has been fueled by deregulation and foregone litigation. Restoring antitrust protections—comparable to those in other industries—would help small lenders gain footholds and grow.

## B. Regulatory Failures

The second local-lending failure is regulatory. Myriad federal regulations weigh particularly on small banks. Federal regulations, to be sure, pose essential safeguards against banking-related risks. These safeguards should not be removed. But at the same time, they can slow small lenders’ growth, inhibit entry, and disadvantage them relative to large banks. This reality justifies separate, offsetting interventions to help small lenders (in ways that do not weaken regulation).

The challenge is not that authorities regulate small banks more than big ones. Many regulations exempt smaller banks from certain provisions,<sup>373</sup> including the 2014 Dodd-Frank Wall Street Reform and Consumer Protection Act, which places certain requirements only on banks with assets above \$1 billion, \$2 billion, or \$10 billion.<sup>374</sup> Banks acknowledge that crossing the \$10 billion threshold adds substantial new expenses.<sup>375</sup> The problem, though, is that the regulatory

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<sup>372</sup> *Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264, 275–76 (2007).

<sup>373</sup> SEAN M. HOSKINS & MARC LABONTE, CONG. RSCH. SERV., R43999, AN ANALYSIS OF THE REGULATORY BURDEN ON SMALL BANKS 13 (2015).

<sup>374</sup> *Id.* at 15–17; see also Jeremy C. Kress & Matthew C. Turk, *Too Many to Fail: Against Community Bank Deregulation*, 115 NW. U. L. REV. 647, 669–70 (2020).

<sup>375</sup> See Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank?* 58 (Mercatus Ctr., Working Paper No. 14-05, Feb. 2014).

burdens small banks *do* face largely involve fixed costs.<sup>376</sup> That means small banks, compared to large ones, spread compliance costs across far smaller asset bases,<sup>377</sup> and each regulation cuts significantly more into profitability.

Just how large is the burden? It is hard to know for sure, partly since regulatory costs seep into virtually all aspects of banks' operations. But others have put forth estimates. According to one Fed study, for banks with under \$100 million in assets, compliance costs total 8.7% of non-interest-payment expenses, but the number is just 2.9% for banks with assets exceeding \$1 billion.<sup>378</sup> Regulatory costs, then, can distort the playing field significantly in favor of bigger banks. Calculations by the American Bankers' Association—albeit no disinterested party—roughly corroborate that figure. Their research puts compliance costs at 12% of community banks' operating costs (a smaller denominator than the Fed study's).<sup>379</sup> Recent regulations have upped the ante. One survey finds that in 2014, the year Dodd-Frank took effect, 83% of community banks saw compliance costs rise over 5%—the highest option on the survey.<sup>380</sup> Findings like these, which

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<sup>376</sup> See, e.g., Ron Feldman, Ken Heinecke & Jason Schmidt, *Quantifying the Costs of Additional Regulation on Community Banks* 5 n.4. (Fed. Rsrv. Bank of Minneapolis, Econ. Pol'y Paper 13-3, 2013).

<sup>377</sup> Peirce et al., *supra* note 374, at 13. Some scholars note that policymakers sought to limit Dodd-Frank's blow to community banks by taking steps like publishing compliance-related guidance yet do not contest, even then, that smaller banks had to spread any "new compliance costs" they ultimately faced over smaller asset bases. Kress & Turk, *supra* note 374, at 670-72.

<sup>378</sup> Drew Dahl, Andrew Meyer & Michelle Nealy, *Bank Size, Compliance Cost and Compliance Performance in Community Banking 2* (Fed. Rsrv. Bank St. Louis, May 2016), [https://www.communitybanking.org/~media/files/communitybanking/2016/session2\\_paper2\\_neely.pdf](https://www.communitybanking.org/~media/files/communitybanking/2016/session2_paper2_neely.pdf) [<https://perma.cc/MAK2-3PBW>].

<sup>379</sup> Lux & Greene, *supra* note 163, at 22.

<sup>380</sup> Peirce et al., *supra* note 374, at 34. Dodd-Frank, to be sure, included countervailing provisions that worked to subsidize community banks, and some argue that such provisions offset several of the Act's costliest requirements for smaller banks. Kress & Turk, *supra* note 374, at 672-76 tbl. 1. The fact remains, though, that a broad range of Dodd-Frank provisions create compliance costs. More importantly, the salient point here

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reveal large regulatory economies of scale, are unsurprising given most regulatory costs' fixed nature.

What rules do small banks find burdensome? Today, the Dodd-Frank Act accounts for some of them. For instance, small banks widely report compliance costs from the statute's ability-to-pay provision,<sup>381</sup> effectuated by Regulation Z, which requires banks to document, track, and report mortgage borrowers' income, employment, credit history, monthly expenses, and other data.<sup>382</sup> Banks collected much of these data before 2014. But documenting it meticulously per regulators' specifications adds paperwork, increases reporting burdens and regulator interactions, and creates liability risk.<sup>383</sup> Analyzing and understanding the rule's nuances and exceptions—such as the “qualified mortgage” provisions, which waive certain requirements for some mortgage loans—saps significant manpower.<sup>384</sup> Further, regulators vigorously monitor and enforce these rules.<sup>385</sup>

Regulation Z is just one example of Dodd-Frank rules—or banking regulations generally—that weighs differentially on small lenders. Researchers, including those at the Government Accountability Office, identify sizeable fixed costs from Dodd-Frank's rules on mortgage-loan

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is banking regulation *overall* involves fixed costs, notwithstanding the direction in which Dodd-Frank pushed the regulatory baseline, on a relative basis.

<sup>381</sup> Lux & Greene, *supra* note 163, at 23.

<sup>382</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 1411, 15 U.S.C. § 1639c; Patricia A. McCoy & Susan M. Wachter, *Why the Ability-to-Repay Rule Is Vital to Financial Stability*, 108 GEO. L.J. 649, 666–79 (2020). Originally, banks with less than \$2 billion in assets and making fewer than 500 mortgage loans were exempt, 12 C.F.R. §§ 1026.35(b)(2)(iii), 1026.43(e)(5) (2014), and more recently, the CFPB upped the loan cutoff to 2,000, 12 C.F.R. §§ 1026.35(b)(2)(iii), 1026.43(e)(5) (2019).

<sup>383</sup> See, e.g., HOSKINS & LABONTE, *supra* note 372, at 26–27, 34; David Vera, *The Effect of New Mortgage-Underwriting Rule on Community (Smaller) Banks' Mortgage Activity*, 18 J. APPLIED BUS. & ECON. J. 101, 101–02 (2016) (finding evidence that banks reduced mortgage loans thanks to the ability-to-pay rule, albeit not statistically significantly).

<sup>384</sup> See Peirce et al., *supra* note 374, at 51–52.

<sup>385</sup> McCoy & Wachter, *supra* note 381, at 653–54.

modifications,<sup>386</sup> escrow requirements,<sup>387</sup> mortgage servicing,<sup>388</sup> and capital planning and stress tests.<sup>389</sup> Data and reporting obligations under the 1970 Bank Secrecy Act (BSA) and Fair Credit Reporting Act are also notably burdensome<sup>390</sup> (although survey data show small banks find the BSA less so than Dodd-Frank<sup>391</sup>).

All told, community banks must understand tens of thousands of pages of regulations.<sup>392</sup> Regulators steadily add new regulations—which can produce ambiguities or internal contradictions among rules—and examiners may apply rules unevenly.<sup>393</sup> Analyzing each rule thoroughly, let alone actually implementing it, taxes small banks' relatively tiny compliance teams.<sup>394</sup>

These regulatory distortions, which the data suggest are sizeable, can make or break community lenders. A second Fed study finds that, for the average bank with under \$50 million in assets, hiring just *two* extra compliance staff turns profits negative.<sup>395</sup> The reason is that compliance expertise is costly—particularly for rural banks, which struggle to attract

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<sup>386</sup> Lux & Greene, *supra* note 163, at 23.

<sup>387</sup> GOV'T ACCOUNTABILITY OFF., GAO-16-169, DODD-FRANK REGULATIONS: IMPACTS ON COMMUNITY BANKS, CREDIT UNIONS AND SYSTEMICALLY IMPORTANT INSTITUTIONS 30–31 (2016).

<sup>388</sup> *Id.* at 32–33.

<sup>389</sup> CONG. RSCH. SERV., R46699, BANKING POLICY ISSUES IN THE 117TH CONGRESS 4–5 (2021); Lux & Greene, *supra* note 163, at 23.

<sup>390</sup> Lux & Greene, *supra* note 163, at 22.

<sup>391</sup> Peirce et al., *supra* note 374, at 37.

<sup>392</sup> See, e.g., *Regulatory Burdens: The Impact of Dodd-Frank on Community Banking*, Hearing Before the H. Subcomm. on Econ. Growth, Job Creation & Regul. Affs., 113th Cong. (July 18, 2013) (statement of Eddie Creamer).

<sup>393</sup> *Id.*

<sup>394</sup> *Addressing the Financial Needs of Small Businesses*, BD. GOVERNORS FED. RESRV. SYS. 3 (July 21, 2010), [https://www.federalreserve.gov/newsevents/conferences/sbc\\_small\\_business\\_summary.pdf](https://www.federalreserve.gov/newsevents/conferences/sbc_small_business_summary.pdf) [<https://perma.cc/BU34-YECK>]; Peirce et al., *supra* note 374, at 13.

<sup>395</sup> Feldman et al., *supra* note 375, at 2, 4–5.

top-tier talent away from cities<sup>396</sup>—and most community banks are leanly staffed. The median U.S. bank has just 42 employees,<sup>397</sup> and before Dodd-Frank, sixty percent of small banks employed one compliance officer.<sup>398</sup>

Ample empirical evidence illustrates these distortions' concrete impacts on markets. In Dodd-Frank's first year, for instance, the share of banks with one compliance officer dropped to thirty percent, and a plurality reported employing two.<sup>399</sup> Community banks also scaled back their services. In 2014, thanks largely to the ability-to-pay rule, more than 5% stopped originating residential mortgages altogether,<sup>400</sup> and two-thirds changed the types of mortgages they offered (or were considering doing so).<sup>401</sup> Anecdotally, many community banks that shuttered since 2014 cited Dodd-Frank as a cause.<sup>402</sup> Dodd-Frank is also community banks' most common reason for mergers (38% of merging banks) and major IT purchases (35% of buyers).<sup>403</sup> The Act also forces many to redeploy existing staff toward compliance.<sup>404</sup> And according to FDIC data analysis, post-financial-crisis regulations—though aimed at large banks—have slowed small-bank entries and

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<sup>396</sup> TANYA D. MARSH & JOSEPH W. NORMAN, AMER. ENTER. INST., THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 37 (May 2013); see Peirce, et al., *supra* note 374, at 36.

<sup>397</sup> Rob Nichols, *Yes, Community Banks Are Struggling Under Dodd-Frank*, POLITICO (Sept. 6, 2016 3:18 PM EDT), <https://www.politico.com/agenda/story/2016/09/community-banks-dodd-frank-000197/> [<https://perma.cc/UW2G-2S2P>].

<sup>398</sup> Peirce et al., *supra* note 374, at 35.

<sup>399</sup> *Id.*

<sup>400</sup> *Id.* at 30.

<sup>401</sup> *Id.* at 49.

<sup>402</sup> See, e.g., MARSH & NORMAN, *supra* note 395, at 4; Peirce et al., *supra* note 374, at 28 (reporting one community bank employee's remark that Dodd-Frank "regulations have all but destroyed our market"); Francesco Guerrerra, *Dodd-Frank, Seen From Missouri*, WALL ST. J. (Jan. 21, 2013, 8:43 PM ET), <https://www.wsj.com/articles/SB10001424127887323301104578255620875424966> [<https://perma.cc/2D76-F3A8>].

<sup>403</sup> Lux & Greene, *supra* note 163, at 24.

<sup>404</sup> GOV'T ACCOUNTABILITY OFF., *supra* note 386, at 39; *Addressing the Financial Needs of Small Businesses*, *supra* note 393, at 3.

catapulted closures. Between 2000 and 2009, over 70% of new banks formed with under \$20 million in equity—and most years, more than 90%.<sup>405</sup> But since the crisis, that proportion fell to zero and recently peaked at 30% in 2019.<sup>406</sup> The FDIC deems new regulations' fixed costs an important cause.<sup>407</sup> At the same time, moreover, community-bank closure rates have soared, which the FDIC attributes partly to regulatory change.<sup>408</sup>

It is crucial to stress, once more, that banking regulations serve vital social purposes. For example, the ability-to-repay rule curtails predatory lending<sup>409</sup> and preserves financial stability.<sup>410</sup> Imposing (even overbroad) regulations to curb abuses might well be normatively right, despite being less “efficient,” in conventional economics. My point, then, is *not* that lawmakers should revoke such rules. Rather, it is that banking regulations—which serve important social purposes—put costs on community banks, disadvantage them vis-à-vis large ones, and result in less-than-efficient local-lending levels. Insofar as such regulations should not change, they warrant offsetting policy interventions on the smallest lenders' behalf.<sup>411</sup>

That said, small banks (that is, those below the \$10 billion, \$2 billion, or \$1 billion asset thresholds) face at least some rules that could merit reconsideration. For example, despite

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<sup>405</sup> FED. DEPOSIT INS. CORP., FDIC COMMUNITY BANKING STUDY 5-22 – 5-24 (2020).

<sup>406</sup> *Id.*

<sup>407</sup> *Id.* at 5-22 – 5-24 (2020).

<sup>408</sup> *Id.* at 5-20 – 5-22 (2020).

<sup>409</sup> See Aurel Hizmo & Shane Sherlund, *The Effect of the Ability-to-Repay / Qualified Mortgage Rule on Mortgage Lending*, BD. GOVERNORS FED. RSRV. SYS. (Nov. 16, 2018), <https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-the-ability-to-repay-qualified-mortgage-rule-on-mortgage-lending-20181116.htm> [<https://perma.cc/5JQC-7EUK>].

<sup>410</sup> McCoy & Wachter, *supra* note 381, at 653–54.

<sup>411</sup> Cf. Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 824 n.5, 825–27 (2000). (writing that “one distortion may offset another”).

having generally sounder portfolios, with fewer complex financial instruments, small banks typically have the same capital requirements as those with \$50 billion assets or more.<sup>412</sup> Some of these could be streamlined. Amending other regulations like FIL-16-2016, to permit flexibility surrounding in-person appraisals for loans,<sup>413</sup> and Regulation W,<sup>414</sup> to ease complex asset-valuation and risk-testing requirements on certain transactions, might also aid community lenders without meaningfully raising their riskiness.<sup>415</sup>

The foregoing discusses regulations applicable to small banks, not nonbank lenders. Some institutions, like loan funds, are largely unregulated and face few such barriers. But regulatory burdens affect other nonbanks. Credit unions, for example, must comply with various unique rules, enforced by the National Credit Union Administration (NCUA). Generally, they must establish, maintain, and enforce policies delineating the organization's permissible business loans, geographic scope, and membership qualifications<sup>416</sup>—all of which takes time and manpower. They also face meaningful limits on lending. Under the Credit Union Membership Access Act, lending cannot exceed 1.75 times the credit union's net worth or 12.25 percent of its assets, whichever lower.<sup>417</sup> Loans to businesses in certain industries have stricter caps.<sup>418</sup> The NCUA places other restrictions on credit unions' portfolio composition and collateral requirements, which curtail the

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<sup>412</sup> Lux & Greene, *supra* note 163, at 30–31.

<sup>413</sup> *Hearing on Fostering Economic Growth: Regulator Perspective*, S. Comm. on Banking, Housing, and Urban Affs., 115th Cong. 17 n.5 (June 22, 2017) (statement of Martin J. Gruenberg, Chairman, FDIC).

<sup>414</sup> 12 C.F.R. §§ 223.21 – 223.24 (2021).

<sup>415</sup> See Jeff Gerrish, *Insider and Affiliate Transactions Subject to More than Printed Regs*, BANKING EXCH. (Jan 24, 2014, 2:16 PM), <https://m.bankingexchange.com/sections/community-banking-blog/item/4349-insider-and-affiliate-transactions-subject-to-more-than-printed-regs> [<https://perma.cc/4KMQ-Q47J>].

<sup>416</sup> 12 C.F.R. §§ 723.5, 723.6(a), (b), (f), (m) (2021).

<sup>417</sup> 12 U.S.C. § 1757a(a) (2021); 12 C.F.R. § 723.16 (2021).

<sup>418</sup> 12 U.S.C. § 1464(c)(3)(C) (2021); 12 C.F.R. 560.30 (2021) (limiting savings associations' lending to construction firms).

scope of their lending.<sup>419</sup> Banks (and in particular large banks) lack comparable obligations. And credit unions, like small banks, must report significant lending data to federal authorities.<sup>420</sup>

### C. Capital-Market Frictions

The third market failure, conversely, affects CDFIs disproportionately but also restricts the operations of smaller, non-CDFI community banks. That failure is capital-market frictions. Small businesses and LMI borrowers, it turns out, are not the only ones who need more capital. The community-based groups serving them frequently do, too.

Most *larger* community banks—that is, those with assets closer to \$500 million or \$1 billion—can raise funds reasonably well, when they must.<sup>421</sup> Though selling stock publicly can introduce more regulatory costs than it is worth, larger community banks often have at least some well-capitalized clients whom they can entice to invest.<sup>422</sup> Not so for smaller banks and CDFIs. Without wealthy clientele, these organizations rely far more on earnings to maintain operations and fund expansion. And CDFIs, the smallest banks, loan funds, and the like struggle to fundraise outside their communities, even when they *can* deploy capital profitably. The vast majority of CDFIs—sixty percent—receive no financing from banks or other regulated financial entities.<sup>423</sup> Even those that do widely report needing more to expand or scale up operations.<sup>424</sup> Not only do many CDFIs

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<sup>419</sup> U.S. DEP'T OF TREASURY, CREDIT UNION MEMBER BUSINESS LENDING 14–15 (2001).

<sup>420</sup> *Id.* at 20.

<sup>421</sup> See Elizabeth Judd, *New Ways for Community Banks to Fundraise*, INDEP. BANKER (Jan. 30, 2018), <https://independentbanker.org/2018/01/new-ways-for-community-banks-to-fundraise/> [<https://perma.cc/7YX6-KLVJ>].

<sup>422</sup> *Id.* This would not hold, of course, for community banks struggling to maintain a profit thanks to the market failures discussed in this subsection.

<sup>423</sup> FED. RSRV. BANK OF RICHMOND, COMMUNITY FINANCIAL DEVELOPMENT INSTITUTIONS (CDFIs) BY THE NUMBERS 14 (2019).

<sup>424</sup> See, e.g., Seidman et al., *supra* note 131, at 2–4.



today struggle to access credit at affordable rates;<sup>425</sup> CDFIs particularly need equity capital, with over forty percent saying lack of equity prevents their growth.<sup>426</sup> Further, few markets exist for CDFIs to securitize and sell the loans they originate, which crimps their originations.<sup>427</sup>

Various market frictions prevent CDFIs (and similar lenders) from accessing capital markets.<sup>428</sup> As for private fundraising, the main source of market failure is transaction costs,<sup>429</sup> which can make third-party investments in CDFIs prohibitively expensive. Since CDFIs serve vastly different markets, they offer bespoke financial services, with divergent financing terms, specifications, and standards.<sup>430</sup> The industry has little, if any established consensus on “best

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<sup>425</sup> *Id.* at 2.

<sup>426</sup> FED. RES. BANK OF RICHMOND, *supra* note 424, at 17; Seidman et al., *supra* note 131, at 3–4.

<sup>427</sup> Campbell & Shin, *supra* note 170, at 14; Beth Bafford & Patrick Davis, *Scaling Community Finance to Fill a Growing Market Gap*, STAN. SOC. INNOVATION REV. (June 23, 2021), [https://ssir.org/articles/entry/scaling\\_community\\_finance\\_to\\_fill\\_a\\_growing\\_market\\_gap](https://ssir.org/articles/entry/scaling_community_finance_to_fill_a_growing_market_gap).

<sup>428</sup> For a full discussion between of the relationship between transaction costs (which include market frictions) and market failure, see *infra* notes 441–446 and accompanying text. Some economists distinguish between market frictions and market inefficiencies, Ramon P. DeGennaro & Cesare Robotti, *Financial Market Frictions*, 2007 ECON. REV. 1, 3 (2007), though others treat them roughly interchangeably, for example, Alessandro Gavazza & Alessandro Lizzeri, *Frictions in Product Markets*, in 4 HANDBOOK OF INDUSTRIAL ORGANIZATIONS 433, 433–50 (Kate Ho, Ali Hortaçsu & Alessandro Lizzeri eds., 2021). For the present purpose, however, little turns on the efficiency/friction distinction, as economists and policymakers accept that frictions can justify policy interventions similarly to inefficiencies. See, e.g., Thomas Philippon & Vasiliki Skreta, *Optimal Interventions in Markets with Adverse Selection*, 120 AM. ECON. REV. 1, 23 (2012).

<sup>429</sup> Ample literature discusses how trading costs, other transaction costs, and market frictions impede the efficient functioning of financial markets. See, e.g., Yee Cheng Loon & Zhaodong (Ken) Zhong, *Does Dodd-Frank Affect OTC Transaction Costs and Liquidity? Evidence from Real-Time CDS Trade Reports*, 119 J. FIN. ECON. 645, 645–46 (2016).

<sup>430</sup> See, e.g., Campbell & Shin, *supra* note 170, at 16; Loyas, *supra* note 261, at 66; Bafford & Davis, *supra* note 428.

practices” for CDFI products.<sup>431</sup> As a result, CDFIs struggle to attract institutional investment, since the sector’s dispersed nature makes it costly for investors to understand, evaluate, and monitor investment options at scale.<sup>432</sup> Most asset managers seek investments in asset classes with common “technical characteristics”—like regulatory treatment, ease of access, and reporting frequency and transparency—and at larger scale (e.g., hundreds of millions of dollars) than what most CDFIs offer.<sup>433</sup> Divergent standards place prohibitive costs, too, on CDFIs’ ability to coordinate, align their products, and approach investors jointly.<sup>434</sup> In rare cases where CDFIs *have* coordinated, they typically require a non-CDFI intermediary whose relationships with institutional investors, philanthropies, and other groups reduce market frictions.<sup>435</sup>

Many of the same information challenges afflicting LMI borrowers affect CDFIs, too. Because CDFIs’ customers are low-income, low-information groups, CDFI investments involve less hard data and are often unsecured.<sup>436</sup> This reality dissuades institutional investors from capitalizing CDFIs, in turn, particularly when the investors have loan-to-value collateral requirements for lenders they finance.<sup>437</sup> The information sparsity of CDFIs’ broader neighborhoods does little to help this problem.<sup>438</sup> Owing to these trends—and compounding them, in turn—credit agencies rarely rate

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<sup>431</sup> Loyas, *supra* note 261, at 70.

<sup>432</sup> See sources cited *supra* note 431. There is also evidence that, partly because of CDFIs’ lack of familiarity with institutional investors, some struggle to communicate with them in a way that conveys the full merits or potential of their investments. See Seidman et al., *supra* note 131, at 6.

<sup>433</sup> Seidman et al., *supra* note 131, at 6–7.

<sup>434</sup> *Id.*

<sup>435</sup> Bafford & Davis, *supra* note 428 (describing post-COVID-19 collaboration among CDFIs to scale and attract capital in New York State); Seidman et al., *supra* note 131, at 7 (describing the work of intermediaries like ImpactUS, which are “limited and relatively new”).

<sup>436</sup> Campbell & Shin, *supra* note 170, at 7.

<sup>437</sup> *Id.*

<sup>438</sup> *Id.*

investments in CDFIs and other loan funds.<sup>439</sup> That decreases the available information on them, relative to better-rated investments. Some rating agencies and data aggregators have worked to disseminate data on CDFIs, but these services are expensive and force CDFIs to shoulder significant administrative costs.<sup>440</sup>

A final major source of the failure is the lack of liquid markets for CDFI assets.<sup>441</sup> Investors commonly buy assets owing at least partly to their expectation of reselling them later at a reasonable price. But because CDFIs are so underinvested—and thanks, also, to the above-referenced transaction costs and information asymmetries—investors are hard pressed to resell CDFI assets. That discourages buying in the first place.<sup>442</sup>

Unable to win private financing, CDFIs fare little better in public markets, where these market failures apply with similar force and new ones crop up, too. CDFIs can rarely issue bonds or notes because of compliance and transaction-cost burdens.<sup>443</sup> Large banks issue such instruments all the time, but for CDFIs, doing so would require hiring legal personnel, devoting resources to paperwork and reporting, and assuming liability risks, among other costs.<sup>444</sup> And here, credit agencies' absence from the CDFI landscape again creates challenges. Some CDFIs' need for equity to maintain stable debt/equity ratios, further, prohibit fundraising on bond markets anyhow.<sup>445</sup> And regulatory hurdles, as well the

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<sup>439</sup> *Id.* at 10; Loyas, *supra* note 261, at 66–67.

<sup>440</sup> Loyas, *supra* note 261, at 66–67.

<sup>441</sup> Economists recognize that a market's lack of a "market maker," which leads to illiquidity, is a failure that can impede the market's efficient functioning. *See, e.g.*, Paul Davidson, *Securitization, Liquidity, and Market Failure*, 51 CHALLENGE 43, 50 (2008).

<sup>442</sup> Seidman et al., *supra* note 131, at 4.

<sup>443</sup> At least nine large CDFIs have sold bonds or notes to institutional or retail investors, but these are the exception to the rule. Campbell & Shin, *supra* note 170, at 13.

<sup>444</sup> *Id.*

<sup>445</sup> *Id.*

market failures discussed above, also preclude CDFIs from raising equity in public exchanges.<sup>446</sup>

#### D. Transaction Costs in Low-Income-Lending Markets

Community lenders (as should by now be clear) lend differently from large banks. Their “relationship-based” model relies on local knowledge, soft information, and borrower interactions. This model, by virtue of being relationship based, is difficult to scale and replicate from one neighborhood to the next. In other words, most would-be entrants to LMI credit markets face significant transaction costs. These costs contravene the assumption that community-lending markets are efficient. They suggest, further, that market forces “produce” such lending at inefficiently low levels.

“Transaction costs” are a fraught economic concept. Scholars have long struggled to define them in a principled way.<sup>447</sup> Most economists, however, consider them to include certain categories of expenses inherent to operating in the marketplace—which, at least when large enough,<sup>448</sup> can warrant government intervention. Major categories include *identification costs*, or the cost of finding parties with whom to transact; *negotiation costs*, which arise from working to specify deal terms; and *enforcement costs*, from monitoring agreements *ex post*.<sup>449</sup> These costs distort efficient marketplaces, the thinking goes, by restricting players’ entry. That undermines “perfect competition,” or the condition of having many homogenous buyers and sellers seeking to trade under a price system.<sup>450</sup> (Transaction costs can thus also be

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<sup>446</sup> Nonprofit CDFIs are also legally prohibited from doing so. *Id.*

<sup>447</sup> Pierre Schlag, *The Problem of Transaction Costs*, 62 S. CAL. L. REV. 1661, 1673–76 (1989); Peter G. Toumanoff, *A Positive Theory of Market Failure*, 37 KYLOS 529, 535–37 (1984).

<sup>448</sup> See Toumanoff, *supra* note 448, at 535–37.

<sup>449</sup> *Id.* at 531; see also Schlag, *supra* note 448, at 1673; Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621, 687 (1993).

<sup>450</sup> BOUNDLESS ECONOMICS 373–76 (Lumen Learning, 2013).

formulated as “barriers to entry”—another concept that economists define in *ad hoc* terms.<sup>451</sup>)

Of course, no real-world transaction is truly “costless.”<sup>452</sup> At a minimum, buying and selling on the marketplace takes time, implying opportunity cost. Cordoning off certain expenses as “transaction costs,” which deviate from some normative baseline, involves at least some measure of arbitrary line drawing. The point here, though, is not to resolve these definitional challenges. It is that LMI lending—per the community-lender model—implicates costs that economists broadly view as impairing efficient markets.

Relationships are the core of the problem. Particularly for small-business lending, CDFIs and similar groups lean on deep networks of relationships with founders, employees, consumers, third-party suppliers, and other community stakeholders.<sup>453</sup> These connections are hard for new entrants to replicate.<sup>454</sup> Practitioners of community-development finance widely report as much, and they observe that, without relationships, operating in any community can be difficult.<sup>455</sup> In some communities, suspicion toward outside investors prohibits it altogether.<sup>456</sup> And to the extent outsiders *can* build familiarity and trust, doing so takes time.<sup>457</sup>

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<sup>451</sup> Harold Demsetz, *Barriers to Entry*, 72 AM. ECON. REV. 47, 56 (1982).

<sup>452</sup> See Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390 (1973) (“[T]here is a cost of using the price mechanism.”).

<sup>453</sup> Theodos et al., *supra* note 270, at 7–8.

<sup>454</sup> *Id.* See generally Martin Mende, Linda Court Salisbury, Gergana Y. Nenkov & Maura L. Scott, *Improving Financial Inclusion Through Communal Financial Orientation*, 30 J. CONSUMER PSYCH. 379 (2020).

<sup>455</sup> Brett Theodos, Jorge González & Ananya Hariharan, *Making Community Development Capital Work in Small and Midsize Cities*, URB. INST. 7 (Feb. 2021), <https://www.urban.org/sites/default/files/publication/103600/making-community-development-capital-work-in-small-and-midsize-cities.pdf> [<https://perma.cc/G25B-FS4B>]; Nowak, *supra* note 181, at 22 (“No CDFI practitioners with whom we spoke viewed geographic expansion as an issue in terms of increased risk as long as they had a local partner (including another CDFI) or local office.”).

<sup>456</sup> Theodos et al., *supra* note 456, at 9.

<sup>457</sup> *Id.* at 8.

Relationship-based lending, importantly, often requires *long-term* relationships.<sup>458</sup> New entrants cannot forge these overnight.

The upshot is that—even when communities have the conditions for relationship-based lenders to thrive—only a few players, if any, may be positioned to enter. Sometimes, that subset might include only existing residents, who derive connections and credibility from years living in the community. Even then, hometown residents might lack other characteristics necessary for entry. Members of LMI communities suffer unequal access to education, financial or business training, and relevant business experience<sup>459</sup>—all of which matter for financial services work.<sup>460</sup> Potential LMI founders might also be too liquidity constrained to take the (otherwise rational) risk of entering community lending.<sup>461</sup>

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<sup>458</sup> Covington & Courtney, *supra* note 252, at 2.

<sup>459</sup> See, e.g., Vincent J. Roscigno, Donald Tomaskovic-Devey & Martha Crowley, *Education and the Inequalities of Place*, 84 SOC. FORCES 2121, 2121–23 (2006); Kahliah Laney, Jonathan Bowles & Tom Hilliard, *Launching Low-Income Entrepreneurs*, CTR. FOR AN URB. FUTURE 16 (April 2013), <https://nycfuture.org/pdf/Launching-Low-Income-Entrepreneurs.pdf> [<https://perma.cc/YM3D-FBQZ>]; Ozlem Ogutveren Gonul, *Encouraging and Supporting Minority Entrepreneurship for Long-Term Success*, ENTREPRENEUR & INNOVATION EXCH., at 3 (Nov. 5, 2018), <https://eiexchange.com/content/352-Encouraging-and-Supporting-Minority-Entrepreneur> [<https://perma.cc/4S3E-PYEN>].

<sup>460</sup> See, e.g., Domingo Ribeiro Soriano & Gary J. Castrogiovanni, *The Impact of Education, Experience and Inner Circle Advisors on SME Performance: Insights from a Study of Public Development Centers*, 38 SMALL BUS. ECON. 333, 333–34 (2012) (“Experience [from] having previously worked in . . . the same industry before starting a business [is] related to productivity . . . [as is] general business knowledge and industry-specific knowledge.”).

<sup>461</sup> Lack of income security holds back low-income entrepreneurs across all sectors. Evidence from New York’s Self-Employment Assistance program, which paid unemployment-benefits to individuals working full time to found companies, indicates that reduced founder income security helps many viable firms launch. Christopher Gergen, Nic Gunkel, Bruce Katz & Victor Hwang, *Entrepreneurship and the Next CARES Act*, THE NEW LOCALISM (July 21, 2020), <https://www.thenewlocalism.com/newsletter/entrepreneurship-and-the-next-cares-act/> [<https://perma.cc/ESM5-R8TZ>].

Even when viable entrants exist, they might only be able to enter after a time lag,<sup>462</sup> leaving neighborhoods inefficiently lenderless for years. These dynamics contradict any assumption of perfectly competitive credit markets, with many potential entrants.

Making matters worse, when a new lender sets up shop in one place, expanding elsewhere is rarely simple. The community-lending model is inherently fragmented. Each LMI neighborhood has different characteristics, dynamics, and credit needs, meaning local lenders all have different underwriting styles.<sup>463</sup> Sometimes, of course, CDFIs and local banks *do* expand geographically. But these lenders are the exception, and they face myriad costs exporting their business models. Beyond the time invested in new relationships, CDFIs expanding geographically pay for technical assistance, local-expert consultants, and even language translation.<sup>464</sup> Such costs are prohibitive for the large majority of CDFIs, let alone their optimal use of funds.

The significant resources LMI-credit-market entrants need to locate, understand, and connect with community stakeholders, then, prevent them from operating at efficient levels. This justifies offsetting interventions.

## E. Banking Deserts

The growing number of “banking deserts” in the United States—themselves a product of other failures—are a distinct failure that independently depresses small-lender activity.

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<sup>462</sup> Cf. ROBERT M. MORONEY & JUDY KRYSIK, *SOCIAL POLICY AND SOCIAL WORK: CRITICAL ESSAYS ON THE WELFARE STATES* 199 (1991) (discussing time lags’ relationship with market failure).

<sup>463</sup> See, e.g., Theodos et al., *supra* note 456, at 7; David Cohen, *Top 5 Attributes of Successful Community Relationships*, CONNECT CRE (Aug. 13, 2021), <https://www.connectcre.com/stories/top-5-attributes-of-successful-community-relationships/> [<https://perma.cc/AW2N-7FBP>].

<sup>464</sup> See Theodos et al., *supra* note 456, at 7 (discussing the successful expansion of VEDC).

Nationwide, the number of banking deserts—that is, parts of the country without any (or nearly any) bank branches<sup>465</sup>—has surged in recent years, especially in rural areas. About forty percent of rural counties have no bank branches whatsoever.<sup>466</sup> One study using 2014 data finds that over 2,100 census tracts, with 7.7 million residents, have either zero or one branch within 10 miles.<sup>467</sup> Most of these tracts are in rural areas, and within the rural subset, majority-minority neighborhoods are overrepresented.<sup>468</sup>

Banking deserts simultaneously stem from banking consolidation and, in turn, reinforce it. Deserts are the logical outcome of community-bank shutdowns and large banks' decisions to buy up branches, concentrate their services in cities, and close elsewhere.<sup>469</sup> Other economic forces, like declining populations<sup>470</sup> and stagnating growth,<sup>471</sup> spur rural deserts, too. When deserts appear—and lending dries up

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<sup>465</sup> Drew Dahl & Michelle Franke, *Banking Deserts Become Common as Branches Dry Up*, FED. RESRV. BANK OF ST. LOUIS (July 25, 2017), <https://www.stlouisfed.org/publications/regional-economist/second-quarter-2017/banking-deserts-become-a-concern-as-branches-dry-up> [<https://perma.cc/9YZW-8ASA>].

<sup>466</sup> Covington & Courtney, *supra* note 252, at 2. Similar inequities exist regarding nonbank institutions, too. CDFIs in populous (that is, non-rural) counties, for instance, receive on average up to four times as much extra county financing as those in other counties (depending on how one measures it). Brett Theodos & Eric Hangen, *Tracking the Unequal Distribution of Community Development Funding in the US*, URB. INST. (Jan. 2019), [https://www.urban.org/sites/default/files/publication/99704/tracking\\_the\\_unequal\\_distribution\\_of\\_community\\_development\\_funding\\_in\\_the\\_us\\_2.pdf](https://www.urban.org/sites/default/files/publication/99704/tracking_the_unequal_distribution_of_community_development_funding_in_the_us_2.pdf) [<https://perma.cc/9GDN-T475>].

<sup>467</sup> Dahl & Franke, *supra* note 466.

<sup>468</sup> *Id.*

<sup>469</sup> Anna Hrushka, *Keeping the Banking Desert at Bay in Rural America*, BANKING DIVE (Feb. 18, 2020), <https://www.bankingdive.com/news/bank-deserts/572124/> [<https://perma.cc/9XFV-E8ET>].

<sup>470</sup> Covington & Courtney, *supra* note 252, at 2.

<sup>471</sup> See Russell D. Kashian, Ran Tao & Claudia Perez-Valdez, *Banking the Unbanked: Banking Deserts in the United States 12–13* (2015) (unpublished manuscript) ([http://swfa2015.uno.edu/F\\_Banking/paper\\_90.pdf](http://swfa2015.uno.edu/F_Banking/paper_90.pdf) [<https://perma.cc/QG64-HYD3>]).



within them—the information asymmetries normally stifling LMI lending grow larger.<sup>472</sup> And as lending short-circuits, economic growth stalls further, precipitating a downward spiral. In short, banking deserts are an especially severe manifestation of the information-externality problem Professor Klausner and others discuss.<sup>473</sup> These uncaptured externalities make it hard—harder, that is, than other trends like low economic growth would predict—for new lenders to penetrate deserts and underwrite residents.<sup>474</sup>

Large and small lenders alike struggle to enter deserts. But because the “desert” effect is difficult even for community lenders to overcome, they are worth highlighting as a community-lender market failure separate from general information challenges that Part III discusses.<sup>475</sup> Banking deserts therefore especially need policy solutions. Today, though, the CRA can exacerbate entry challenges, if anything, by heightening banks’ LMI-lending obligations when they enter new markets. Empirical research indicates that, for census tracts with between twenty-fifth and fiftieth percentile income, possessing LMI status (which triggers CRA

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<sup>472</sup> Tony Cookson, *How Growing Up in a Bank Desert Can Hurt Your Credit for the Rest of Your Life*, PUB. BROAD. SERV. (Feb. 20, 2020), <https://www.pbs.org/newshour/economy/making-sense/column-how-growing-up-in-a-bank-desert-can-hurt-your-credit-for-the-rest-of-your-life> [<https://perma.cc/5GAH-FNVE>].

<sup>473</sup> *Supra* Section II.B.

<sup>474</sup> *See, e.g.*, Hrushka, *supra* note 470.

<sup>475</sup> *See, e.g.*, Scott Horsley, *What Are We Going to Do?: Towns Reel as Banks Close Branches at Record Pace*, NAT’L PUB. RADIO (Mar. 26, 2021), <https://www.npr.org/2021/03/26/979284513/what-are-we-going-to-do-towns-reel-as-banks-close-branches-at-record-pace> [<https://perma.cc/F6TT-RXZQ>]. *But see* Ben Schiller, *Where the Big Banks Have Fled, This Community-Owned Bank Is Stepping In*, FAST CO. (Jan. 30, 2014) <https://www.fastcompany.com/3024690/where-the-big-banks-have-fled-this-community-owned-bank-is-stepping-in>.

obligations) raises the net rate of bank closures,<sup>476</sup> as legal scholars have predicted.<sup>477</sup>

## V. THE WAY FORWARD

The previous Part explained why policymakers should (in theory) promote large-bank/small-lender collaboration. This Part examines how. Section A discusses why the CRA, in particular, is a good policy tool for this purpose. Section B gets into specific prescriptions. To ground its prescriptions theoretically, Section B starts by abstracting generalized principles from the foregoing discussion that should guide CRA reform efforts. It then evaluates Trump-era OCC reforms according to these principles, as a case study, and it finally uses them to develop an original set of prescriptions.

### A. Why the CRA?

Failures in LMI credit markets might justify intervention in theory. But, in practice, should the government step in? If so, how? This Section argues that the government can, and should, use the CRA—and the CRA, specifically—to support local lenders. First, as discussed directly below, it is well within the government's power to foster large-bank/small-lender collaboration—as historical examples show. The following subsection argues, then, that the CRA is among the best policy options Congress realistically has (though it should use others, too).

#### 1. Supporting Local Lenders Works

To argue that federal programs should boost community lending, those programs must actually be capable of doing so. The prospect of large banks linking arms with local lenders, subject to light regulatory prodding, has a nice ring to it. But

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<sup>476</sup> Lei Ding & Carolina K. Reid, *The Community Reinvestment Act (CRA) and Banking Branch Patterns* 30 tbl. 4 (Fed. Reserve Bank of Phila., Working Paper 19–36, Sept. 2019) (reporting a positive, statistically significant coefficient for the second model under Panel A).

<sup>477</sup> *Supra* Section II.B.

can it be done? Ample precedent suggests it can. Federal programs have a robust track record, in fact, of expanding credit access by bringing larger lenders and local players together. All this evidence furnishes support for the proposition that policymakers can scale up these efforts with the CRA.

Consider, first, the ways by which large lenders might support small ones. To start, they can provide financing.<sup>478</sup> Greater access to debt and equity capital can be essential for small lenders, including CDFIs, to scale up operations.<sup>479</sup> Other instruments, like loan guarantees, can also help small lenders take on bigger portfolios.<sup>480</sup> Liquidity can matter especially for small lenders offering technical assistance, which may be capital intensive.<sup>481</sup> Large banks might also supply capital on preferential terms, such as through low-interest loans.<sup>482</sup> And they can help bridge capital shortfalls in particular circumstances—as seen at the start of the COVID-19 pandemic, when small banks faced high demand for Paycheck Protection Program loans.<sup>483</sup> Moreover, these types

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<sup>478</sup> See, e.g., ASS'N. FOR NEIGHBORHOOD & HOUS. DEV., INC., THE COMMUNITY REINVESTMENT ACT, BANK REINVESTMENT, AND THE OPPORTUNITY OF EQUITABLE ECONOMIC DEVELOPMENT IN NEW YORK CITY 4 (2014).

<sup>479</sup> See *supra* Section IV.C.

<sup>480</sup> FED. DEPOSIT INS. CORP., STRATEGIES FOR COMMUNITY BANKS TO DEVELOP PARTNERSHIPS WITH COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS 25 (2014).

<sup>481</sup> GEOFF SMITH, JENNIFER NEWON, SEAN ZIELENBACH & SARAH DUDA, COLLABORATORS OR COMPETITORS? EXPLORING THE RELATIONSHIPS BETWEEN COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS AND CONVENTIONAL LENDERS IN SMALL BUSINESS FINANCE 32 (2008).

<sup>482</sup> *Id.* at 28.

<sup>483</sup> See, e.g., *Critical Capital for Small Businesses: Recommendations for Expanding Access to Credit Through Community Development Financial Institutions (CDFIs)*, BANK OF AM. 1–27 (Nov. 2022), <https://business.bofa.com/content/dam/flagship/public-policy/esg/cdfis-critical-capital-for-small-businesses-november-2022.pdf> [<https://perma.cc/G6DJ-E9V3>]; *Holding Megabanks Accountable: An Update on Banking Practices, Programs, and Policies: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong., 1st Sess., (May 27, 2021) (testimony of David M. Solomon, CEO, Goldman Sachs).

of investments can benefit large banks, too, by diversifying their portfolios.<sup>484</sup>

A second channel for support is grants, provision of services, or other in-kind donations. This aid can assume many forms. Often, large banks can easily give technical assistance to small ones, including training and mentorship across different staff functions.<sup>485</sup> They might also, for example, use their facilities, staff, and brand recognition for events or activities that raise awareness for small lenders<sup>486</sup>—helping them expand services to borrowers that need them.

A final method of support is active partnerships among large banks and small lenders. This work, too, can take varied forms. As some examples, well-capitalized banks might arrange for local lenders to originate loans on their behalf, within certain communities or among niche borrowers.<sup>487</sup> Small lenders, conversely, might outsource certain work to large banks—including cash management or compliance—which have efficient infrastructure and technologies for these purposes.<sup>488</sup> (In some cases, large banks might outsource back-office functions instead.<sup>489</sup>) Alternatively, community lenders might enlist banks' services attracting outside financing.<sup>490</sup> Other times, lending institutions develop

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<sup>484</sup> FED. DEPOSIT INS. CORP., *supra* note 481, at 25.

<sup>485</sup> SMITH ET AL., *supra* note 482, at 28; FED. DEPOSIT INS. CORP., *supra* note 481, at 25; ASS'N. FOR NEIGHBORHOOD & HOUS. DEV., INC., *supra* note 479, at 4;  *Holding Megabanks Accountable: An Update on Banking Practices, Programs, and Policies: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong., 1st Sess. (May 27, 2021) (testimony of David M. Solomon, CEO, Goldman Sachs).

<sup>486</sup> *Critical Capital for Small Businesses*, *supra* note 484, at 6.

<sup>487</sup> *See, e.g.*, CONSUMER FIN. PROT. BUREAU, FINAL REPORT OF THE SMALL BUSINESS REVIEW PANEL ON THE CFPB'S PROPOSALS UNDER CONSIDERATION FOR THE SMALL BUSINESS LENDING DATA COLLECTION RULEMAKING 70–71 (2020).

<sup>488</sup> SMITH ET AL., *supra* note 481, at 30.

<sup>489</sup> U.S. DEP'T OF TREASURY, ASSESSING THE IMPACT OF NEW ENTRANT NON-BANK FIRMS ON COMPETITION IN CONSUMER FINANCE MARKETS 14, 26–27 (2022).

<sup>490</sup> SMITH ET AL., *supra* note 481, at 30.

referral relationships—which can be legally formalized<sup>491</sup>—whereby large banks funnel borrowers they cannot underwrite to community lenders.<sup>492</sup> When the borrowers are small businesses, large banks might then adopt them once they’ve grown.<sup>493</sup> And as an even closer form of collaboration, large lenders and small ones might form joint ventures, as distinct legal entities, to lend to certain borrowers or communities.<sup>494</sup> These ventures pool the resources, strategies, and expertise of each institution, relying particularly on the smaller lender’s local knowledge.

Federal programs have proven able to spur each sort of activity above. To start, the CRA itself partly achieves this goal already. Although the Act does not proactively encourage large-bank/community-lender collaboration, it *permits* these activities as one way to satisfy obligations. For instance, banks may receive CRA lending credit for purchasing otherwise-qualifying loans off CDFIs’ balance sheets.<sup>495</sup> They may also score points for loans to CDFIs, themselves,<sup>496</sup> as well as equity investments<sup>497</sup> and technical assistance<sup>498</sup> (so

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<sup>491</sup> *Id.* at 29.

<sup>492</sup> *Critical Capital for Small Businesses*, *supra* note 477, at 1–2, 7.

<sup>493</sup> *Id.*

<sup>494</sup> *See, e.g., Multi-Bank Partnerships for Community Development Financing*, COMPTROLLER OF THE CURRENCY ADM’R OF NAT’L BANKS 1–2 (2010),

[https://www.novoco.com/sites/default/files/atoms/files/occ\\_factsheet\\_multibankpartnerships.pdf](https://www.novoco.com/sites/default/files/atoms/files/occ_factsheet_multibankpartnerships.pdf) [<https://perma.cc/7QUK-ENGW>].

<sup>495</sup> *Bank Partnership with Community Development Financial Institutions and Benefits of CDFI Certification*, OFF. OF THE COMPTROLLER OF THE CURRENCY 3 (Sept. 2019), <https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-factsheets/pub-fact-sheet-bank-partnerships-with-cdfis.pdf>

[<https://perma.cc/AQ7X-N9AK>]. For large banks, these purchases apply to the retail portion of the lending test.

<sup>496</sup> *Id.* Banks may receive lending credit for loans below \$1 million if the CDFI meets the statutory definition of “small business.” Regardless of loan volume and CDFI size, such loans can earn community-development credit, too.

<sup>497</sup> *Id.* at 3–4. Banks’ stakes in CDFIs further entitle them to pro rata credit for the CDFI’s independent CRA-qualifying activities.

<sup>498</sup> *Id.* at 4–5.

long as CDFIs fall within their assessment areas). Banks take advantage of these options. The CRA, experts widely report, is the single largest driver of private capital into CDFIs.<sup>499</sup> Without the Act, by some activists' calculations, the CDFI industry would be much smaller than today.<sup>500</sup> Why do banks and CDFIs collaborate? Large banks know that, while they receive no extra credit for doing so, working with community lenders is often the best way to reach LMI borrowers.<sup>501</sup> This should come as no surprise, given how local lenders underwrite.<sup>502</sup>

Of course, the fact that the CRA redirects *some* capital to CDFIs does not mean it has reached the optimum. Even against the CRA's backdrop, Part IV's market failures still persist, and the law should go further. But this fact does show that policymakers, by correctly aligning incentives, can and do induce bank/CDFI cooperation—despite all the market barriers to doing so.

Other federal programs tell a similar story. One important example is the State Small Business Credit Initiative (SSBCI)—a 2010 program enacted aimed at helping small businesses recover from the 2008 financial crisis.<sup>503</sup> Congress that year set aside \$1.5 billion for SSBCI funding, and it let states apply for funds to run programs promoting small-

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<sup>499</sup> See, e.g., Seidman et al., *supra* note 131, at 8.

<sup>500</sup> *Reforming the Community Reinvestment Act Regulatory Framework: Docket ID OCC-2018-0008, Comments by the CDFI Coalition*, CDFI COAL. 1 (Feb. 2019), <https://cdfi.org/wp-content/uploads/2019/02/CRA-Comment-Letter-CDFI-Coalition-Final.pdf> [<https://perma.cc/Y9XZ-R4MC>].

<sup>501</sup> See FED. DEPOSIT INS. CORP., STRATEGIES FOR COMMUNITY BANKS TO DEVELOP PARTNERSHIPS WITH COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS 1, 6, 17–19 (2014) (describing collaboration as, “[i]n some instances,” banks’ “most effective and efficient way . . . to meet the market needs of low-income borrowers in their assessment areas”).

<sup>502</sup> See *supra* Section III.C.

<sup>503</sup> Robert Maxim, Eric Cromwell, Dan Schmisser, Joseph Parilla & Mark Muro, *How Cities, States, and Tribes Can Boost Entrepreneurship via the American Rescue Plan*, BROOKINGS INST. (May 19, 2021), <https://www.brookings.edu/research/how-cities-states-and-tribes-can-boost-entrepreneurship-via-the-american-rescue-plan> [<https://perma.cc/3NLR-P7TW>]. Congress in 2021 reauthorized SSBCI at a funding level of \$10 billion, as part of the American Rescue Plan.

business credit.<sup>504</sup> States had broad freedom to tailor plans—eligible projects ran the gamut from loan guarantees to collateral support to state-run venture capital funds<sup>505</sup>—but Treasury guidance imposed two main requirements. First, applicants had to “reasonabl[y] expect” to generate ten dollars in small-business credit for each SSBCI dollar granted.<sup>506</sup> Second, they had to show a strong likelihood of reaching LMI businesses and other underserved ones.<sup>507</sup>

To meet these burdens, most states’ proposals involved close collaboration with local lenders.<sup>508</sup> State governments enlisted CDFIs, credit unions, and small community banks to originate loans, deliver technical assistance, and market new credit products.<sup>509</sup> The results speak for themselves. Of the 21,000 loans worth \$10.7 billion that the Treasury attributes to the program,<sup>510</sup> more than 40% reached LMI areas.<sup>511</sup> Government auditing finds that cooperation with community lenders, and CDFIs in particular, drove these outcomes.<sup>512</sup> The SSBCI, then, offers yet more proof that state-backed large-bank/local-lender collaboration works.

Some lessons emerge, moreover, from the foregoing examples. The CRA and the SSBCI have at least two elements

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<sup>504</sup> *Id.* Just over \$1 billion in federal funding was ultimately used for programs.

<sup>505</sup> ROBERT JAY DILGER & GRANT A. DRIESSEN, CONG. RSCH. SERV., R42581, STATE SMALL BUSINESS CREDIT INITIATIVE: IMPLEMENTATION AND FUNDING ISSUES 5–8 (2021).

<sup>506</sup> *Id.* at 9.

<sup>507</sup> *Id.*

<sup>508</sup> CTR. FOR REG’L ECON. COMPETITIVENESS & CROMWELL SCHMISSEUR, U.S. DEP’T OF TREASURY, PROGRAM EVALUATION OF THE US DEPARTMENT OF TREASURY STATE SMALL BUSINESS CREDIT INITIATIVE 11–12 (2016); STATE SMALL BUS. CREDIT INITIATIVE, USING THE SSBCI PROGRAM TO IMPROVE ACCESS TO CAPITAL IN UNDERSERVED COMMUNITIES 1–2 (2014).

<sup>509</sup> See sources cited *supra* note 510.

<sup>510</sup> DILGER & DRIESSEN, *supra* note 506, at 3.

<sup>511</sup> See CTR. FOR REG’L ECON. COMPETITIVENESS & CROMWELL SCHMISSEUR, *supra* note 509, at 21.

<sup>512</sup> See STATE SMALL BUS. CREDIT INITIATIVE, BEST PRACTICE FROM PARTICIPATING STATES: PARTNERING WITH COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS (CDFIS) 10 (2015).

in common that drive their success. First, federal authorities refrained from specifying exactly *how* large players and small ones should cooperate. The CRA delegates these decisions entirely to banks; the SSBCI opened up funds for a broad variety of programs. Second, and relatedly, both programs leverage market competition where possible. Banks, for instance, have incentives to fulfill CRA requirements in the most efficient manner, and the SSBCI involved competitive applications, which rewarded the most promising proposals. These characteristics ensure that, when cooperation happens, parties with local knowledge set the deal terms and ventures stand the greatest odds of success.

## 2. Policy Alternatives

Policymakers, large banks, and local lenders can work together. But is the CRA the right instrument to do it? Law-and-economics orthodoxy suggests it might not be. When conducting *redistributive* policy, for instance, economic theory insists taxation is the best tool.<sup>513</sup> The logic is that, compared with lump-sum taxes, less-targeted policies will distort markets yet offer no redistributive advantages.<sup>514</sup> Importantly, this Article's arguments appeal to *efficiency*, not redistribution, but the same intuition applies. Rather than aiding small lenders indirectly through the CRA—which brings knock-on distortions for the activities of large banks, their depositors and investors, and other actors—why not give them targeted tax subsidies? On this logic, economists frequently highlight how certain tax policies correct inefficiencies more efficiently than other measures.<sup>515</sup>

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<sup>513</sup> See, e.g., Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 667–68 (1994).

<sup>514</sup> *Id.*; see also N. Gregory Mankiw, Matthew Weinzierl & Danny Yagan, *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSPS. 147, 149 (2009).

<sup>515</sup> See, e.g., Nicholas Stern, *The Effects of Taxation, Price Control, and Government Contracts in Oligopoly and Market Competition*, 32 J. PUB. ECON. 133, 134, 149 (1987).



These rejoinders are theoretically sound. Applied to the CRA, however, they miss the forest for the trees. Simply put, Congress cannot condense the entirety of national fiscal policy into a sweeping overhaul of the U.S. tax code. Even if lawmakers wanted to—which they don’t<sup>516</sup>—they couldn’t sell the public on it. When most people think about politics, they evaluate policies on a category-by-category basis—in “policy silos,” or in separate “mental accounts.”<sup>517</sup> Whereas the economist’s “benevolent central planner” can, perhaps, solve any problem with optimal taxes and transfers, real-world politicians, in contrast, effect change using a spectrum of second-best, nontax policy tools.<sup>518</sup> In fact, living in this second-best world, lawmakers are often well-served by a “thousand points approach”—that is, pursuing their goals across numerous diverse policy channels.<sup>519</sup> Pulling on many second-best levers at once, incrementally, maximizes policymakers’ impact per “unit” of deviation from “optimal” policy.<sup>520</sup> That conclusion, itself, follows the law of diminishing marginal returns, a fundamental axiom of standard economics frameworks.

The CRA, then, is certainly an important part of policymakers’ toolbox. The CRA is already good law, and it trades on the common intuition that banks, specifically, should “give back” to their communities. Moreover, ratcheting up the CRA’s local-lending support stands to gain a groundswell of backing from community groups already relying on it. These characteristics make it an ideal platform to drive change.

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<sup>516</sup> Cf. Joseph Zeballos-Roig, *Democrats Say They Have ‘No Sense’ of What Kyrsten Sinema Wants in Biden’s Safety-Net Package as She Opposes Tax Hikes*, BUS. INSIDER (Oct. 14, 2021, 5:31 PM), <https://www.businessinsider.com/democrats-sinema-biden-spending-plans-opposes-tax-hikes-2021-10> [<https://perma.cc/3CN9-9JQ2>].

<sup>517</sup> Zachary D. Liscow, *Redistribution for Realists*, 107 IOWA L. REV. 495, 511–512 (2022).

<sup>518</sup> *Id.* at 525–28.

<sup>519</sup> *Id.* at 34.

<sup>520</sup> *Id.* at 39–43.

Of course, as this discussion makes clear, policymakers should not rely *only* on the CRA, either. They need other tools to combat credit-market inefficiencies. A full treatment of such complementary programs is beyond this Article's scope, yet it is worthwhile to observe some fruitful paths forward. One program to consider scaling up is the Treasury's CDFI Fund, which annually guarantees about \$100 million in loans to CDFIs, as well as issuing about \$150 million in grants.<sup>521</sup> Congress might allocate more money for grants, particularly for technical assistance, which CDFIs sorely need to expand.<sup>522</sup> Tax policies can help, too. Lawmakers might enact, for instance, tax exemptions on interest from community-bank deposits, which could raise local banks' deposit bases, lending power, and revenues.<sup>523</sup> Regulating agencies, further, might exempt the smallest banks from regulations that implicate their business models minimally, as discussed in Part IV.<sup>524</sup> Congress, the SBA, or the Treasury could also subsidize third-party "market makers" that securitize and sell CDFI debt, or that connect small lenders to technical assistance.<sup>525</sup> And lawmakers, of course, can design all sorts of other tax credits, fiscal subsidies, or other measures that support local lenders in targeted ways.

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<sup>521</sup> CMTY. DEV. FIN. INST. FUND, U.S. DEP'T TREASURY, CDFI FUND'S YEAR IN REVIEW 2018, at 19 (2019).

<sup>522</sup> See *supra* Sections IV.C & IV.D.

<sup>523</sup> This reform would be analogous to existing tax exemptions on interest payments from municipal bonds. Daniel Garrett, Andrey Ordin, James W. Roberts & Juan Carlos Suárez Serrato, *Tax Advantages and Imperfect*

*Competition in Auctions for Municipal Bonds*, BROOKINGS INST. 1–2 (May 2018), [https://www.brookings.edu/wp-content/uploads/2018/04/Suarez\\_Serrato.pdf](https://www.brookings.edu/wp-content/uploads/2018/04/Suarez_Serrato.pdf) [https://perma.cc/QJ8H-J7CZ].

<sup>524</sup> See *supra* Section IV.B.

<sup>525</sup> See *supra* Section IV.C. The SBA, for instance, spends about \$250 million annually on technical-assistance programs, some of which could be awarded to these kinds of organizations. See *generally* CONG. RESEARCH SERV., R41352, SMALL BUSINESS MANAGEMENT AND TECHNICAL ASSISTANCE TRAINING PROGRAMS (2020).

## B. Policy Prescriptions

How can Congress and agencies retool the CRA to heighten its local-lending impact? To answer this question, this Section first proposes three principles to guide future CRA reforms. These principles draw lessons from the discussion in Parts III and IV. Next, this Section evaluates recent reform efforts. It discusses, specifically, the OCC's now-rescinded 2020 CRA reinterpretation, which heralded a (temporary) sea change in the agency's implementation. Finally, it concludes with novel reform proposals, including certain elements of the 2020 rule that agencies should preserve.

### 1. A Framework for Reform

The foregoing analysis has made the case for the CRA to reroute large banks' dollars through local lenders. Absent further elaboration, that directive could mean many things. For example, does it entail giving *all* local lenders a lift? The same *kind* of support, if not the same magnitude? Or what about different LMI communities? Would the same treatment work everywhere? The framework below sketches answers to these questions, and more. It advances three principles, which incorporate insights from the discussion above, to guide policymakers translating the small-lender effect into CRA reform.

*Principle 1—the CRA must target the stakeholders that need it most.* CRA dollars can have outsized impacts when deployed through local lenders. But not all lenders—or borrowing populations—need the Act's assistance equally. Pushing proportionally harder on banks to channel dollars where most needed<sup>526</sup> will capture the biggest efficiency benefits.<sup>527</sup> What groups exactly should the Act target? Most importantly, as Part III illustrates, it should prioritize

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<sup>526</sup> Directing policy assistance to recipients based on need-related or similar characteristics not only enjoys theoretical support but is also standard within U.S. policymaking. See Mankiw et al., *supra* note 515, at 162–64.

<sup>527</sup> Cf. Liscow, *supra* note 518, at 38–43.

communities that have (1) the lowest income and wealth or (2) the least preexisting, information-generating lending activity<sup>528</sup>—including banking deserts.<sup>529</sup> Neighborhoods with sparse local-lender presence might figure prominently as well, even if their large-bank competition is greater.<sup>530</sup> Small-dollar borrowers, whom large banks rarely underwrite, also require attention.<sup>531</sup> As for lenders, the CRA should prioritize the smallest ones, like CDFIs, struggling most to raise capital in the first place.<sup>532</sup> And the local lenders likeliest to deploy extra capital in new LMI markets—especially banking deserts<sup>533</sup>—should take precedence.<sup>534</sup>

*Principle 2—the CRA must preserve local control over the means of assistance.* Just as some CRA beneficiaries require more help than others—which Principle 1 recognizes—different communities need help in different ways. But regulators are not positioned well to know what, exactly, each group needs.<sup>535</sup> Players on the ground know better. Community stakeholders, after all, are the ones with local information.<sup>536</sup> Therefore, the CRA should preserve freedom regarding the *means* by which large players and small ones collaborate.<sup>537</sup> Some local lenders, for instance, might need creditors;<sup>538</sup> others might seek only “market makers” who securitize their loans;<sup>539</sup> others might want regulatory support<sup>540</sup> or technical assistance.<sup>541</sup> As much as possible, the

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<sup>528</sup> *Supra* Sections III.A & III.B.

<sup>529</sup> *Supra* Section IV.E.

<sup>530</sup> *Supra* Section IV.A.

<sup>531</sup> *Supra* Section III.B.

<sup>532</sup> *Supra* Section IV.C.

<sup>533</sup> *Supra* Section IV.E.

<sup>534</sup> *Supra* Section IV.D.

<sup>535</sup> *Supra* Section V.A.1.

<sup>536</sup> *Supra* Sections III.A & III.B.

<sup>537</sup> *Supra* Section V.A.1.

<sup>538</sup> *Supra* Section IV.C.

<sup>539</sup> *Supra* Section IV.C.

<sup>540</sup> *Supra* Section IV.B.

<sup>541</sup> *Supra* Section IV.D.

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CRA should let private actors tailor their deal terms, without distortion.

*Principle 3—the CRA must strive for geographic balance.* Following banking consolidation,<sup>542</sup> CRA dollars have hugely unequal geographic distributions. With banks concentrating in cities,<sup>543</sup> certain urban centers have emerged as CRA hotspots, whereas CRA dollars fail to reach others.<sup>544</sup> To preserve horizontal equity<sup>545</sup>—and to maximize each dollar’s information externalities<sup>546</sup> and efficacy against market failures<sup>547</sup>—groups needing similar levels of aid<sup>548</sup> should receive that support regardless of geography. This requires a balancing act. On the one hand, removing the CRA’s geographic nexus altogether might improve efficiency for some communities with low bank presence. But it could drain dollars from others that need them, compounding ongoing market failures. Fully preserving the geography mandate, on the other hand, would entrench existing distributions. Lawmakers, then, should correct imbalances without leaving the CRA’s spatial distribution entirely up to (broken) market mechanisms. (The CRA’s current rulemaking, to be sure, could well help work to this effect.<sup>549</sup>)

## 2. The OCC’s 2020 Rule

Until 2020, the Fed, OCC, and FDIC had implemented the CRA the same way since 1995.<sup>550</sup> That June, however, the OCC broke with its counterparts and, with a new final rule, overhauled its approach to the law. That rule was short lived.

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<sup>542</sup> *Supra* Section IV.A.

<sup>543</sup> *Supra* Section III.B.

<sup>544</sup> *Supra* Section IV.E.

<sup>545</sup> See Mankiw et al., *supra* note 515, at 164.

<sup>546</sup> *Supra* Sections II.B & III.C.2.

<sup>547</sup> *Supra* Section V.A.1.

<sup>548</sup> *Supra* notes 527–35 and accompanying text.

<sup>549</sup> See *supra* notes 70–72 and accompanying text.

<sup>550</sup> *Community Reinvestment Act (CRA)*, OFF. OF THE COMPTROLLER OF THE CURRENCY, <https://www.occ.treas.gov/topics/consumers-and-communities/cra/index-cra.html> [https://perma.cc/4VGT-UHCL] (last visited June 4, 2023).

In December 2021, President Biden’s OCC released a new rule “effectively rescind[ing]” it and restoring the 1995 regime.<sup>551</sup> Since then, as discussed, Fed, OCC, and FDIC proposed a new CRA rule in May that would update the Act more consistently with the principles undergirding the pre-2020 CRA regime.<sup>552</sup>

How, though, did the now-rescinded rule fare by the principles above? The 2020 reform—which drew substantial controversy<sup>553</sup>—brought changes to nearly all aspects of the CRA regime. It redefined CRA-eligible activities, altered rules for drawing assessment areas, changed the calculations of CRA credit, and updated reporting requirements.<sup>554</sup> Its most impactful changes, though, can be broken down into three groups.

First, the rule newly extended CRA credit to many unprecedented activities.<sup>555</sup> For example, it let banks earn credit from *nonmortgage* loans to otherwise-qualifying consumers, as well as loans to *non-LMI* mortgage borrowers within LMI census tracts.<sup>556</sup> It significantly expanded “community development” investments, too. It redefined the “essential community facilities” and “essential infrastructure” subcategories, for instance, to include projects only “partially” benefitting targeted people or places;<sup>557</sup> it made similar changes for “essential infrastructure.”<sup>558</sup> The OCC pledged to police these standards using “reasonable methods.”<sup>559</sup> As for other newly CRA-eligible activities, the OCC included financial-literacy programs (regardless of recipients’

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<sup>551</sup> 86 Fed. Reg. 52,026, 52,026 (Sept. 17, 2021); *Community Reinvestment Act (CRA)*, *supra* note 551.

<sup>552</sup> *See supra* Section II.A.

<sup>553</sup> Brendan Pedersen, *Community Groups Plan to Sue OCC Over CRA Rule*, AM. BANKER (May 21, 2020, 5:38 PM EDT), <https://www.americanbanker.com/news/community-groups-plan-to-sue-occ-over-cra-rule> [<https://perma.cc/PXP6-8J3L>].

<sup>554</sup> 85 Fed. Reg. 34,734, 34,734–36 (June 5, 2020).

<sup>555</sup> *Id.* at 34,738–39.

<sup>556</sup> *Id.* at 34,739. The former category excluded credit-card financing.

<sup>557</sup> *Id.* at 34,744.

<sup>558</sup> *Id.*

<sup>559</sup> *Id.*

incomes),<sup>560</sup> support for certain government-sponsored initiatives,<sup>561</sup> and *pro rata* credit for more projects only partly benefitting LMI populations.<sup>562</sup> It also subtracted from the list many activities by banks' affiliates.<sup>563</sup>

Second, beyond expanding what banks get credit for, the OCC introduced "multipliers" that boosted credit from particular activities. Overnight, this change made certain CRA activities more "valuable" than others. Four categories, in particular, received a multiplier of two. These were activities taken in conjunction with CDFIs, affordable-housing-related loans, certain kinds of community-development investments, and lending in OCC-certified "CRA deserts."<sup>564</sup> The OCC also retained discretion to award particular "complex" activities a multiplier of up to four.<sup>565</sup> As for banking deserts—a new category under CRA regulation—banks had to request OCC certification for regions in which they lent.<sup>566</sup> To avoid a drop-off in CRA activity, the rule only let banks claim multipliers if their unweighted CRA credits remained stayed roughly constant from one period to the next.<sup>567</sup> Additionally, the OCC *devalued* community-development investment overall, rewriting the investment test as a binary threshold, where hitting some (unspecified) minimum awarded full marks.<sup>568</sup>

The third major change was relaxing the CRA's geographic nexus. Under general-performance review—that is, the primary CRA analysis for large banks—banks usually received credit for otherwise-qualifying activities *outside* their

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<sup>560</sup> *Id.* at 34,745–46.

<sup>561</sup> *Id.* at 34,745.

<sup>562</sup> *Id.* at 34,754.

<sup>563</sup> *Id.* at 34,749.

<sup>564</sup> *Id.* at 34,755.

<sup>565</sup> *Id.*

<sup>566</sup> *Id.* at 34,747. CRA deserts were to include areas with low bank presence, fewer loans than expected from "demographic" factors alone, or low presence of community-development organizations and infrastructure. *Id.* at 34,748.

<sup>567</sup> *Id.* at 34,798.

<sup>568</sup> *Id.* at 34,772–73.

assessment areas.<sup>569</sup> Banks also gained freedom to enlarge their assessment areas—in some cases up to their entire state.<sup>570</sup>

Before rescinding this rule, the Biden administration committed to replacing it with a new one—this time, with full banking-agency buy-in.<sup>571</sup> The substitute rule has yet to be finalized. Regardless, when thinking about future CRA reform, should policymakers discard all the 2020 changes? Many, doubtless, made the CRA worse. Per the framework above, though, some took it in (at least partly) positive directions.

The rule's expansion of CRA activities fares worst. Giving banks flexibility in how to earn credit fits Principle 2—that is, not distorting banks' choice of means—but the OCC swung too far away from effective targeting (Principle 1). Credit for non-LMI loans, the new *pro rata* rules, and the weakened community-investment standards seem primed—as activists and commenters widely feared<sup>572</sup>—to funnel funds away from borrowers sidelined by market failure. New CRA-eligible activities would, ideally, help banks aid out-of-reach borrowers, rather than letting them avoid LMI loans altogether.

The geographic changes are more mixed. Letting large banks earn credit *anywhere* counteracted CRA-dollar

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<sup>569</sup> 86 Fed. Reg. 52,026, 52,033–35 (Sept. 17, 2021).

<sup>570</sup> 85 Fed. Reg. at 34,798 (June 5, 2020).

<sup>571</sup> See Brendan Pedersen, *Regulators Hit Reset on CRA Reform, Commit to Joint Rulemaking*, AM. BANKER (July 20, 2021, 4:55 PM EDT), <https://www.americanbanker.com/news/regulators-hit-reset-on-cra-reform-commit-to-joint-rulemaking> [<https://perma.cc/F8XL-5PY5>].

<sup>572</sup> See, e.g., Pedersen, *supra* note 572; Laurie Goodman, Ellen Seidman & Jun Zhu, *The OCC's Final CRA Rule Improves Upon the Proposed Rule but Remains Unsatisfactory*, URB. INST. 2 (July 2020), [https://www.urban.org/sites/default/files/publication/102515/the-occs-final-cra-rule-improves-upon-the-proposed-rule-but-remains-unsatisfactory\\_0.pdf](https://www.urban.org/sites/default/files/publication/102515/the-occs-final-cra-rule-improves-upon-the-proposed-rule-but-remains-unsatisfactory_0.pdf) [<https://perma.cc/5NDK-4YWB>]; *NCRC Comment Letter on OCC Proposal to Rescind Its Harmful CRA Final 2020 Rule*, NAT'L CMTY. REINVESTMENT COAL. (Oct. 29, 2021), <https://ncrc.org/ncrc-comment-letter-on-occ-proposal-to-rescind-its-harmful-cra-final-2020-rule/> [<https://perma.cc/VPY2-J6HA>].



concentration in certain (urban) neighborhoods. It also distorted lending less, enhancing efficiency—something scholars have long supported. On the other hand, the rule might have caused the lowest-income places see CRA dollars dry up. Under the 2020 standards, banks had little incentive to service physically proximate hard-to-reach borrowers. Separately from the national-level review, the OCC *did* continue evaluating banks' CRA activities within each assessment area, but banks could still win “outstanding” ratings with poorer showings in twenty percent of them.<sup>573</sup> Particularly given that the 2020 rule was forecast to inflate ratings significantly,<sup>574</sup> geographic flexibility likely left needier borrowers behind. That fits poorly with Principle 3's balancing test.

The multipliers, though, were a positive step conceptually (setting aside the lower community-development threshold tied to this change). In general, as Principle 1 dictates, weighting investments favorably when they leverage local lenders, overcome information asymmetries, or combat market failures makes for good targeting. Moreover, the OCC picked some good investments to single out. Collaboration with CDFIs is exactly what the CRA should push, and importantly, the multiplier covered a broad swathe of activities—satisfying Principle 2. The CRA-desert multiplier, too, addresses important market failures and fulfills geographic-distribution goals, per Principles 1 and 3.

### 3. Bolstering the CRA

The 2020 rule left much to be desired, yet the appropriate policymakers could take lessons from its geography and multiplier provisions. They might also change other aspects of

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<sup>573</sup> 85 Fed. Reg. 34,798, 34,801-02 (June 5, 2020).

<sup>574</sup> See Buzz Roberts, *OCC's Final CRA Rule Weakens Affordable Housing and Community Development Initiatives*, NOVODAC (July 2, 2020), <https://www.novoco.com/periodicals/articles/occs-final-cra-rule-weakens-affordable-housing-and-community-development-incentives> [<https://perma.cc/8CSZ-P38C>].

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the Act that the 2020 updates left untouched. I chart four main ways forward.

First, policymakers should impose multipliers on CDFI collaboration and banking deserts. They should also add other lenders—like small community banks, non-CDFI loan funds and credit unions, and perhaps certain fintechs—to the former carveout. Policymakers should clarify, per Principle 2, that this multiplier covers a broad range of noninvestment support for local lenders, like regulatory assistance. However, to balance Principles 1 and 2, some especially important outputs could receive higher weights. For example, policymakers might reward equity investments in CDFIs—which are sorely needed<sup>575</sup>—with especially high multipliers. Collateralization services, to help liquidity-constrained lenders improve their capitalization,<sup>576</sup> could also be elevated. As for banking deserts, policymakers could provide for an *ex ante* formula to identify them—one that incorporates bank and nonbank presence alike. Additionally, policymakers should adopt new multiplier categories. Small-dollar loans, unattractive to banks given underwriting's fixed costs,<sup>577</sup> should be encouraged to help borrowers with sparse credit histories.

Policymakers should also calibrate multiplier weights differently from 2020. Since the 2020 rule imposed only multipliers above one, its likely effect was to decrease banks' *aggregate* CRA spending. Yet policymakers can achieve the same *relative* weighting among activities, without altering total dollars invested, by lowering some uses and raising others. For instance, agencies might assign a 0.9 multiplier to standard large-bank LMI loans but 1.2 to bank purchases of CDFI-originated debt. Or loans to LMI borrowers in wealthy areas might carry a multiplier of 0.8, reflecting lower information externalities.

Second, policymakers should diverge from the 2020 rule on activity eligibility. Principle 1 counsels *increasing* investments' LMI nexus, not decreasing it. Policymakers can

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<sup>575</sup> See *supra* Sections IV.C & IV.D.

<sup>576</sup> See *supra* Section IV.C.

<sup>577</sup> See *supra* Section III.B.

do so in multiple ways, but small-business loans are a fruitful starting point. Currently, banks receive CRA credit for such investments generally, but regulators should restrict credit to small-business loans within LMI census tracts, to employers of such residents, or to low-income founders. Empirical research suggests lenient small-business requirements help banks satisfy CRA responsibilities with minimal LMI-neighborhood impact.<sup>578</sup> Policymakers should also provide for higher LMI-benefit standards for community-development projects, rather than weakening them.

Third, policymakers should rethink geography. Most importantly, banks should receive credit for investing in certain “multiplier categories”—specifically, CDFI collaboration and banking deserts—anywhere in the country. Greater flexibility would also raise information externalities for general CRA activities—and indeed, forthcoming CRA rulemaking might help capture some such externalities.<sup>579</sup> Yet policymakers, when thinking about ideal policy, should not completely axe geographic restrictions. Doing so could exacerbate failures in neighborhoods with credit only *by virtue of* large-bank presence—replacing old deserts with new ones. Policymakers should therefore let banks count nationwide loans only for *a portion* of total lending. Policymakers could define this maximum “free-floating share” as a percentage of banks’ total within-assessment-area obligations. Further, they could vary banks’ free-floating-share sizes by their assessment areas’ *total* CRA dollars. Banks in CRA hotspots, that is, would be allowed (or required) to meet more CRA obligations elsewhere. Other banks, by contrast, could not count hotspot loans even toward their free-floating quotas. These changes would equalize loan distributions, maximize information externalities, and shrink deserts.<sup>580</sup>

Finally, policymakers should use carrots, as well as sticks. Banks performing especially well on CRA obligations—or, as Principle 1 might suggest, on *certain* CRA activities—should

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<sup>578</sup> Goodman et al., *supra* note 76.

<sup>579</sup> See *supra* notes 73-75 and accompanying text.

<sup>580</sup> See *supra* Section IV.E.

receive benefits to encourage compliance. Policymakers could create a new CRA-performance category above “Outstanding,” termed “Exceptional,” for banks significantly outperforming peers (or, perhaps, outperforming on banking-desert loans or CDFI joint ventures). To prevent rating inflation, policymakers could cap the “Exceptional” category at ten percent of national banking organizations.<sup>581</sup> Policymakers might then exempt “Exceptional” banks from certain requirements, like certain reporting obligations. These exemptions, by disproportionately benefiting community banks, would have the additional upside of counteracting regulatory failures.<sup>582</sup> Policymakers could also provide for tax credits, or other tax treatment, conditioned on banks’ earning “Exceptional” marks. These credits would satisfy Principles 1 and 3, by rewarding targeted assistance and geographically optimal lending, as well as Principle 2, by subsidizing all means of delivering such assistance.<sup>583</sup>

## VI. CONCLUSION

With expanding credit access, local lenders must lead the charge. Community banks, CDFIs, and similar groups have the relationships, skillsets, and incentives to underwrite marginalized groups that big banks cannot reach. For too long, legal scholars have overlooked this reality. Scholars have rightly questioned whether the CRA is efficient, imposes costs on lenders, or succeeds in reaching LMI borrowers. Yet they eschew a straightforward strategy for restoring credit-market efficiency, minimizing costs, and maximizing positive impact: helping local lenders who lend best to lend more.

This intervention counsels legal and policy reforms, which this Article has begun to sketch. Policymakers, first, should adjust how much CRA credit various activities generate, to support local lending especially in the most marginalized communities. Second, they should focus CRA-eligible

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<sup>581</sup> See Roberts, *supra* note 575.

<sup>582</sup> See *supra* Section IV.B.

<sup>583</sup> Cf. Mankiw et al., *supra* note 515, at 149 (discussing lump-sum taxes).

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activities on ones that target LMI groups or deliver concentrated aid to community lenders—without overly prescribing what that support looks like. Third, they should recalibrate the CRA’s geographic requirements to distribute CRA dollars more efficiently. Finally, they should offer greater incentives (including through tax credits and similar measures) for exceptional small-lender support. These steps would retool the CRA to fix credit-market failures that most harm low-income groups—by working through lenders who *actually* lend to them.