Revisiting the CRA:

Perspectives on the Future of the Community Reinvestment Act

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Foreword

The Community Reinvestment Act (CRA), enacted in 1977, has fostered access to financial services for low- and moderate-income communities across the country. Together with other antidiscrimination, consumer protection, and disclosure laws, the CRA remains today a key element of the regulatory framework, encouraging the provision of mortgage, small business, and other credit, investments, and financial services in low- and moderate-income neighborhoods.

Yet, since the passage of the act, the financial landscape has changed dramatically. How well has the CRA kept up over 30-plus years? Wherever one stands on the answer to this question, there is a general consensus on the need to reexamine this important regulation in the context of financial modernization.

To commemorate the 30th anniversary of the CRA, the Federal Reserve Bank of Boston hosted a special forum in October 2007. Researchers, regulators, bankers, nonprofit practitioners, and community advocates participated in the event. The discussion began with a speech on the legislative intent of the original act. Speakers addressed the changes and consolidation in the banking industry, the growth of nonbank providers of financial services, the major revisions to the CRA and to the examination process, innovations at the state level, and the demographic changes in low- and moderate-income communities. The event closed with a discussion of the future of the CRA, including proposed alternatives. Overall, this discussion underscored the need for an even deeper look at the CRA.

To tackle the many-sided issue of CRA reform, the Federal Reserve Bank of Boston partnered with the Federal Reserve Bank of San Francisco in assembling a team of experts to share their ideas, opinions, and research. The authors who contributed to this project include academic researchers, current and former regulators, community development practitioners, and financial service industry representatives. Of course, they have various, and sometimes divergent views, but they possess a common desire to improve the regulatory system to ensure access to financial services for all in a safe and sound way.

In this volume, we capture many different perspectives on the past and future of the CRA, provide facts, and highlight possible reforms—all in an effort to foster debate. Our efforts were helped considerably by the participation of Ellen Seidman of the New America Foundation, whose knowledge and expertise was invaluable in identifying topics and authors for this volume.

We also address the critics of the act who have pinned the blame for the subprime mortgage crisis on the CRA. There is no empirical evidence to support the claim that the CRA is responsible for the crisis, as several authors in the volume make clear. First, former Federal Reserve Governor Randall Kroszner argues in a speech included in this volume that the CRA did not contribute to any erosion in safe and sound lending practices. He specifically cites an analysis by the Federal Reserve Board that revealed that 60 percent of higher-priced loans went to middle- or higher-income borrowers or neighborhoods not covered by the CRA, and only six percent of all higher-priced loans were extended by CRA-covered lenders to lower-income borrowers or neighborhoods in their CRA assessment areas. Moreover, a research paper by the Federal Reserve Bank of San Francisco in this volume finds that loans originated by CRA-covered lenders were significantly less likely to be in foreclosure than those originated by independent mortgage companies not covered by the CRA.

The current financial crisis challenges us to reconsider the entire financial regulatory system, including updating the CRA. Proposals calling for reform have rightly been offered in this volume. We welcome a reasoned debate about solutions.

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A Framework for Revisiting the CRA

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The Community Reinvestment Act (CRA) of 1977 was enacted to address the concern that depository institutions had not met the credit needs of their entire communities. In many ways, the act can be credited with changing the way that banks do business in low- and moderate-income (LMI) communities. While the statute itself and the regulations that implement it have changed over the intervening decades, a re-examination of the CRA now seems particularly relevant as the financial crisis and the legislative and regulatory responses to it unfold.

The banking and broader financial services industries have evolved significantly since the CRA was passed. Legislative changes, the growth of automated underwriting, and the expansion of the secondary market allowed financial institutions to grow and consolidate, while encouraging the growth of entities not covered by the CRA (see Avery, Courchane and Zorn's article in this volume). However, alterations to the CRA have not kept up with fundamental changes in the structure of the financial services industry. The 1995 changes to the CRA regulations were intended to streamline the CRA evaluation process and make it more performance-oriented. These changes achieved their goal, in part because of the public transparency of the process, the acknowledgement of the differences in bank size, the ability to enforce other antidiscrimination statutes, and the focus on safety and soundness (see American Bankers Association article). The 2005 regulatory changes were more modest, introducing a new bank size category and revising the definition of community development.

Today, the recent turmoil in the financial services industry has prompted calls for a broad re-examination of the regulation and supervision of the entire industry to ensure the safety and soundness of future lending. This re-examination has raised questions about what role the CRA should play in financial services regulation, and to what institutions the CRA ought to apply. The Federal Reserve Banks of Boston and San Francisco jointly present this publication to capture the detailed views of leading thinkers on the CRA. The contributors, including banking and insurance industry representatives, former regulators, community advocates, and academics, offer a broad range of observations and proposals. The themes summarized here generate an extensive range of questions for both policymakers and practitioners. The goal of the publication is to stimulate a thoughtful discussion among on the future of the CRA.

In this article, we present an overall framework for considering the future of the CRA, describe some key implementation considerations, and examine enforcement issues. Throughout, we refer to some of the key ideas contained in the articles in this volume.

Key Questions and an Overall Framework

One of the key questions identified in the articles herein involves the philosophical underpinning of the CRA. What is its underlying intent? Is it designed to repair a market failure, perhaps a lack of information about credit quality in LMI areas? Is it intended to encourage banks to look harder for business opportunities that they would otherwise miss? Is it intended to compel banks to help meet social policy objectives, perhaps as compensation for the privilege of the bank charter, deposit insurance, or access to the Federal Reserve's Discount Window? As Lindsey asks in his article, is access to credit and financial services, real estate lending, and consumer education a public good in its own right that would be underprovided or too costly without government intervention? If the latter, is the intent of the CRA to encourage banks to do things that are somewhat less profitable (or even unprofitable) to further social goals? Have the philosophical underpinnings of the CRA evolved over time with changes in regulations and the banking environment itself?

While Congress found in enacting the CRA that banks have a "continuing and affirmative obligation" to help meet the credit needs of the communities in which they are chartered, we may also ask whether other types of financial institutions have a similar obligation. Further, if the CRA is applied to bank holding companies, nonbank lenders, insurance companies, or even hedge funds, clarifying the rationale for that broader application is important. Many point to the oft-cited *quid pro quo* rationale: that depository institutions are compelled to meet the CRA criteria in exchange for benefits such as deposit insurance, bank charter status, and/or access to the Discount Window. Therefore, if taxpayer subsidy or support is the "hook" on which the CRA hangs for banks and thrifts, recent events suggest that other industries that enjoy explicit or implicit taxpayer support should be subject to similar requirements. Establishing a clear philosophical underpinning would allow the CRA to respond to current and future needs and help in creating a needed benchmark for measuring its success.

While many of the contributions in this volume grapple with detailed questions about the nature and enforcement of the CRA, several authors ask a more basic question: Is the CRA the best way to address a lack of access to fair credit in LMI communities? Lawrence White suggests that vigorous enforcement of the Equal Credit Opportunity Act and antitrust laws could reduce discrimination and make financial markets more competitive. This larger strategic question therefore brings us back to the philosophical underpinnings of the CRA. Has the problem that prompted the creation of the CRA changed? Is the CRA the most useful approach for achieving social goals, such as poverty alleviation, greater access to affordable housing, and neighborhood revitalization? Do its benefits outweigh its costs? Has its original intent been achieved as Lindsey suggests?

Moreover, while we can frame this discussion using the CRA as a starting point, policy makers may also want to consider starting from a blank slate. What are the financial market issues in the 21st century? What inequalities are of concern? Is the CRA peculiar to banks, and a systemic treatment of these issues should start elsewhere? Are there contemporary problems best solved by an intervention that draws on, but is fundamentally different from, the CRA?

The questions posed above can seed a discussion about the future of the CRA. The articles in this volume grapple with many of these questions while suggesting different ways to organize our re-evaluation of the CRA. Broadly speaking, three main approaches emerged.

The first approach is to ***reform the existing CRA regulation and examination process.*** This approach would consider the ways in which the CRA has worked, or not worked, for banks, thrifts and communities in its current form. With feedback from key stakeholders, including banks and thrifts, federal regulators, community-based organizations, municipalities, and residents and businesses in lower-income communities, this approach might re-examine a wide range of questions like the relative weight of the Lending, Investment, and Service Tests, the definition of community development, the use of assessment areas, or focus on the enforcement process and the nature of public disclosure.

Several authors in this volume (including Rust and Taylor and Silver) point out that evaluating performance requires quality data, calling for improvements in Home Mortgage Disclosure Act (HMDA) data variables and CRA small-business data. Meanwhile, despite the evolution of the financial services industry, some argue that access to traditional bank branches and deposit accounts remains critical to LMI consumers' wealth building and small-business development. Several authors commented on the need for greater attention to the Service Test (including Barr and Taylor and Silver).

Other authors (including Quercia, Ratcliffe, and Stegman and Essene and Apgar) argue for the inclusion of affiliates and outside-assessment-area lending in CRA exams. Banks and thrifts are currently allowed to choose whether their non-depository affiliates are included in their CRA exams. Advocates have raised concerns that this option enables bank affiliates to engage in discriminatory practices, arguing that this loophole should be closed (Taylor and Silver). Others suggest that risk-based examinations of affiliates may be most appropriate (Barr).

The second approach is to ***consider whether CRA-like obligations should be extended to other types of financial institutions.*** Some authors suggest that the CRA should be extended to investment banks, bank holding companies, insurance companies, nonbank lenders, credit unions, etc. This approach suggests the need for clarity about why a CRA-like law should apply to these institutions, and would call for a much broader discussion among these financial institutions and the various entities that supervise them. Further discussion of the current enforcement of the CRA and how it might be modified to apply to a wider range of financial institutions would be needed as well.

Cohen and Agresti argue that investment banks, broker-dealers, and other financial institutions should be required to comply with an updated CRA in return for the access to the Discount Window that comes with bank holding company status. The authors offer examples of the kinds of financial services that each type of institution could provide to LMI customers. They argue that all institutions should provide fair access to financial services in exchange for the federal safety net.

Meanwhile, Pinsky argues that the Troubled Asset Relief Program and other federally sponsored "bailouts" carry an implicit CRA standard to serve all markets equally well and without discrimination, while Taylor and Silver suggest that the CRA be expanded to credit unions, nonbank institutions, and securities firms. Ludwig and colleagues recommend expansion to broker-dealers, insurance companies, and credit unions at a minimum, and to all other major financial institutions, such as hedge funds and private equity firms, given the implicit and explicit benefits they receive from the government. The also suggest that nonbanks and other newly regulated entities could partner with banks and thrifts that currently meet CRA requirements or with Community Development Financial Institutions (CDFIs).

Alternately, given that many view the CRA as a tax on the banking industry, Lindsey suggests that CRA-related activities be viewed as public goods. Adopting this rationale would discourage expanding the CRA to institutions that do not provide the core public goods of payment services, real estate lending, and consumer education.

The third approach, instead of taking the current CRA as the starting point, would ***take a completely fresh look at 21st century financial and credit markets and the financial services needed to promote strong families and neighborhoods.*** To start anew in this fashion would call on all stakeholders to take a more systemic, holistic approach to the entire financial services industry and its role in ensuring equal and fair access to credit and financial services for all Americans and in promoting community and economic development.

As a public policy expert in the insurance industry, Gainer investigates the potential role of the insurance industry in addressing household financial stability and risk within a fair and uniform regulatory environment. Meanwhile, White argues that existing laws should be more vigorously enforced, but also that worthwhile lending that is not being provided by the industry should be funded directly by the government, through entities such as the CDFI Fund.

Pinksy suggests that a new investment class be established to facilitate CRA financing, and Barr borrows from behavioral economics to recommend an "opt-out" mortgage plan under which all borrowers would start with a standard mortgage, but could choose an alternative mortgage.

Klausner suggests a market-based approach using tradable obligations along the lines of a "cap-and-trade" system. Following the emissions trading program approach, banks would have to fulfill CRA obligation quotas on their own or pay another institution to provide them. This tradable obligation approach might work in expanding the CRA to institutions such as nonbank lenders, who could more cost-effectively transfer their obligations to institutions with CRA lending expertise. This strategy could also involve partnering with CDFIs to fulfill CRA quotas.

Seidman suggests that "any financial institution that provides an essential consumer product must make that product available in a fair and transparent manner to LMI consumers in all communities in all broad geographies in which the entity does more than an incidental amount of business in the product." Based on the products and services offered, Seidman's proposal covers all essential financial services and their providers wherever they have a significant market share while enhancing public disclosures and fair lending responsibilities of the current CRA.

These three approaches are not mutually exclusive. It may be necessary not only to revise the CRA for banks, but also develop a parallel law for other institutions, and take a fresh look at the financial system.

Important Implementation Considerations

In addition to the above major themes, a number of other important considerations must inform any analysis of the future of the CRA.

People or Place?

A key theme raised by a re-examination of the CRA is the question of whether it ought to be targeted at LMI people or LMI places. The focus on these LMI geographies grew out of the fact that banks traditionally had very specific geographic markets. Therefore, the current regulations measure whether banks and thrifts are serving the credit needs of both LMI geographies and people within their assessment areas, the geographic areas where institutions have their main office, branches, and deposit-taking ATMs, as well as the surrounding areas where banks have originated a substantial portion of loans. However, the majority of lending to LMI borrowers and communities in the mid-2000s was not by CRA-regulated institutions within their assessment areas and therefore had fewer consumer protections (Essene and Apgar).

While the notion of banks and the "communities they serve" meant one thing in 1977, the significant industry consolidation and geographic expansion of institutions since then calls for an updated understanding of the relationship between financial institutions and local communities. In a world of internet banking and ATMs, should "assessment areas" still be based on branch locations? What about financial institutions with delivery mechanisms that do not rely on a branch network; what comprises their "community"? If the assessment area is not based on branch presence, how should it be defined? If an institution makes loans or passes some other threshold for market share in a geographical area, should that area be included in the bank's assessment area? Or do we lose an important local connection when we expand the geographic definition to include any area in which an institution does business?

Several authors argue that, given that banking is now defined not by geography but rather by consumer demographics, delivery channels, and product innovations, the concept of assessment area merits review. Taking a demographic approach suggests that every product or service that a financial institution offers in a geography should be equitably extended to all customers in the geography. This suggests that an institution would choose its market, and that market would define its service area. Pinsky suggests that beyond geographic market channels, economic market channels should also be considered. In fact, since 2001 several proposals have been discussed, including using market share instead of branch location to determine assessment area (Taylor and Silver). Klausner's tradable obligation approach would also transcend the problem of geography.

Another question is whether the population segments and communities targeted by the CRA should be based solely on income, or whether race should be introduced into the CRA calculus. Taylor and Silver argue that fair lending enforcement should be made a stronger part of the CRA examination. Adams notes that despite the historical context of the CRA as a response to redlining, the CRA exam does not assess whether banks and thrifts are affirmatively making loans to ethnic and racial minorities. She argues that the CRA should explicitly encourage investments and promote the creation of wealth in minority neighborhoods. Taylor and Silver suggest that a bank's performance in lending to minorities should be part of the CRA exam. Given that the guiding principle of the CRA is that financial institutions should serve the credit needs of "the entire community," and given that research consistently demonstrates differential access to credit among minority groups and in high-minority geographies, policymakers might contemplate how the CRA could better focus on the needs of these underserved communities.

Access or Fairness?

The historical problem that the CRA was intended to address was access to credit by LMI communities and borrowers. Yet, as the uneven distribution of high-cost lending makes clear, focusing simply on the expansion of access is insufficient unless accompanied by an analysis of the price, terms, and affordability of credit. To what extent should an updated regulation focus on the terms and price of credit rather than simple access to credit? Rust suggests expanding the data collected under the Home Mortgage Disclosure Act (HMDA) to better capture information on loan terms.

Process, Outputs, or Outcomes?

The early CRA examination framework contained 12 "assessment factors" that focused largely on the process by which banks engaged in CRA-related activities. Critiques of this early framework noted that the rules focused too much on bank policies and procedures rather than actual performance. Therefore, the thrust of the 1995 revisions to the regulations was to focus more on outputs than processes. The regulations emphasized the number of loans, investments, and services provided rather than the effort extended.

This transition from process to outputs has been acknowledged broadly by both industry and advocacy groups as a positive step. The CRA is seen by some as encouraging market innovations such as special marketing programs, more flexible underwriting and servicing, and borrower credit counseling. Whether through specialized units or formal partnerships, the CRA has facilitated coordination among banks and reduced information costs. Yet, counting mortgages is easier than evaluating whether an institution truly meets the needs of its community through community development lending and investments (Barr).

However, the transition from process to outputs has generated a concern about whether the CRA examination has become purely a "numbers game" (Willis). Has the examination process lost the ability to properly acknowledge the additional effort that is often extended in underwriting complex community development transactions? In other words, is there some benefit to evaluating the bank's process instead of just whether a loan, investment, or service was provided? A review of the CRA examination procedures might include an evaluation of how to balance outputs with the process used.

Beyond the question of processes versus outputs is an analysis of the outcomes of CRA-related activity. Whether the ultimate goal of the CRA is to solve a market failure, provide a public good, or promote community development, a new look at the CRA should include an assessment of whether that goal has been reached. Asking whether LMI borrowers are better off, whether credit is more available, and on more reasonable terms, and whether LMI communities have greater assets may be the most pertinent questions. There is scant research on measuring outcomes from the CRA beyond the outputs of volume, cost, access, and profitability of lending. While banks are a critical source of credit and financial services, and while they play a critical role in financing community development, they operate within a broader network of lenders, service providers, and community development funders. Teasing out their specific contribution to these larger goals will be difficult.

Important Enforcement Issues

In addition to questions about the underlying philosophy and goals of the CRA, a re-examination of the regulation also raises questions about enforcement. While most other laws and regulations, especially those relating to consumer protection, present a simple enforcement scheme–"do x and you're in compliance, fail to do x and you will suffer a specified sanction"–enforcement of the CRA is more complex. CRA performance by banks is encouraged not just through exams, but also by the public nature of the CRA examination process, and by the incentives offered. Below are three themes related to the enforcement of the CRA and incentives for CRA-related activities.

Disclosure of CRA Performance

One critical aspect of the CRA's impact on the industry and the communities it serves is the public nature of the Performance Evaluation. Any member of the public can access an evaluation (as well as the closely related HMDA data), form his/her own opinion about the institution's performance, and interact with the bank and its supervisors to encourage greater community development activity.

Given the easy public access to this information, what role does disclosure play? Should the law simply require the disclosure of information about products and services, terms, geographies served, etc., or should it compel or encourage institutions to adopt new products or practices? How can community organizations use the information to encourage change and the development of new credit products that better serve their communities' needs?

Examinations

The current CRA examination process has improved over time and now thoroughly enforces the CRA for banks and thrifts. Well-trained examiners, many of whom have considerable expertise in community development issues, periodically examine banks and prepare a comprehensive examination report. Examiners balance statistical analyses of a bank's performance with qualitative assessments of its responsiveness to community credit needs and performance context issues. Meanwhile, banks and thrifts collect, analyze, and report data in preparation for the CRA examination. Today, some argue for continued simplification and greater flexibility (American Bankers Association). Is there a way to streamline the process, make it more consistent across examiners, and reduce the costs to both the supervisors and financial institutions? Given the complexity of CRA activity at very large institutions, should a different examination framework be established for these institutions? If the CRA were expanded to other types of institutions, who would enforce it and what supervisory resources would be needed?

Incentives for CRA Performance

Regulators are required to take into account a financial institution's CRA record when considering applications for acquisitions, mergers, or new branches. Banks considering such changes thus have a strong incentive to have their CRA affairs in order. Are there similar incentives to encourage CRA-related activity at other types of financial institutions? Further, does the merger approval process adequately enforce community reinvestment obligations, or does this process merit review (Taylor and Silver)?

While an Outstanding CRA rating can be viewed as an incentive in itself, its benefits are difficult to quantify, and many institutions seem content with a Satisfactory rating. Should a new CRA rule consider some reward for excellence, for example by rewarding institutions with an Outstanding rating with favorable treatment? What kind of favorable treatment would be appropriate? Or should the CRA serve as a floor, ensuring that all institutions are at least doing a reasonably good job of meeting credit needs? Do concerns over grade inflation point to needed reforms? While some suggest that the high incidence of "passing" ratings calls for the inclusion of more rating categories (Taylor and Silver), others suggest that the ratings indicate the overall high quality of lending (American Bankers Association). For those who do not receive high ratings, should there be penalties for noncompliance? In such cases, some suggest penalty rates on loans from the Discount Window, other fines (Cohen and Agresti), or a CRA improvement plan (Taylor and Silver).

Seeding the Discussion

One error that ought to be avoided in a new look at the CRA is to exaggerate its influence. Extreme views here can result in missed opportunities. For example, erroneously ascribing to the CRA a central role in the subprime mortgage crisis runs the risk of diverting attention from more serious questions, such as the supervision of nonbank lenders, safety and soundness considerations, and fair lending enforcement (Laderman and Reid). It also ignores the positive impact the CRA has had. Not only has the CRA increased access to mortgage lending for LMI borrowers, but it has also played a role in other areas, such as multifamily housing, community facilities, and economic development. By the same token, the CRA alone will not solve neighborhood and poverty issues. If the development of LMI neighborhoods is one of the primary goals of the CRA, we ought to determine what the CRA can and cannot do for neighborhoods. Expanding government funding for the Community Development Block Grant program or the Community Development Financial Institutions Fund may be a more effective policy response to community development needs. Quite likely, many strategies are needed.

Our hope for this volume is that it will inform discussion and bring about positive change. More voices will surely join the conversation. The opportunity to revisit the CRA is before us. Our paramount concern remains enabling the financial services industry to provide access to credit and basic financial services in a safe, responsible, and equitable way to all LMI borrowers and communities. ■

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The Community Reinvestment Act and the Recent Mortgage Crisis[1]

Randall Kroszner
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The Federal Reserve, together with the other federal financial regulatory agencies, has had some experience in addressing the credit needs of underserved communities, using the Community Reinvestment Act (CRA) as our guide. The CRA encourages financial institutions not only to extend mortgage, small business, and other types of credit to lower-income neighborhoods and households, but also to provide investments and services to lower-income areas and people as part of an overall effort to build the capacity necessary for these places to thrive.

Some critics of the CRA contend that by encouraging banking institutions to help meet the credit needs of lower-income borrowers and areas, the law pushed banking institutions to undertake high-risk mortgage lending. We have not yet seen empirical evidence to support these claims, nor has it been our experience in implementing the law over the past 30 years that the CRA has contributed to the erosion of safe and sound lending practices. In the remainder of my remarks, I will discuss some of our experiences with the CRA. I will also discuss the findings of a recent analysis of mortgage-related data by Federal Reserve staff that runs counter to the charge that the CRA was at the root of, or otherwise contributed in any substantive way to, the current subprime crisis.

Regulatory Efforts to Meet Credit Needs in Underserved Markets

In the 1970s, when banking was still a local enterprise, the Congress enacted the CRA. The act required the banking regulators to encourage insured depository institutions—that is, commercial banks and thrifts—to help meet the credit needs of their entire community, including low- and moderate-income areas. The CRA does not stipulate minimum targets or goals for lending, investments, or services. Rather, the law provides incentives for financial institutions to help meet the credit needs of lower-income people and areas, consistent with safe and sound banking practices, and commensurately provides them favorable CRA consideration for those activities. By requiring regulators to make CRA performance ratings and evaluations public and to consider those ratings when reviewing applications for mergers, acquisitions, and branches, the Congress created an unusual set of incentives to promote interaction between lenders and community organizations.

Given the incentives of the CRA, bankers have pursued lines of business that had not been previously tapped by forming partnerships with community organizations and other stakeholders to identify and help meet the credit needs of underserved communities. This experimentation in lending, often combined with financial education and counseling and consideration of nontraditional measures of creditworthiness, expanded the markets for safe lending in underserved communities and demonstrated its viability; as a result, these actions attracted competition from other financial services providers, many of whom were not covered by the CRA.

In addition to providing financial services to lower-income people, banks also provide critical community development loans and investments to address affordable housing and economic development needs. These activities are particularly effective because they leverage the resources available to communities from public subsidies and tax credit programs that are targeted to lower-income people. In just the past two years, banks have reported making over $120 billion in community development loans nationwide.[2] This figure does not capture the full extent of such lending, because smaller

1 *This article is an excerpt from a speech given by Federal Reserve Governor Randall Kroszner titled "The Community Reinvestment Act and the Recent Mortgage Crisis." The speech was delivered at the Confronting Concentrated Poverty Policy Forum at the Board of Governors of the Federal Reserve System in Washington, DC on December 3, 2008.*

2 *Data are from filings made by larger banking institutions to the Federal Financial Institutions Examination Council on CRA-related small business, small farm, and community development lending; for more information, see FFIEC website: http://www.ffiec.gov/.*

institutions are not required to report community development loans to their regulators.

Evidence on the CRA and the Subprime Crisis

Over the years, the Federal Reserve has prepared two reports for the Congress that provide information on the performance of lending to lower-income borrowers or neighborhoods—populations that are the focus of the CRA.[3] These studies found that lending to lower-income individuals and communities has been nearly as profitable and performed similarly to other types of lending done by CRA-covered institutions. Thus, the long-term evidence shows that the CRA has not pushed banks into extending loans that perform out of line with their traditional businesses. Rather, the law has encouraged banks to be aware of lending opportunities in all segments of their local communities as well as to learn how to undertake such lending in a safe and sound manner.

Recently, Federal Reserve staff has undertaken more specific analysis focusing on the potential relationship between the CRA and the current subprime crisis. This analysis was performed for the purpose of assessing claims that the CRA was a principal cause of the current mortgage market difficulties. For this analysis, the staff examined lending activity covering the period that corresponds to the height of the subprime boom.[4]

The research focused on two basic questions. First, we asked what share of originations for subprime loans is related to the CRA. The potential role of the CRA in the subprime crisis could either be large or small, depending on the answer to this question. We found that the loans that are the focus of the CRA represent a very small portion of the subprime lending market, casting considerable doubt on the potential contribution that the law could have made to the subprime mortgage crisis.

Second, we asked how CRA-related subprime loans performed relative to other loans. Once again, the potential role of the CRA could be large or small, depending on the answer to this question. We found that delinquency rates were high in all neighborhood income groups, and that CRA-related subprime loans performed in a comparable manner to other subprime loans; as such, differences in performance between CRA-related subprime lending and other subprime lending cannot lie at the root of recent market turmoil.

In analyzing the available data, we focused on two distinct metrics: loan origination activity and loan performance. With respect to the first question concerning loan originations, we wanted to know which types of lending institutions made higher-priced loans, to whom those loans were made, and in what types of neighborhoods the loans were extended.[5] This analysis allowed us to determine what fraction of subprime lending could be related to the CRA.

Our analysis of the loan data found that about 60 percent of higher-priced loan originations went to middle- or higher-income borrowers or neighborhoods. Such borrowers are not the populations targeted by the CRA. In addition, more than 20 percent of the higher-priced loans were extended to lower-income borrowers or borrowers in lower-income areas by independent nonbank institutions—that is, institutions not covered by the CRA.[6]

Putting together these facts provides a striking result: Only six percent of all the higher-priced loans were extended by CRA-covered lenders to lower-income borrowers or neighborhoods in their CRA assessment areas, the local geographies that are the primary focus for CRA evaluation purposes. This result undermines the assertion by critics of the potential for a substantial role for the CRA in the subprime crisis. In

3 *See Board of Governors of the Federal Reserve System, Report to the Congress on Community Development Lending by Depository Institutions (Washington, DC, 1993), 1–69; and Board of Governors of the Federal Reserve System, The Performance and Profitability of CRA-Related Lending (Washington, DC, July 2000), 1–99, available at http://www.federalreserve.gov/BoardDocs/Surveys/CRAloansurvey/cratext.pdf.*

4 *The staff analysis focused on loans originated in 2005 and 2006. The analysis is available at http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf.*

5 *Loan origination data are from information reported pursuant to the Home Mortgage Disclosure Act (HMDA). The HMDA data do not identify subprime loans directly, in part because there is not a single definition of what loans fall into this category. Rather, the HMDA data indicate which loans are categorized as higher priced, including subprime loans and some alt-A loans. The analysis of data includes first-lien conventional loans for home purchase or refinance related to site-built homes. It excludes business-related loans to the extent they could be identified. For more information on HMDA data and higher-priced lending, see Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," Federal Reserve Bulletin 93 (2007), available at http://www.federalreserve.gov/pubs/bulletin/2007/articles/hmda/default.htm.*

6 *About 17 percent of the higher-priced loan originations were made by CRA-covered lenders or their affiliates to lower-income populations in areas outside the banking institutions' local communities. Such lending is not the focus of the CRA and is frequently not considered in CRA performance evaluations.*

other words, the very small share of all higher-priced loan originations that can reasonably be attributed to the CRA makes it hard to imagine how this law could have contributed in any meaningful way to the current subprime crisis.

Of course, loan originations are only one path that banking institutions can follow to meet their CRA obligations. They can also purchase loans from lenders not covered by the CRA, and in this way encourage more of this type of lending. The data also suggest that these types of transactions have not been a significant factor in the current crisis. Specifically, less than two percent of the higher-priced and CRA-credit-eligible mortgage originations sold by independent mortgage companies were purchased by CRA-covered institutions.

I now want to turn to the second question concerning how CRA-related subprime lending performed relative to other types of lending. To address this issue, we looked at data on subprime and alt-A mortgage delinquencies in lower-income neighborhoods and compared them with those in middle- and higher-income neighborhoods to see how CRA-related loans performed.[7] An overall comparison revealed that the rates for all subprime and alt-A loans delinquent 90 days or more are high regardless of neighborhood income.[8] This result casts further doubt on the view that the CRA could have contributed in any meaningful way to the current subprime crisis.

Unfortunately, the available data on loan performance do not let us distinguish which specific loans in lower-income areas were related to the CRA. As noted earlier, institutions not covered by the CRA extended many loans to borrowers in lower-income areas. Also, some lower-income lending by institutions subject to the law was outside their local communities and unlikely to have been motivated by the CRA.

To learn more about the relative performance of CRA-related lending, we conducted more-detailed analyses to try to focus on performance differences that might truly arise as a consequence of the rule as opposed to other factors. Attempting to adjust for other relevant factors is challenging but worthwhile to try to assess the performance of CRA-related lending. In one such analysis, we compared loan delinquency rates in neighborhoods that are right above and right below the CRA neighborhood income eligibility threshold. In other words, we compared loan performance by borrowers in two groups of neighborhoods that should not be very different except for the fact that the lending in one group received special attention under the CRA.

When we conducted this analysis, we found essentially no difference in the performance of subprime loans in Zip codes that were just below or just above the income threshold for the CRA.[9] The results of this analysis are not consistent with the contention that the CRA is at the root of the subprime crisis, because delinquency rates for subprime and alt-A loans in neighborhoods just below the CRA-eligibility threshold are very similar to delinquency rates on loans just above the threshold, hence not the subject of CRA lending.

To gain further insight into the potential relationship between the CRA and the subprime crisis, we also compared the recent performance of subprime loans with mortgages originated and held in portfolio under the affordable lending programs operated by

7 *Data are from the First American Loan Performance (LP). For the analysis, Zip code delinquency data were classified by relative income in two different ways. First, the data were classified using information published by the U.S. Census Bureau on income at the Zip Code Tabulation Area (ZCTA) level of geography. The data are available at http://www.census.gov/geo/ZCTA/zcta.html. Because the ZCTA data provide an income estimate for each Zip code, delinquency rates can be calculated directly from the LP data based on the Zip code location of the properties securing the loans. Second, delinquency rates for each relative income group (lower, middle, and higher) were calculated as the weighted sum of delinquencies divided by the weighted sum of mortgages, where the weights equal each Zip code's share of the population in census tracts of the particular relative-income group. Relative income is based on the 2000 decennial census and is calculated as the median family income of the census tract divided by the median family income of its metropolitan statistical area or nonmetropolitan portion of the state. Both approaches yield virtually identical results.*

8 *The analysis focused on loans originated from January 2006 through April 2008 with performance measured as of August 2008. However, a virtually identical relationship in loan performance across neighborhood income groups is found if the pool of loans evaluated is expanded to cover those originated in 2004 or 2005. The only material difference is that the levels of delinquency are lower for the loans covering longer periods. Loans that are 90 days or more delinquent include those that end in foreclosure or as real estate owned. Delinquency rates were somewhat higher in the lower-income areas. However, the somewhat higher delinquency rates in lower-income areas is not a surprising result because lower-income borrowers tend to be more sensitive to economic shocks given that, among other things, they have fewer financial resources on which to draw in emergencies.*

9 *The CRA neighborhood income threshold is where the neighborhood median family income is 80 percent of the median family income of the broader area, such as a metropolitan statistical area or nonmetropolitan portion of a state, depending on the specific location of the neighborhood.*

NeighborWorks America (NWA). As a member of the board of directors of the NWA, I am quite familiar with its lending activities. The NWA has partnered with many CRA-covered banking institutions to originate and hold mortgages made predominantly to lower-income borrowers and neighborhoods. So, to the extent that such loans are representative of CRA-lending programs in general, the performance of these loans is helpful in understanding the relationship between the CRA and the subprime crisis. We found that loans originated under the NWA program had a lower delinquency rate than subprime loans.[10] Furthermore, the loans in the NWA affordable lending portfolio had a lower rate of foreclosure than prime loans. The result that the loans in the NWA portfolio performed better than subprime loans again casts doubt on the contention that the CRA has been a significant contributor to the subprime crisis.

The final analysis we undertook to investigate the likely effects of the CRA on the subprime crisis was to examine foreclosure activity across neighborhoods grouped by income. We found that most foreclosure filings have taken place in middle- or higher-income neighborhoods; in fact, foreclosure filings have increased at a faster pace in middle- or higher-income areas than in lower-income areas that are the focus of the CRA.[11]

Two key points emerge from all of our analysis of the available data. First, only a small portion of subprime mortgage originations are related to the CRA. Second, CRA- related loans appear to perform comparably to other types of subprime loans. Taken together, as I stated earlier, we believe that the available evidence runs counter to the contention that the CRA contributed in any substantive way to the current mortgage crisis.

Conclusions

Our findings are important because neighborhoods and communities affected by the economic downturn will require the active participation of financial institutions. Considering the situation today, many neighborhoods that are not currently the focus of the CRA are also experiencing great difficulties. Our recent review of foreclosure data suggested that many middle-income areas currently have elevated rates of foreclosure filings and could face the prospect of falling into low-to-moderate income status. In fact, 13 percent of the middle-income Zip codes have had foreclosure-rate filings that are above the overall rate for lower-income areas.

Helping to stabilize such areas not only benefits families in these areas but also provides spillover benefits to adjacent lower-income areas that are the traditional target of the CRA. Recognizing this, the Congress recently underscored the need for states and localities to undertake a comprehensive approach to stabilizing neighborhoods hard-hit by foreclosures through the enactment of the new Neighborhood Stabilization Program (NSP). The NSP permits targeting of federal funds to benefit families up to 120 percent of area median income in those areas experiencing rising foreclosures and falling home values.

In conclusion, I believe the CRA is an important model for designing incentives that motivate private-sector involvement to help meet community needs. ■

Randall S. Kroszner took office as a Federal Reserve Board Governor on March 1, 2006, to fill an unexpired term ending January 31, 2008. Before becoming a member of the Board, Dr. Kroszner was Professor of Economics at the Graduate School of Business of the University of Chicago from 1999 to 2006. He was also Assistant Professor (1990-1994) and Associate Professor (1994-1999) at the University. Dr. Kroszner was director of the George J. Stigler Center for the Study of the Economy and the State and editor of the Journal of Law & Economics. He was a visiting scholar at the American Enterprise Institute, a research associate at the National Bureau of Economic Research, a director at the National Association for Business Economics and a member of the Federal Economic Statistics Advisory Committee at the Bureau of Labor Statistics in the Department of Labor. Dr. Kroszner was also a member of the President's Council of Economic Advisers (CEA) from 2001 to 2003. Since submitting his letter of resignation to President Bush, Dr. Kroszner has returned to the Booth School of Business at the University of Chicago to assume a newly created chaired professorship. Dr. Kroszner received a SB magna cum laude in applied mathematics-economics (honors) from Brown University in 1984 and an MA (1987) and PhD (1990), both in economics, from Harvard University.

10 *No information was available on the geographic distribution of the NeighborWorks America loans. The geographic pattern of lending can matter, as certain areas of the country are experiencing much more difficult conditions in their housing market than other areas.*

11 *Data are from RealtyTrac, covering foreclosures from January 2006 through August 2008. These data are reported at the Zip code level. Foreclosure filings have been consolidated at the property level, so separate filings on first- and subordinate-lien loans on the same property are counted as a single filing.*

The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution

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Described by Congressman Barney Frank as "a market-friendly model" for bank reform,[1] the Community Reinvestment Act (CRA) was passed by Congress in 1977[2] to fuel reinvestment as a cure for urban blight, and to promote access to mortgage capital to remedy the adverse implications of persistent redlining. In deference to concerns about unsound and unprofitable loans, the CRA did not establish specific benchmarks or levels of credit, nor did it provide much guidance as to how regulators should evaluate bank performance.[3] Instead, the CRA created an affirmative obligation for banks to reinvest in poor communities.

While some critics continue to debate the effectiveness and cost of CRA regulations, a report issued by the Federal Reserve Board in 2000 concluded that mortgage loans that satisfy the low- and moderate-income (LMI) element of the CRA's Lending Test proved to be at least marginally profitable for most institutions, and that many institutions found that CRA lending performed no differently than other lending.[4] Others have recently raised concerns that the CRA caused the subprime debacle, but analysis of the data proves otherwise. Former Federal Reserve Governor Kroszner's article in this publication succinctly addresses these concerns.[5]

Beginning in 1977, the problem shifted from access to credit, to access to fair credit; today the LMI community has come full circle to face renewed problems with access to credit. Over the last three decades, the proportion of loans under the CRA has continued to decline. The Home Mortgage Disclosure Act (HMDA) data from 2006 indicate that "only ten percent of all loans are CRA-related — that is, lower-income loans made by banks and their affiliates in their CRA assessment areas."[6]

Meanwhile, 34 percent of all mortgage loans were LMI loans. Removing the ten percent of CRA-related loans, 24 percent of all loans were outside of the regulatory reach of the CRA and were LMI loans. The 24 percent of non-CRA mortgage lending includes 13 percent originated by CRA-regulated lenders outside their assessment areas and another 11 percent originated by independent mortgage companies. Therefore, while low-income borrowers and neighborhoods had increased access to credit by the mid-2000s, the majority of this lending was not covered by the CRA and therefore provided fewer consumer protections.

The importance of regulatory and supervisory uniformity and the need to restore access to fair credit for all borrowers places the CRA at the center of current discussions on regulatory reforms. This is not to suggest a return to the

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* *The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Boston. The authors thank Patricia McCoy, Susan LeDuc, Andy Olszowy, Peter Zorn, Robert Avery and Jim Campen for their helpful comments and feedback.*

1 *Barney Frank, "The Community Reinvestment Act: Thirtieth Anniversary Roundtable," Federal Reserve Bank of Boston, October 22, 2007.*

2 *The CRA was enacted by Congress in 1977 (12 U.S.C. 2901(b)) and implemented by Regulations 12 CFR parts 25, 228, 345, and 563e. The CRA sought to encourage depository institutions to invest in community development ventures and lending to small businesses and low- and moderate-income (LMI) people and neighborhoods in areas where the institution maintained banking operations, consistent with safety and soundness principles.*

3 *See Michael Barr, "Credit Where it Counts," New York University Law Review (2005), Vol. 75:600 for a summary of a broad range of CRA critiques.*

4 *Board of Governors of the Federal Reserve System, "The Performance and Profitability of CRA-Related Lending, A report submitted to Congress pursuant to Section 713 of the Gramm-Leach-Bliley Act of 1999." (Washington, DC, July 17, 2000), available at http://www.federalreserve.gov/BoardDocs/Surveys/CRAloansurvey/cratext.pdf.*

5 *Governor Randall S. Kroszner, "The Community Reinvestment Act and the Recent Mortgage Crisis," presented at the Confronting Concentrated Poverty Policy Forum, Board of Governors of the Federal Reserve System, Washington, D.C., December 3, 2008, available at http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm.*

6 *Glenn Canner and Neil Bhutta, "Staff Analysis of the Relationship between the CRA and the Subprime Crisis," Board of Governors of the Federal Reserve System, November 21, 2008, available at http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf.*

days of lax underwriting and opaque markets. Instead, as access to fair credit is restored, the CRA-regulated entities' expertise about safe and sound lending to LMI neighborhoods could prove invaluable for efforts to address the foreclosure crisis and stabilize neighborhoods. Beyond learning from the CRA's successes, there is also a need to address the CRA's greatest weakness: the lack of uniform coverage across the industry. This flaw enabled less supervised nonbank lenders[7] to operate largely outside of the CRA regulatory framework and to gain market share from more closely regulated mortgage market participants.[8] As the subprime crisis unfolds, the need for more uniform regulations and consumer protections for all borrowers has become evident.

The purpose of this paper is fourfold. First, we review the historic and regulatory changes in each decade since the enactment of the CRA. Second, we explore the evolution of the mortgage market, including the rise of large organizations, the growth of secondary market sources of funding and wholesale lending, and the proliferation of new products. Next, we discuss the current industry and regulatory challenges, focusing on the differences in lending inside and outside of assessment areas and by nonbank entities. We consider how and why this coverage varies and its adverse effects. Lastly, we consider ways to reform the CRA. We suggest applying the CRA framework to all lenders, reconsidering assessment area definitions, expanding fair lending enforcement, improving data collection for compliance monitoring, and finding ways for all institutions to provide all services.

Methodology

This article utilizes the Joint Center for Housing Studies Enhanced Home Mortgage Disclosure Act (HMDA) Database, which combines loan-level data on the characteristics of one- to four-family home mortgage originations and borrower information, as well as data on lender characteristics and branch locations from the Board of Governors of the Federal Reserve System (Federal Reserve).[9] The Federal Reserve's lender file contains information that facilitates aggregation of individual HMDA reporters into commonly owned or commonly controlled institutions, which can then be analyzed as integrated units. The assessment area definitions come from the Board's branch-location file. This article assumes that if a lending entity subject to the CRA has a branch office in a particular county, then that entire county is part of that entity's assessment area. Loans made in counties where the lending entity does not have a branch are assumed to fall outside of that entity's assessment area.

To assess the influences of economic, demographic, and housing market trends on lending, the Joint Center linked other information on metropolitan area and neighborhood characteristics to the HMDA loan-level data. These included U.S. Department of Housing and Urban Development (HUD) data used to classify loans based on both the income of the applicant and the income of the census tract in which the property is located.[10]

Although imperfect in many ways, HMDA data provide a complete census of mortgage lending, including information on first- and second-lien mortgages for the purchase and refinance of one- to four-family owner-occupied residences, as well as absentee-owned one- to four-family structures. Unlike other readily available data, HMDA provides information on borrower income and race/ethnicity, as well as the location of the property identified at the census tract level. This permits a detailed assessment of the impact of changing patterns of mortgage lending on both historically disadvantaged population subgroups and specific neighborhoods.

Supported in part by the Ford Foundation, the Joint Center Enhanced HMDA Database has been used to

7 *"Nonbank institutions" are independent mortgage banks (IMBs) and other independent mortgage lenders. These terms may be used interchangeably throughout this paper and represent institutions that are not covered by CRA.*

8 *When the CRA was enacted in the 1970s, CRA-regulated depository institutions generated the majority of home mortgage and small business loans. By 2006 the share of all loans covered by detailed CRA review of LMI borrowing had fallen to just 26 percent compared to 41 percent ten years earlier.*

9 *The work presented here updates and expands on a previous paper by William C. Apgar and Mark Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges," Economic Policy Review, Federal Reserve Bank of New York (2002), available at http://www.jchs.harvard.edu/publications/governmentprograms/cra02-3_apgar.pdf.*

10 *For a more complete description of the database see Joint Center for Housing Studies (JCHS), "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System," prepared for the Ford Foundation by the JCHS of Harvard University, March, 2002, available at http://www.jchs.harvard.edu/research/crareport.html. Note that in addition to information on loan originations, the HMDA data also include limited information on the sale of mortgages by loan originators to wholesale investors or mortgage conduits.*

support a wide range of innovative research. To date, these data have been used in ongoing Joint Center research on the impact of the CRA on housing market dynamics,[11] the implications of the changing mortgage banking industry for community-based organizations,[12] and how the uneven application of mortgage market regulations in both the primary and secondary market combined to permit unfair mortgage pricing with respect to race and ethnicity.[13] Finally, these data were deployed in a broader examination of the impact of the mortgage market meltdown on low- and moderate-income communities.[14]

The Regulatory Environment

The 1970s: The CRA Marks a New Era in Regulation

In the late 1970s, many inner cities were faced with urban decline and deterioration while the suburbs were booming. Housing advocates were concerned that lower-income and minority residents of inner-city communities did not have access to conventional mortgages and small business lending.[15] Many reasons for this disinvestment have been put forward, including blatant discrimination in the form of 'redlining,' where conventional lenders refused to lend to certain borrowers or neighborhoods based on their race or income. Beyond the systemic causes of this disinvestment, some have argued that conventional lenders lacked lending relationships within these lower-income communities and/or used traditional underwriting criteria that did not address non-conforming, yet creditworthy applicants.[16]

Grassroots community groups working in coalition through National People's Action pointed out that depository institutions accepted deposits from inner-city neighborhoods yet refused to lend in these same areas, choosing instead to lend in more affluent and growing suburban areas. To address concerns about how deposits were deployed, advocates argued that banks were obligated by a *quid pro quo*: if banks receive federal benefits (including federal deposit insurance, low-cost capital, or access to the payment system and the Discount Window) they are obligated to serve the credit needs of their entire service areas. This *quid pro quo* was one of the leading Congressional arguments for new legislation.[17] There was also discussion at the time of a greater obligation of banks to improve access to underserved communities, with the goal of reducing discriminatory practices.

Fair lending laws were already on the books but did not proactively address the concern that low-income and minority consumers and neighborhoods lacked access to credit. Following the civic unrest of the late 1960s and the assassination of Rev. Martin Luther King Jr., the Fair Housing Act, passed as part of the Civil Rights Act of 1968,[18] and the Equal Credit Opportunity Act (ECOA) of 1974[19] prohibited creditor discrimination. To support

11 Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System."

12 William Apgar and Allegra Calder, "Credit Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Joint Center for Housing Studies, Harvard University, 2004, available at http://www.jchs.harvard.edu/publications/communitydevelopment/ccc04-1.pdf.

13 William Apgar, Amal Bendimerad and Ren S. Essene, "Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data," Joint Center for Housing Studies, Harvard University, 2007, available at http://www.jchs.harvard.edu/understanding_mortgage_markets/index.htm.

14 Joint Center for Housing Studies, "America's Rental Housing: The Key to a Balanced National Policy," Harvard University, 2008, available at http://www.jchs.harvard.edu/publications/rental/rh08_americas_rental_housing/index.html.

15 While these communities lacked traditional access to credit, more predatory loans such as land contract sales (under which the borrower pays on an installment basis with few rights to equity) became common in neighborhoods like Chicago's south side. See Joseph C. Cornwall, The Million-Dollars-A-Day Cost of Being Black: A History of African-American, Catholic and Jewish Struggles Against Real Estate Speculation in Chicago, 1957-1981." (Cornwall Metropolitan Studies, Rutgers University, 2002).

16 Chairman Ben S. Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges," speech at the Community Affairs Research Conference, Washington, DC, 2007.

17 Senator William Proxmire, Statement in 123 Congress, Record Number 17604, Washington, DC, 1977.

18 The Fair Housing Act (Title VIII of the Civil Rights Act of 1968), as amended, prohibits discrimination in the sale, rental, and financing of dwellings, and in other housing-related transactions, based on race, color, national origin, religion, sex, familial status, and disability, available at http://www.hud.gov/offices/fheo/FHLaws/.

19 ECOA prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, use of public assistance, or for exercising their rights under the Consumer Credit Protection Act, available at http://www.usdoj.gov/crt/housing/housing_ecoa.php.

fair lending enforcement, in 1975 the HMDA[20] acknowledged the failure of lending institutions to provide equal access to credit and ensured that information would be available to quantify whether institutions met the credit needs of their communities.

Enacted in 1977, the CRA established a "continuing and affirmative obligation" for federally insured depository institutions to help meet the credit needs of their local communities and required that lenders demonstrate that they serve the convenience and needs of LMI communities with both credit and deposit services. To encourage fair lending and curb the racially discriminatory practice of redlining, the CRA sought to have lenders use the same loan criteria, regardless of whether borrowers lived in lower-income central-city neighborhoods or more prosperous communities.[21] The CRA promotes an increased distribution of capital to LMI and minority households and at its enactment, covered a substantial share of all home mortgage and small business lending activities.

The initial form of CRA enforcement included periodic non-public exams, subjective examination procedures, and the ability of regulators to delay merger or expansion proposals of institutions that did not comply with CRA obligations. The initial rulemaking established 12 assessment factors to evaluate a bank's performance and instituted periodic CRA exams for depository institutions.[22] To incentivize performance, these examinations were to be considered when an institution applies to open a branch, merge with another institution, or become a financial holding company.

CRA regulations also provided an opportunity for public comment during the merger process. Community groups used this opportunity to pressure banks to reinvest in underserved communities and to encourage lenders to meet with community groups to consider a CRA agreement.[23] Yet, just eight of 40,000 applications were denied due to the CRA in the first decade of the regulation.[24] With no public disclosures of ratings, few mergers to protest, and evaluations based on the lender's intentions instead of tangible outcomes, advocates found it difficult to evaluate a lender's track record and pressure poor performing lenders to reinvest in low-income neighborhoods. This would change over the next two decades.

The 1980s and a Renewed Focus on Fair Lending

Arguably, CRA exams in the 1980s did little to expand lending in underserved markets, as 97 percent of institutions received one of the two highest ratings, and some regulators conducted no CRA exams at all.[25] In a world of limited consolidation and evaluation, the CRA had limited ability to punish poor performance or reward "good behavior" through denying or permitting mergers. While some community activists used the CRA mandate to pressure banks to experiment with new loan underwriting criteria and products to meet the needs of their communities, without publicly available ratings it was difficult for community groups to scrutinize institutional lending records and create a reputational risk for poor performance. Meanwhile, underserved markets continued to lack access to credit, and racial disparities persisted. Documenting these challenges was the ground-breaking, Pulitzer Prize–winning "Color of Money" series in the *Atlanta Journal Constitution*, which

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20 HMDA is implemented by the Federal Reserve's Regulation C, available at http://www.ffiec.gov/hmda/history.htm HMDA was enacted to provide loan-level information to ensure that depository institutions are not engaging in lending discrimination. HMDA data became public in 1989 and are used in CRA exams to ensure that CRA-regulated lenders are serving the housing needs of their communities.

21 Paul S. Grogan and Tony Proscio, Comeback Cities: A Blueprint for Urban Neighborhood Revival (Boulder: Westview Press, 2002), p. 114.

22 The Federal Reserve System regulates all bank holding companies, financial holding companies, and state-chartered member banks; the Office of the Comptroller of the Currency (OCC) regulates banks with a national charter; the Federal Deposit Insurance Corporation (FDIC) regulates state-chartered banks that are not members of the Federal Reserve System; and the Office of Thrift Supervision (OTS) regulates savings and loan institutions.

23 A CRA agreement is made between a community organization and a bank where both commit to a specific program of loans and/ or investments. The bank may agree to a certain volume of lending and the community group may help play a specific role such as marketing or counseling. For more information see: National Community Reinvestment Coalition, "CRA Commitments," September 2007, available at http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf. See also: Raphael W. Bostic and Breck L. Robinson, "What Makes CRA Agreements Work? A Study of Lender Responses to CRA Agreements." Paper prepared for the Federal Reserve System's "Sustainable Community Development: What Works, What Doesn't, and Why" research conference, Washington, DC, February, 2003.

24 Marilyn Rice Christiano, "The Community Reinvestment Act: The Role of Community Groups in the Formulation and Implementation of a Public Policy." Ph.D. diss., University of Maryland, 1995.

25 Early studies of the impact of the CRA on lending patterns were hindered by the fact that HMDA initially lacked data on the income and racial characteristics of borrowers. For a review of these studies see D.D. Evanoff and L.M. Chu, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending," Federal Reserve Bank of Chicago Economic Perspectives, Volume 20, Number 6, (1996.) See also Apgar and Duda, "The Twenty-Fifth Anniversary of the CRA: Past Accomplishments and Future Regulatory Challenges."

raised concerns about the ongoing racial disparities in access to mortgage loans and the lack of enforcement of the CRA and fair lending laws. Meanwhile, community groups pushed Congress to adopt the Fair Housing Amendments Act of 1988 to expand the scope and strengthen the enforcement of the Fair Housing Act and address ongoing racial disparities.

After the savings and loan crisis of the late 1980s, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989.[26] FIRREA required regulators to prepare a detailed written evaluation of lenders' CRA performance; mandated public disclosure of CRA ratings and evaluations; established a four-tier descriptive rating system; and expanded the HMDA data to include race, ethnicity, gender, and income and enabled community groups to link HMDA data with census tract information to allow more detailed geographic and demographic analysis. These actions strengthened the ability of community groups to evaluate and pressure lenders to actively invest in LMI neighborhoods.

Congressional concern over the CRA's effectiveness led to even broader changes in 1989. As the regulatory climate changed, the press and community advocates raised public awareness of the increasing number of mergers and focused senior banking executives' attention on the reputational risk of being labeled an unfair lender. The increase in federal regulatory action and the new public disclosures encouraged community groups to negotiate more CRA agreements.[27] Meanwhile, the Federal Reserve denied its first merger due to the institution's lack of effort to meet the credit needs of the community, and the Federal Reserve published a policy statement outlining a more aggressive regulatory stance towards the CRA.

CRA Regulations Did Not Keep Pace with the Restructuring in the 1990s

When the CRA was first enacted, regulated depositories largely engaged in mortgage lending through branch banking locations. However, the 1990s witnessed a radical transformation of the financial services industry with which the CRA could not keep pace. Emerging technology in data processing and telecommunications encouraged the growth of large mortgage banking operations, though limits on the geographical expansion of deposit-taking organizations slowed this trend somewhat.

At the same time, new sources of funding for residential mortgages emerged. Rather than depend on deposits to fund loans, mortgage lending operations like the rapidly growing independent mortgage banks (IMBs) were able to tap global capital markets and institutional investors to gain access to virtually unlimited amounts of mortgage capital. This new source of funding and the ability to operate outside the confines of federal regulation enabled IMBs to capture mortgage market share from traditional banks. Indeed, according to an analysis of HMDA data, from 1990 to 1994 the share of all mortgage loans originated by IMBs more than doubled to 38 percent.[28] In contrast, the share of lending by traditional deposit-taking organizations declined by 20 percentage points to 39 percent, while the share of loans made by mortgage banking subsidiaries and affiliates of traditional banks held constant at just over 20 percent.

The rise of IMBs, along with equally dramatic changes in the structure of the retail banking industry, prompted a significant legislative response. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act eliminated most restrictions on interstate bank acquisitions, expanding the ability of banks to operate on a multi-state basis. Some advocates argued that this act was the "final move in an almost complete dismantling of long standing legal barriers to the geographic spread of banks."[29] After the passage of the Riegle-Neal Act, some banks extended their own branch networks across county or even state lines. However, much of this geographic expansion was accomplished by a series of mergers and acquisitions, including the acquisition of major retail banking and mortgage banking affiliates and subsidiaries that became the building blocks of today's financial services giants.

As discussed below, the geographic expansion of bank lending, the growth of IMBs, and the increasing tendency for regulated depositories to conduct their

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26 *FIRREA, 12 U.S.C. 2906(b) (2000).*

27 *Alex Schwartz. "From Confrontation to Collaboration? Banks, Community Groups, and the Implementation of Community Reinvestment Agreements." Housing Policy Debate 9:3, (1998).*

28 *This analysis comes from data collected by Robert Avery at the Federal Reserve Board of Governors for a paper in this publication by Robert Avery, Marsha Courchane and Peter Zorn entitled, "The CRA Within a Changing Financial Landscape," 2009.*

29 *Jim Campen, "It's a Bank-Eat-Bank World," Dollars and Sense (January/February 1998), p. 12.*

mortgage banking operations through subsidiary and affiliate organizations had dramatic implications for the CRA. First and foremost, these trends called into question the basic rationale behind the CRA, namely the link between geographically defined deposit-taking and a geographically determined set of mortgage lending obligations. At the same time, these trends highlight the importance of existing CRA regulations, especially the fact that regulators could use CRA performance to deny requests for mergers or acquisition during the late 1990s.

Rather than fundamentally rethink and potentially realign the rationale for CRA intervention into private mortgage markets in the mid-1990s, the legislative and regulatory response was modest. For example, in response to concerns raised by industry and community leaders about the lack of consistent performance-based reviews and the burden of CRA compliance, the agencies began a review of the CRA in the early 1990s at President Clinton's request. The supervisory agencies issued joint regulations in 1995 to "revise the CRA evaluation process and make it more objective and performance oriented."[30] Focusing on specific performance measurements, these regulations required greater disclosure on a range of lending (including community development lending) and outlined specific tests for large retail, small retail, and wholesale/limited purpose institutions. The three-pronged test of lending, investment, and service was instituted for large retail depositories, while small banks received a more streamlined treatment.[31]

While the 1995 regulations sought to reduce subjectivity, examiners still consider the "performance context" and apply the relevant test depending on the institution and its marketplace. Furthermore, the CRA continues to scrutinize assessment area lending and banking services, and the revised Lending Test also measures lending by the distribution of mortgage loans to borrowers of different income levels. Because HMDA data allow monitoring of institutions' lending patterns, much of the scrutiny from community groups has remained on the Lending Test.[32] With the growing importance of subsidiary and affiliate activity, banks are also allowed to choose whether the lending, investing, or service activities of their affiliates are considered in their CRA examinations. Given that these affiliates and subsidiaries were often mortgage companies specializing in serving lower-income borrowers with risky mortgage products, it is likely that much of this volume therefore escaped examination.

In an effort to bring other banking regulation into compliance with the changing market trends, the Gramm-Leach-Bliley Financial Modernization Act (GLBA) was passed in 1999. Given the prevailing deregulation mindset, it was difficult for CRA proponents to make the case for increased regulation, and many perceived that the best course of action was not to make dramatic changes for fear of losing the CRA entirely. The most substantial effect of the GLBA was the partial repeal and amendment of the Glass-Steagall Act and the liberalization of the Bank Holding Company Act (BHCA). Glass-Steagall had erected walls between commercial banking and insurance and investment banking, which GLBA dismantled. GLBA allowed commercial banks, insurance underwriters, and investment banks to affiliate under the umbrella of a new entity know as a financial holding company, while authorizing less frequent examinations of smaller banks with Satisfactory or better CRA ratings.

Under the new rules, financial institutions could now become large conglomerates through a new financial holding company structure, so long as the holding company's depository institutions had and maintained CRA ratings of Satisfactory or Outstanding. If that and other requirements were satisfied, the financial holding company could be formed with no opportunity for public comment on the company's CRA record.[33] Interestingly, given CRA opponents' concerns over the safety and soundness of CRA-motivated lending activity, the GLBA directed the Federal Reserve System to report to

30 *Robert B. Avery, Paul S. Calem, and Glenn B. Canner, "The Effects of the Community Reinvestment Act on Local Communities," Board of Governors of the Federal Reserve System, Division of Research and Statistics, March 20, 2003, available at http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/cannerglen.pdf.*

31 *For current CRA regulations, see the code of federal regulations 12 CFR 228, available at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title12/12cfr228_main_02.tpl.*

32 *Consistent with the renewed focus on HMDA data in CRA reviews, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) required regulators to evaluate and report on potential errors in HMDA data in the public portion of CRA reports.*

33 *Meanwhile, with rising international concerns about the lack of U.S. federal privacy legislation and several high-profile cases against banks for privacy violations, concerns arose during the GLBA debates around the privacy of borrowers' credit reports and information. Title V of GLBA instituted greater information security requirements, a privacy notice policy offering limited privacy protections, but few restrictions on the sale of consumers' financial information. Patricia A. McCoy. Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts § 4.03[3]-[5] (Lexis 2d ed. 2000 & cumulative supplements).*

Congress and to make available to the public the default rates, delinquency rates, and profitability of these lending activities. These “sunshine” provisions also required public disclosure and annual report filings concerning any CRA agreements made between lenders and community groups.[34]

CRA Revisions in the 2000s and the Rise of Subprime Lending

The revolution in mortgage finance during the 1990s spilled over into the new millennium in the form of an equally dramatic explosion of new subprime mortgage products.[35] These products seemed to foster expanded access to homeownership by communities and individuals not well-served by traditional prime loan products. At the time, many advocates argued that the growth of subprime lending was linked to various predatory loan features and lending practices that encouraged new borrowers to take on mortgage obligations that they did not understand or were unable to pay. Despite the importance of the rise of subprime lending to the LMI market, the largest share of this new subprime lending took place outside of the CRA-regulated channel, as we explain below.

Despite the substantial changes sweeping the mortgage market, substantive changes to the CRA were modest. The 2001 joint Advance Notice of Proposed Rulemaking (ANPR) sought comments on a range of issues concerning the limited ability of the CRA to keep pace with an evolving market; many of these issues persist today. The eight areas of investigation were: the large retail institutions’ evaluations through the three-pronged test, the small institutions’ streamlined evaluations and asset threshold, the community development test as applied to limited-purpose and wholesale institutions, the strategic plan option, the performance context as it relates to quantitative and qualitative evaluations, the role of assessment areas to reasonably and sufficiently designate communities, the lender’s option to include affiliate activities in the CRA exam, and the current data collection requirements and maintenance of public files.[36]

Early in the discussions, there was a proposal to increase the Small Bank asset threshold for institutions with total assets of less than one billion dollars. In response to community groups’ concerns, the 2004 Notice of Proposed Rulemaking (NPR) focused largely on the treatment of these small banks and proposed increasing the threshold to include institutions with total assets of less than $500 million, excluding any holding company assets.[37] After considerable feedback, the Federal Reserve System and the FDIC developed the designation Intermediate Small Bank (ISB) and an ISB two-pronged test, and the Office of the Comptroller of the Currency (OCC) later agreed to this recommendation.

Determining that the CRA was basically sound, the 2005 joint Final Rule of the CRA as published by the Federal Reserve, OCC, and FDIC established the ISB category and clarified that lenders’ CRA evaluations would be adversely affected by discriminatory, illegal, and abusive credit practices in regards to consumer loans regardless of whether the loan is inside or outside of an assessment area or within the bank or an affiliate. Meanwhile, the OTS announced that it would not conduct CRA examinations for institutions holding less than $1 billion in assets, effectively exempting nearly 90 percent of the institutions it regulates, and the FDIC proposed a similar rule.[38] By 2007, the OTS agreed to adopt the 2005 Joint Final Rule.[39] Yet, the lack of early

34 Board of Governors of the Federal Reserve System, “The Performance and Profitability of CRA-Related Lending.”

35 As described by Eric Rosengren, “Housing and the Economy: Perspectives and Possibilities,” in a speech to the Massachusetts Mortgage Bankers Association, Boston, MA, January 8, 2009: “subprime” loans refer to mortgages that have a higher risk of default than prime loans, often because of the borrowers’ credit history. Certain lenders may specialize in subprime loans, which carry higher interest rates reflecting the higher risk. Banks, especially smaller community banks, generally do not make subprime loans, although a few large banking organizations are active through mortgage banking subsidiaries. According to interagency guidance issued in 2001, “The term ‘subprime’ refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories [and] may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria… Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.”

36 Federal Register 66 (139) July 19, 2001 http://www.fdic.gov/news/news/inactivefinancial/2001/fil0165a.pdf.

37 Federal Register 69 (25) February 6, 2004, available at http://www.fdic.gov/regulations/laws/federal/04CRA.html In addition to the increased asset-size threshold and the clarification that discriminatory, illegal, and abusive credit practices will potentially affect the CRA rating, the NPR proposed disaggregating small business and small farm loan data to the census-tract level and publicly disclosing the number, type, and amount of purchased loans, HOEPA loans, and affiliate loans.

38 See Barr, 2005 p. 105 for more details. The OTS finalized the rule on August 18, 2004. See CRA Regulations, 69 Fed. Reg. 51,155 (Aug. 18, 2004) (codified at 12 C.F.R. §563.12(t)). The FDIC proposed a similar rule, Community Reinvestment, 69 Fed. Reg. 51,611 (Aug. 20, 2004).

39 See OTS, CRA Rule Interagency Uniformity, 72 Fed. Reg. 13429 (2007).

agreement by the regulators raised concerns by advocates about potential regulatory arbitrage.[40] Meanwhile, the 2005 Final Rule left untouched important issues such as the definition of assessment areas and the unevenness of CRA coverage across mortgage lenders raised in the initial 2001 ANPR.

Today, the CRA is enforced through periodic exams that establish a public performance rating and report fair lending violations.[41] Regulators take into account not only the volume of lending but also the distribution across geography and borrower characteristics as well as innovation and flexibility of lending to underserved communities. As mentioned earlier, illegal practices and fair lending violations are considered in the assignment of the lender's rating and are reported to the appropriate agencies, as clarified in the 2005 Final Rule. These ratings and the HMDA data are publicly available, allowing for press coverage, permitting public comment on bank expansion applications, and creating a tangible reputational risk for lenders who seek to grow their operations. Providing a public track record through CRA agreements and the comment process has historically given leverage to community groups to act as "regulators from below" and support enforcement efforts.[42] It remains to be seen whether community groups will continue to have such leverage, given the rapid changes underway in the financial world.

The Revolution in Mortgage Finance

Since the CRA was passed in 1977, there has been a virtual revolution in mortgage finance—to which the CRA has failed to adapt. When the CRA was enacted, depository lenders held the majority of loans that they originated in portfolio, because underwriting standards and mortgage documents varied considerably, and third-party investors were reluctant to purchase mortgages that lacked adequate credit enhancement and standard features. As recently as 1980, nearly half of all mortgages for one- to four-family homes were originated by deposit-taking thrift organizations and another 22 percent by commercial banks. As a result of the dramatic restructuring of the mortgage market over the past quarter-century, today the largest share of mortgage capital flows through a wide range of unsupervised or only marginally supervised entities.[43] Changes include the growth of secondary market sources of funding, the rise of large organizations and nonbank lenders, the proliferation of new product development, the expansion of wholesale operations, and the decline of small bank mortgage lending.

The Rise of Large Organizations

The last thirty years have witnessed a dramatic consolidation of the mortgage and banking industry. Stimulated by the globalization of financial services, the removal of federal and state-level restrictions on the expansion of operations across county and state boundaries fueled a dramatic rise in the number of large banking operations. In some instances depositories expanded by opening new branches beyond boundaries established during the Great Depression. However, growth was increasingly accomplished by a series of mergers and acquisitions that helped created a number of large multi-state and even national mortgage banking entities. Moreover, emerging technology in data processing and telecommunications and the creation of nationally recognized brands enabled larger organizations to enhance the economies of scale of their operations and the scope of their product offerings.[44]

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40 The concept of regulatory arbitrage is that by reducing its regulatory oversight, a single regulator could encourage regulated entities to seek a new charter to conduct business under their supervision. To the extent other regulators depend on fees from regulated entities to fund their operations, this could spark a form of destructive competition among regulators that would drive down regulatory enforcement across the board. See letter from Consumer Federation of America to the Chief Counsel's Office, Office of Thrift Supervison, dated January 24, 2005 and regarding proposed regulation No. 2004-53. Available at http://www.consumerfed.org/pdfs/OTScra0102405.pdf.

41 As a result of amendments in GLBA, small institutions that receive a top rating of Outstanding in their last examination do not face another routine CRA examination for at least 60 months. Small institutions that are rated Satisfactory in their last CRA examination do not receive another routine CRA examination for at least 48 months. Small Banks are depository institutions with less than $1 billion in assets (adjusted for inflation). Regulators may conduct CRA examinations for larger institutions more frequently.

42 Allen Fishbein. "The Ongoing Experiment with 'Regulation from Below'": Expanded Reporting Requirements for HMDA and CRA" Housing Policy Debate, 3:2 (1992), available at http://www.knowledgeplex.org/kp/text_document_summary/scholarly_article/relfiles/hpd_0302_fishbein.pdf.

43 Supervision varies greatly among the states and amongst the regulators. For example, while the Federal Trade Commission (FTC) regulates some independent mortgage banks, they have an arguably less robust examination process.

44 Robert B. Avery, et al., "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act," Federal Reserve Bulletin (February, 1999), available at http://www.federalreserve.gov/pubs/bulletin/1999/0299lead.pdf.

The consolidation of the banking industry was evident on many fronts. In a companion paper in this edited volume, Avery, Courchane, and Zorn report that by 2007 the 25 largest depository institutions (determined by assets) operated nearly 40 percent of all retail banking offices, up from just ten percent in 1987. Similarly, over the two decades from 1987 to 2007, the share of deposits received by the top 25 banking organizations more than doubled to nearly 55 percent, while their share of mortgages soared nearly threefold to 67 percent.[45]

These trends towards consolidation posed numerous challenges to smaller, locally-based banks and thrifts that were once the mainstay of both retail banking and mortgage lending. Lacking the economies of scale to compete with these financial services giants on many fronts, over the past two decades smaller banks and thrifts cut back on their residential mortgage origination activities or abandoned them entirely. Instead, many smaller community banks chose to focus on the provision of other forms of consumer credit (e.g., auto loans and small business loans) and other fee-based banking services. By early in the new century this transformation was nearly complete. For example, by 2006, the last full year before the onset of the mortgage market meltdown, HMDA reported that of the 4,150 banking organizations making home purchase mortgage loans, 3,977 made fewer than 1,000 loans and 3,089 fewer than 100 loans.[46] Collectively, organizations making fewer than 1,000 loans accounted for only five percent of all home purchase loans originated that year.

The Growth of Secondary Market Sources of Funding and Wholesale Lending

While the retail banking industry was consolidating, the pooling and selling of packages of mortgages to investors around the world replaced deposit-taking activities as the principal source of funding for residential mortgages. Expanding secondary market institutions included: Ginnie Mae, an organization created to securitize the government-insured portions of the market; Fannie Mae and Freddie Mac, two government sponsored enterprises (GSEs) that securitize large shares of conventional conforming loans; and a host of Wall Street investment banks and private issuers of mortgage-backed securities (MBS).

Traditionally, mortgage sales and outreach efforts were conducted by the retail lending divisions of deposit-taking organizations, with loan officers who worked for the banks and thrifts that initially funded the loan.[47] Over the past decade, an increasing share of loans was funded by large mortgage banking operations termed "wholesale lenders," including entities owned by deposit-taking banks and thrifts, stand-alone entities, and components of large Wall Street investment operations. According to one industry source, wholesale operations accounted for some 56 percent of all prime loans and 78 percent of all non-prime loans in 2005.[48]

As access to non-depository sources of residential mortgage capital expanded, the growth of secondary market operations also fueled the rapid expansion of nonbank lenders, including independent mortgage banking companies, as well as a range of mortgage banking subsidiaries and affiliates of traditional deposit-taking organizations. Contributing to industry consolidation was the fact that many formerly independent mortgage banking operations merged with or were acquired by large deposit-taking operations. At the same time, several large independent mortgage and finance companies including New Century, Option One, and Ameriquest continued to compete directly with large deposit-taking banking organizations in mortgage markets across the country.

The Proliferation of New Product Development

Along with the emergence of mortgage industry giants, new approaches emerged in the marketing and sales of mortgage products to individual borrowers. For example, among the various financial services provided by banks and related businesses, consumer and mortgage lending require more extensive marketing,

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45 Robert B. Avery, Marcia J. Courchane, and Peter M. Zorn, "The CRA Within a Changing Financial Landscape."

46 Joint Center for Housing Studies tabulation of HMDA. Note that HMDA data do not uniformly cover loans made by lenders in rural markets, and hence may underestimate small bank lending in rural areas.

47 William Apgar and Allegra Calder. 2004. See also William Apgar and Mark Duda, "Preserving Homeownership: The Community Development Implications of the New Mortgage Market," a report prepared by the Neighborhood Housing Services of Chicago, 2004, available at http://www.nw.org/Network/pubs/studies/documents/preservingHomeownershipRpt2004_000.pdf

48 Inside Mortgage Finance, "Top Subprime Mortgage Market Players & Key Subprime Data 2005," (Bethesda, MD: Inside Mortgage Finance Publications, 2005).

customer support, account management, and servicing operations. Large-scale operations can spread the high fixed costs associated with these tasks across a sizeable customer base. In addition, the widespread use of risk-based pricing and arguably enhanced capacity to evaluate borrower risk gave rise to an explosion of new mortgage products. Credit scoring was also used to underwrite new types of adjustable rate mortgages (ARMs), such as interest-only and payment-option ARMs, and ever-increasing volumes of low-down-payment mortgages, stated income loans, and higher-risk mortgages. Unfortunately, many of these new products proved to be very risky and by 2002 delinquency and foreclosure rates were on the rise, especially for subprime products issued to LMI borrowers.

Industry Structure and Current Regulatory Challenges

With the complexity and depth of the financial crisis creating a collapse of the credit markets, some believe that new regulation is "up for grabs." Since the late 1990s, changes in the structure of the financial services industry, particularly for mortgage banking, have weakened the link between mortgage lending and the branch-based deposit-taking on which the CRA was based. Further, Alan Greenspan noted the financial sector's inability to police itself contributed to the crisis.[49] Some see the current crisis as an opportunity to promote the competitiveness of those small lending organizations that do have suitable risk management skills and understand the communities where they lend. Yet, over the longer term it is more likely that larger organizations, with their enhanced capacity to tap global capital markets and resulting operational economies of scale, will continue to dominate mortgage lending. Even so, well-managed smaller and regional-scale organizations should have the opportunity to recapture some of the market share they lost over the past three decades.

To ensure the future safety and soundness of the financial system, today's reforms will need to address the structural inadequacies that contributed to the current crisis. The range of existing regulations (from the consumer protections of the CRA, Home Ownership and Equity Protection Act (HOEPA), ECOA, Fair Credit Reporting Act (FCRA), and Truth In Lending Act (TILA) to the monitoring of consumer reporting and ratings agencies and the oversight of the secondary market outlets) must be considered, as some consumers will continue to be uninformed and vulnerable to those who see an opportunity to take advantage of them.[50] Below we discuss these national trends and their implications for the CRA's impact on lending to lower-income borrowers and communities, as well as the variation in the act's regulatory reach across metropolitan areas and individual lenders.

The CRA and Assessment Area Lending

To address the historic problem of redlining of spatially concentrated LMI borrowers and minority communities, CRA examinations have concentrated on the spatial distribution of loans according to borrower and neighborhood income. This parameter is measured by a bank's mortgage lending record within its assessment area (the geographic areas where institutions have their main office, branches, and deposit-taking ATMs, as well as the surrounding areas where banks have originated a substantial portion of loans) and across income ranges of borrowers and neighborhoods.[51] In an effort to ensure that deposit-taking institutions meet the credit needs of the communities they serve, CRA regulators evaluate the lending inside the lender's CRA-defined assessment area and compare it to the activity of the lender's peers. The assessment area was originally adopted to ensure that deposit money from one area is not redeployed to make a disproportionate share of loans outside the assessment area. However, future reforms will need to consider this method of comparison and determine whether an absolute standard or a different kind of comparison is best suited to today's financial world.

As indicated by previous Joint Center research, mortgages made by depository institutions to borrowers living in their assessment areas are subject to the most detailed CRA review. As previously mentioned, CRA regulations apply only to the lending activity of deposit-taking organizations and are not uniformly applied to the subsidiar-

49 *"Greenspan Says He Was Wrong on Regulation," Washington Post, October 24, 2008, available at http://www.washingtonpost.com/wp-dyn/content/article/2008/10/23/AR2008102300193.html.*

50 *"Return of the Predators," New York Times Editorial, November 24, 2008, available at http://www.nytimes.com/2008/11/24/opinion/24mon1.html?_r=1.*

51 *The Code of Federal Regulations Title 12 Part 228.41 provides that a bank must delineate one or more assessment areas within which the Federal Reserve System evaluates the bank's record. Originally, the delineation was the area surrounding the lender's office and branches. In the 1995 revisions this grew to include the area around its deposit-taking facilities including ATMs as well as the surrounding area in which the bank originated or purchased a substantial portion of its loans.*

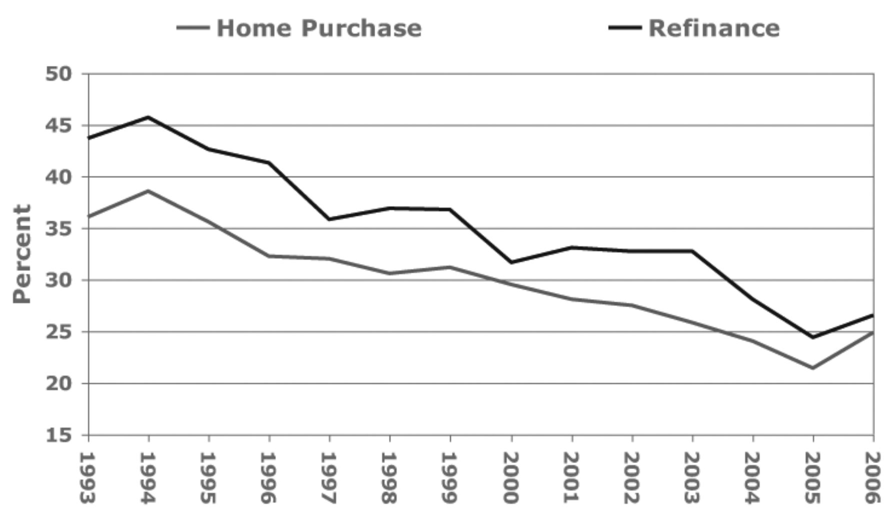
ies or affiliates of these organizations that conduct the bulk of their activity outside of the designated assessment areas. Meanwhile, loans made by independent mortgage companies (also called nonbanks) fall entirely outside the regulatory reach of the CRA. Given the dramatic changes in the financial landscape, with new organizational structures (financial holding companies, multinational financial enterprises, and nonbank lenders) and delivery mechanisms (internet, mobile, and phone banking), the traditional concept of assessment area no longer captures a lender's community.

The increasing share of loans made by mortgage banking subsidiaries or affiliates of bank holding companies and by independent mortgage companies has brought a concomitant decline in the share of mortgage loans originated by deposit-taking institutions in the assessment areas where they maintain branch banking operations (Exhibit 1). Between 1993 and 2006, the number of home purchase loans made by CRA-regulated institutions in their assessment areas as a share of all home purchase loans fell from 36.1 to 26 percent. The decline was even more dramatic for home refinance lending: the CRA assessment area share fell from close to 45 percent in 1993 to just over 25 percent in 2006. For all loans (both home improvement and refinance), the share fell from 40.6 percent to 25.6 percent.

This decline reflects two distinct limitations of CRA coverage. First, from 1994 through 2006, the first full year prior to the onset of the mortgage market meltdown, home purchase lending by independent mortgage companies and credit unions (lending organizations not covered by the CRA) grew by 122 percent, nearly four times faster than lending by banking organizations operating within their CRA-defined assessment areas. Next, even among CRA-regulated institutions, the fastest growth took place outside the markets where these organizations maintained deposit-taking branches, and hence that lending was not subject to the most stringent aspects of the CRA. These out of assessment area loans are therefore not equally examined to determine whether they serve the needs of lower-income borrowers and communities. Indeed, from 1994 to 2006, out of assessment area lending by CRA-regulated banking organizations grew by 187 percent. Similar numbers were recorded for refinance lending.[52]

The Joint Center has made a conservative and simplifying assumption: that all lending done by the depository itself and its affiliates and subsidiaries within

Exhibit 1: Assessment Area Lending Has Fallen Steadily



Note: Percent of mortgage loans originated by deposit taking organizations within their assessment area.

Source: JCHS enhanced HMDA database

52 *From 1994 to 2006, refinance lending by CRA-regulated banks and thrifts operating in their assessment area increased by only 59 percent, compared with growth of 148 percent for non-regulated entities (independent mortgage companies and credit unions) and 334 percent CRA-regulated entities operating outside their assessment areas.*

an assessment area is covered by detailed CRA examinations.[53] To the extent that some unknown number of loans made by affiliates or subsidiaries are not put forward for examination, this assumption results in a clear overstatement of the share of all loans subject to detailed CRA review. Note that in 2006, the last year depicted in Exhibit 1, affiliates and subsidiaries accounted for approximately one fifth of assessment area lending. As a result, the share of loans subject to detailed CRA assessment could be as low as 20 percent, assuming that all entities take advantage of the rule that permits discretion in reporting.[54] As a result, the finding depicted in Exhibit 1—that the share of all loans covered by detailed CRA review has fallen dramatically over the 1994-2006 period—is a conservative estimate of these trends.

CRA Coverage Varies By Neighborhood and Metro Area

The relative importance of assessment-area lending by depository institutions covered by the CRA also varies by neighborhood income and racial/ethnic composition, and from one metro area to another. For example, the nation's historically disadvantaged minority groups have less protection from the CRA given that they are less likely to receive a loan from a CRA-regulated institution. The data show that households living in higher-income and largely white neighborhoods are nearly 30 percent more likely to receive a loan from a CRA-regulated assessment area lender than a borrower living in a largely minority, lower-income area (30.7 percent versus 23.2 percent, see Exhibit 2). A similar pattern holds for refinance lending. In both instances, borrowers in lowest-income and/or minority areas are most likely to obtain mortgage finance from independent mortgage companies, entities not covered by CRA regulations, and are therefore provided fewer consumer protections.

There is also significant variation in assessment area lending across metropolitan statistical areas (MSAs). These patterns, in turn, reflect a spatial variation in banking and mortgage industry organization across metropolitan areas. Among other things, they reflect differences in

Exhibit 2: Assessment Area Lending Lags in Low-Income and Minority Areas

	Home Purchase			Refinance		
	Banking Organizations		Independent Mortgage Companies	Banking Organizations		Independent Mortgage Companies
Neighborhood Type	Inside CRA Assessment Areas	Outside Assessment Areas		Inside CRA Assessment Areas	Outside Assessment Areas	
Low-Income Neighborhood						
Minority Neighborhood	23.2	33.0	43.8	22.7	35.2	42.0
Mixed Neighborhood	24.5	38.3	37.1	21.5	41.0	37.5
White Neighborhood	27.0	40.4	32.6	25.3	43.1	31.5
Moderate-Income Neighborhood						
Minority Neighborhood	21.9	33.2	45.0	23.8	34.5	41.8
Mixed Neighborhood	24.1	37.3	38.6	23.2	39.9	36.8
White Neighborhood	29.3	40.8	29.9	26.5	43.1	30.4
High-Income Neighborhood						
Minority Neighborhood	24.1	33.8	42.2	27.8	33.8	38.4
Mixed Neighborhood	28.4	35.0	36.5	28.5	36.9	34.6
White Neighborhood	30.7	39.6	29.7	28.6	41.5	29.9
Borrower Race/Ethnicity						
American Indian	24.8	38.5	36.7	26.4	42.3	31.4
Asian	29.9	36.1	34.0	32.1	35.6	32.3
Black	19.6	35.7	44.7	18.0	42.4	39.6
Native Hawaiian	22.3	33.5	44.3	23.2	33.9	43.0
Non-Hispanic White	29.1	38.4	32.5	27.4	40.2	32.5
Hispanic	20.4	34.1	45.5	24.9	33.6	41.5

Note: First-lien loans for owner occupied properties only. The small share of loans originated by credit unions are included in outside assessment area totals.

Source: JCHS Enhanced HMDA Database, 2006

53 *This assumption is common in research evaluating assessment area lending.*

54 *According to the Joint Center Enhanced HMDA database, of the approximately 2.3 million loans made by depository institutions directly or by their subsidiaries or affiliates in designated assessment areas in 2006, some 574,000 (or 20 percent) were made by affiliates and subsidiaries.*

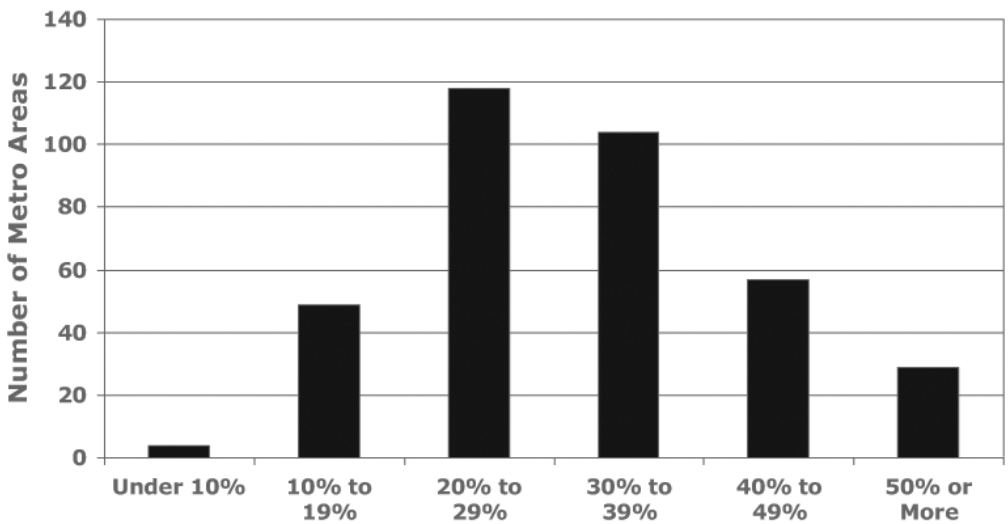
the competitiveness of locally based banks, the relative attractiveness of specific metro area markets to nonbank lenders, and variations in state-level banking regulations. While it is difficult to assess the exact importance of each factor, assessment area lenders can account for more than 50 percent of all mortgage loans in some metropolitan areas and less than 20 percent in others.[55]

CRA Coverage Varies by Lender and Product Type

The variation of CRA coverage across three broad types of lending (in assessment area lending by CRA-regulated banking organizations, out of assessment area lending by CRA-regulated banking organizations, and lending by non-CRA-regulated independent mortgage companies) also has implications for CRA coverage. Note that CRA assessment area lenders are evaluated on the basis of their efforts in extending mortgage loans to lower-income borrowers (borrowers with incomes below 80 percent of metro area median income) and/or to lower-income neighborhoods (e.g. neighborhoods with median household income less than 80 percent of metro area median). Since a disproportionately large share of mortgage delinquencies and foreclosures are now taking place in these same lower-income communities, some commentators have suggested that CRA requirements have contributed to the growing problem of mortgage delinquencies.

To evaluate these claims, the Joint Center reviewed 2004-2007 HMDA data on higher-priced loans, a variable designed by the Federal Reserve research staff as a proxy for non-prime lending to assess lending patterns across borrowers of differing characteristics.[56] This review suggested that the largest share of higher-priced loans made to lower-income borrowers were originated by a handful of large independent mortgage companies, while CRA regulations paid disproportionate attention to smaller assessment area lenders. Despite recent assertions to the contrary, CRA assessment area lending criteria did not play a central role in the explosion of high-risk lending to low-income borrowers living in

Exhibit 3: Assessment Area Share Varies Widely Across Metro Areas



Note: Assessment area share is the number of loans made by CRA regulated entities in designated assessment areas as a share of all metropolitan area loans. First-lien home purchase loans only. Out of 361 Total Metro Areas.

Source: JCHS enhanced HMDA database

55 *For further discussion see Apgar, Bendimerad, and Essene, 2007 and Joint Center for Housing Studies, 2002.*

56 *Starting in 2004, HMDA identified "higher-priced" loans, or loans that have an Annual Percentage Rate (APR) above a designated Treasury benchmark rate. Though APR is just one factor that lenders may use to distinguish a prime from a non-prime loan, and admittedly the threshold will change from one year to the next along with shifts in the mortgage interest yield curve, the concept of "higher-priced" loans nevertheless provides a simple and objective benchmark for assessing lending patterns across borrowers of differing characteristics. For a detailed discussion of the 2004 HMDA data used in this study, see Avery, Robert B., Glenn B. Canner, and Robert E. Cook. "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin, September, 2005, available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf.*

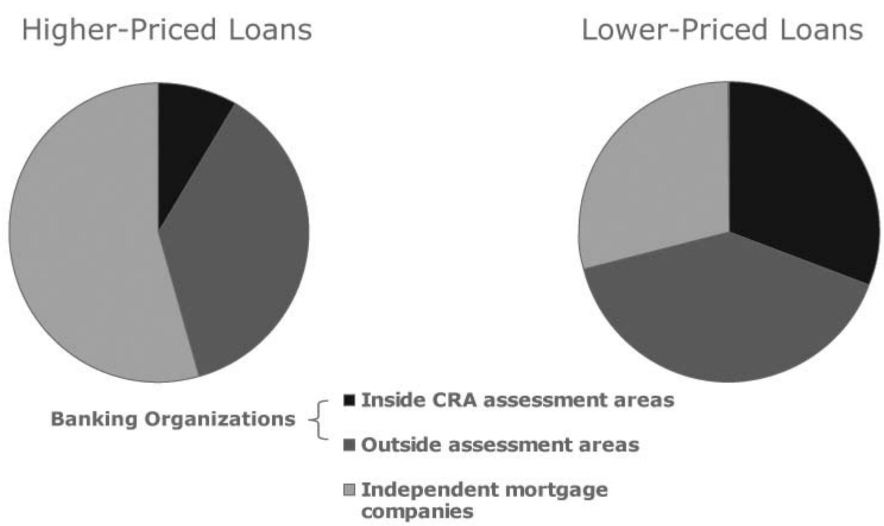
low-income and minority communities. For example, from 2004 through 2006 CRA-regulated depository institutions operating inside their assessment areas made 31 percent of all lower-priced home loans (purchase plus refinance loans) to low-income borrowers or borrowers living in low-income neighborhoods, yet accounted for only nine percent of higher-priced loans in their assessment areas made to low-income borrowers or low-income neighborhoods.[57] In contrast, less supervised independent mortgage companies dominated the origination of higher-priced loans made to low-income borrowers and communities, capturing 55 percent of this market segment. CRA-regulated banking organizations operating outside their assessment area also claimed a significant share of this higher-priced market segment.

The Adverse Impact of Uneven Coverage

The spatial variation of assessment area lending across neighborhoods and metropolitan areas has implications for borrowers and lenders alike. The CRA was designed to expand access to credit to LMI borrowers, and/or borrowers living in LMI neighborhoods in a manner consistent with the safety and soundness of the bank or thrift originating the loan. Yet, depending on which lender serves a neighborhood and/or city, borrowers have different access to credit and consumer protection.

Though not explicitly designed to promote fair lending, the CRA has historically played a role in protecting borrowers from abusive mortgage lending practices including redlining and other forms of racial discrimination. Since African Americans and Hispanics constitute a disproportionately large share of lower-income households and households living in lower-income communities, these groups have been differentially served by CRA rules designed to expand access to mortgage capital. Because fair lending reviews often accompany CRA examinations, and federal regulators have relatively recently stated that lending in violation of federal fair lending laws can reduce a lending institution's CRA ratings, the CRA has also become a fair lending enforcement tool.

Exhibit 4: CRA Regulation Applied to Only a Small Fraction of Loans to Low-Income Borrowers or Low-Income Neighborhoods.



Note: Conventional first-lien loans for owner-occupied site-built, one-to-four family properties. Includes purchase and refinance between 2004 and 2006. Low-income borrower (neighborhood) defined as having personal income (tract median household income) less than 80% of the MSA/MD median household income. The small share of loans originated by credit unions are included in outside assessment area totals.

Source: JCHS Enhanced HMDA Database

57 *For further description of this analysis of 2004-2006 data, see Kevin Park, "Subprime Lending and the Community Reinvestment Act" Research Note N08-2 (Cambridge, MA: Joint Center for Housing Studies, Harvard University), available at http://www.jchs.harvard.edu/publications/governmentprograms/n08-2_park.pdf. See also, Governor Randall S. Kroszner, 2008, footnote 4 that finds that only six percent of all higher-priced loans in 2006 only were made by CRA-covered institutions or their affiliates to lower-income borrowers or neighborhoods in their assessment areas.*

While it remains important that all prime-qualified borrowers have equal access to prime loans on fair terms, guaranteeing fair terms and equal access for subprime borrowers is an equally worthy goal. Yet, the largest share of regulated banks and thrifts make no or only a few higher-priced loans. Though the reasons for this may vary, many regulated entities claim that they are unable to effectively compete in the subprime marketplace with less-regulated nonbanks. However, by choosing not to compete in the non-prime marketplace today, many CRA-regulated banks and thrifts may have ceded territory to their less-supervised competitors who saw an opportunity to use risk based pricing to compete, while CRA-regulated institutions chose not to engage in this marketplace.

In fact, nonbank independent mortgage companies do not have to meet CRA requirements and indeed may even gain a market advantage by being less regulated and meeting less stringent capital requirements. This is especially important, given the fact that many of the most risky loans—made to some of the nation's most disadvantaged lower–income borrowers—were made by these less-regulated lending organizations. Moreover, unlike their bank counterparts who have a more visible presence in the markets they serve, many nonbanks marketed their products to subprime borrowers through thousands of less-regulated mortgage brokers and hence have less sensitivity to the reputational risks associated with originating more default-prone products.

One important consequence of this shifting competitive balance is that consumers living in areas with a limited presence of CRA assessment area lenders do not receive the same degree of CRA-based consumer protection as those living where assessment area lenders retain a more substantial market presence. This includes the consumer benefits that derive from CRA-mandated oversight of lending in LMI communities and CRA-linked engagement with fair lending monitoring and enforcement activities.

Regulatory Reform of the CRA

As argued throughout this paper, fundamental fairness suggests that the nature and extent of federal oversight and consumer protection should not depend on whether a loan application is submitted by a loan officer working for a CRA-regulated institution or a mortgage broker working for a nonbank or CRA-regulated bank operating outside its assessment area. Nor should it matter to the consumer which particular retailer or wholesaler originates the mortgage, and which secondary market channel is tapped to secure the investment dollars that ultimately fund the loan. Instead, all consumers need access to an efficient mortgage market built on a foundation of uniform and fair regulations and oversight. While the CRA is not the cure for all the woes of the financial industry, the CRA could be strengthened considerably to ensure equal access to safe and profitable lending. Many of the critical issues raised in the 2001 ANPR were not substantially addressed and now provide a good point of departure for future regulatory reform.

Over the past decade, the combination of rising rates of homeownership and the ability of distressed borrowers to use growing home equity to refinance their way out of delinquency masked the structural flaws of the mortgage system. While some studies pointed to these flaws, the prevailing political climate favored deregulation, and the calls for reform were not heeded. As the ongoing collapse of the nation's mortgage banking system now illustrates, reforms are vital to ensure appropriate oversight to limit future abuses as credit is restored. This section suggests some potential areas for reform.

CRA Reform Is a Good Place to Start

When Congress modernized financial services through the Gramm-Leach-Bliley Act of 1999, it did little to bring the CRA (or other consumer protection regulations) into conformance with the rapidly evolving financial services world. This created a competitive advantage for nonbank lenders and provided fewer consumer protections to their borrowers. Though nonbank institutions clearly played a key role in the boom and bust of the subprime market and the resulting market disruption and are involved in the complex matrix of financial relationships, they are subject to only limited oversight. Additionally, though the net effect of this marginally regulated lending has put the safety and soundness of the entire financial system at risk, there has still not been enough focus on the riskiest segments of the marketplace. Further, the rationale for government regulation must move beyond a *quid pro quo* for depository insurance and other federal benefits.

To realign regulation with the evolving structure of the financial services industry, uniformity of regulation is needed across all segments of the mortgage industry. To standardize the rules by which lenders operate, some appropriate reforms might include improvement in the delineation of assessment areas, strengthening of fair lending enforcement, and improvements in compliance monitoring through software and data analysis techniques specifically designed to detect fraud.

Apply the CRA Framework to All Lenders

The CRA should be uniformly expanded to cover independent mortgage banking companies and other newly emerging nonbank lenders; it should be made applicable to the subsidiaries and affiliates of depository institutions; and it must be enforced through an appropriately funded regulator. The fact that nonbanks, affiliates, and subsidiaries are not uniformly regulated denies consumers equal access to the benefits of legally mandated federal oversight. It may also distort competition if some market participants shift business from one market segment to the next to avoid regulation. When considering how to expand the CRA, establishing appropriate evaluation methodology is critical, as the current criteria may be inadequate for application to new institution types and their lending.

One model to consider is the Massachusetts Mortgage Lender Community Investment (MLCI) law, which took effect on September 5, 2008.[58] While it may still be too early to evaluate the strengths and weaknesses of the MLCI, the fact that it is uniformly applied to all Massachusetts mortgage lenders and mortgage loans is a step in the right direction. The MLCI created a two-pronged test to evaluate a lender's lending and services, similar to the intermediate small-bank approach mentioned earlier. The MLCI Lending Test considers the geographic distribution of lending to LMI areas, borrower characteristics, innovative or flexible lending practices within the bounds of safety and soundness, fair lending performance, and loss of affordable housing. This last criterion was developed to allow the MLCI to proactively consider predatory practices that reduce the stock of affordable housing, such as early payment defaults. The Service Test of the MLCI is unusual in that it considers the availability and effectiveness of the lender's delivery systems to LMI communities (such as whether they incorporate the internet), as well as the lender's community development services and loss mitigation practices.

Expand Assessment Area Definitions

Expanding the definition of assessment area has gone unaddressed in previous rule making and should be placed at the top of a reform agenda. Most agree that the assessment area definition does not account for today's world of electronic banking and national-scale mortgage-lending operations. In light of these changes, the traditional concept of assessment area needs to be reconsidered. In moving forward, it would be useful to review the comments provided in response to the 2001 ANPR. For example, the National Association of Homebuilders proposed that assessment areas should be where retail banking services are delivered and not related to branch or ATM locations.[59] Alternatively, the National Community Reinvestment Coalition suggested that assessment areas should be expanded to any state or MSA where the lender (including the independent mortgage companies and the subsidiaries and affiliates of regulated depositories) achieves a significant market presence–such as one-half of one percent of all loans.[60]

Other regulations have already broadened the concept of assessment areas and could be considered. The 2008 Massachusetts law (MLCI) assigns the assessment area as the entire state, unless a lender "opts out" and the request is approved by an examiner. Because of the difficulty of assigning a geographic assessment area for lenders serving military personnel, the current CRA regulation defines the assessment area as the entire customer base which in essence abandons assessment areas altogether and does not address non-customers who are not served. Similarly, Massachusetts uses the membership base as the definition for assessing credit unions. These approaches could be adapted and applied to internet banks and other non-traditional entities. As mentioned previously, the current practice is to compare an institution to its peers. Future reforms will need to address the evaluation methodology, and an absolute standard may be more appropriate.

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58 The Commonwealth of Massachusetts is one of three states (the others are Connecticut and New York) that examine financial institutions, including state-chartered credit unions, for compliance with community reinvestment at the state level. The Massachusetts statute M.G.L. c. 167, section 14 and the implementing regulation 209 CMR 46.000 is generally based on the federal legislation yet has an extra exam category of "high satisfaction" to better characterize lender performance, available at http://www.mass.gov/?pageID=ocamodulechunk&L=4&L0=Home&L1=Government&L2=Our+Agencies+and+Divisions&L3=Division+of+Banks&sid=Eoca&b=terminalcontent&f=dob_209cmr54&csid=Eoca.

59 National Association of Homebuilders, "Comments on Advance Notice of Proposed Rulemaking Regarding CRA," Letter from David Crowe, Senior Staff Vice President, Washington, DC, October 18, 2001.

60 National Community Reinvestment Coalition, "Comments on Advance Notice of Proposed Rulemaking regarding CRA," letter from Josh Silver, Vice President of Research and Policy, Washington, DC, October 2, 2001.

Expand Fair Lending Enforcement

Unlike other antidiscrimination laws, fair lending laws are enforced by banking regulators, who examine regulated banks for illegal and discriminatory practices, which are contrary to the goals of the CRA and can jeopardize the safety and soundness of the banking system.[61] CRA loan-level reviews are an important method for ensuring that regulated entities are in compliance with fair lending laws. When examiners identify a poor program, they issue a compliance report and may choose to examine that violator more often, enter informal enforcement actions, or use formal public enforcement actions.[62] While adverse findings and illegal credit practices are factored into the CRA rating by examiners, it remains unclear what specific criteria or thresholds are used to ensure that a lenders' score is reduced according to its fair lending violations.[63]

While regulators believe that their proactive approach allows few violations, a gap in oversight can occur when not all institutions are subject to loan-level review or not all loans are included in these reviews. Violations appear to be increasing within under-supervised channels, and hands-on loan oversight and fair lending review may help remedy these violations. Beyond applying fair lending review to non CRA-regulated institutions and evaluating fair lending according to race and other protected status, the inclusion of egregious violations in the public performance report could also increase transparency and strengthen fair lending enforcement.

Use Improved Data Collection and Software to Improve Compliance Monitoring

HMDA data have provided a critical tool for regulators, lenders, and community groups to evaluate whether covered institutions and loans are meeting the credit needs of the communities they serve. HMDA statistical analysis has allowed regulators to evaluate fair lending violations and identify potential problem lenders or products. Meanwhile, the public disclosure of HMDA has created greater transparency and enforcement of CRA regulations and allowed community groups to evaluate the contributions of lenders who serve their communities.

Yet, to conduct thorough analysis, regulators have at times purchased data from private sources to enforce public regulations. It is in the public interest for regulators to have access to loan-level data, like those collected under HMDA, that include detail on loan pricing and creditworthiness; in this way, regulators can provide proper oversight and examiners can conduct thorough file reviews. Furthermore, though some claim that increased data collection for regulatory or public uses is onerous, those data are already provided to private data aggregators in machine-readable form. In short, given better and more uniform loan-level data, regulators may be able to conduct more focused (and potentially automated) reviews to detect mortgage abuse and fraud.

All Institutions Provide All Services

The CRA was established to ensure that if a lender is in the mortgage business, it must be safely and soundly in the business for all customers. Recall that the CRA was designed to ensure that regulated banks and thrifts met the credit needs of all residents of their communities. Though we acknowledge that specialization has a role in mortgage lending, in the same way that utility companies cannot decide to serve only some neighborhoods, cherry-picking borrowers or even neighborhoods with specific credit scores is not in the public interest. CRA implementation should ensure that regulated entities do not opt out of their responsibility to meet the needs of the credit impaired, but otherwise sound, low-income and low-wealth borrowers who participate in the non-prime market.

All lenders should be required to evaluate all customers using adequate underwriting and appraisal techniques. At minimum, each regulated entity could be required to serve the full range of the credit needs of the community by offering referrals to other entities that provide non-

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61 John R. Walter, "The Fair Lending Laws and Their Enforcement," Federal Reserve Bank of Richmond Economic Quarterly 81:4 (1995).

62 Formal public enforcement actions may include civil money penalties, Written Agreements, or Cease and Desist Orders. Bank regulations also mandate that the regulator refer all patterns and practices of discrimination to the Department of Justice, which determines whether or not to investigate and whether the results warrant an administrative enforcement by the FRB, a public civil enforcement, or a settlement.

63 Sandra Braunstein, "The Community Reinvestment Act and fair lending examination processes," testimony before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform, U.S. House of Representatives, Washington, DC, 2007. Located at: http://www.federalreserve.gov/newsevents/testimony/braunstein20071024a.htm. Braunstein's testimony provides two excellent examples of when violations did and did not require a reduced CRA rating.

prime mortgages on a fair and non-discriminatory basis, or growing correspondent relationships with specific lenders or nonprofits. Admittedly, mandating that any particular market participant engage in non-prime lending is fraught with peril. Over the years, many regulated thrifts and banks, often working in conjunction with non-profit organizations, have developed the capacity to participate in non-prime markets. This evidence suggests that, given the proper incentives, banks and thrifts now largely specializing exclusively in prime lending could also acquire the expertise necessary to participate in the non-prime market and serve low-wealth, low-income, and/or subprime borrowers who cannot qualify for prime loan products.

Reform of Other Elements of the Regulatory Environment

This paper calls for uniform regulation for all mortgage lenders to reduce predatory practices, ensure a certain degree of consumer protection, and level the playing field for all lenders. Because many of the basic consumer protections are in place in the CRA-regulated portions of the market, the CRA provides a valuable framework for successful and cost-effective lending regulation market-wide. Yet, CRA reform is just one of a broad range of needed reforms in the financial system. Though a uniform CRA could address many of the concerns about access to fair credit, it is also critical to reinforce the consumer protections offered through the Truth In Lending Act, the Real Estate Settlement Procedures Act, and the Home Ownership and Equity Protection Act (HOEPA).

In remarks made to the CRA and Fair Lending Colloquium in Boston in 2001, the late Federal Reserve Governor Edward M. Gramlich reminded his audience that the art of CRA regulation is the balance between assessing the quantity and quality of an institution's lending and determining whether it has had a net positive effect on the community. Undoubtedly, the CRA has given financial institutions incentives to reinvest in underserved communities and community development organizations. As CRA regulations are expanded to apply to all mortgage lenders, considering how the CRA has helped to provide LMI borrowers better access to fair credit is worthy of examination. ■

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The CRA within a Changing Financial Landscape

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I. The Financial Landscape from 1977 to 2007

The financial landscape has changed significantly since the passage of the Community Reinvestment Act (CRA) in 1977. In this paper we provide an overview of how these changes have affected the coverage of the CRA, the structure of CRA-regulated institutions, and their effectiveness in meeting the goals of the CRA. By design and necessity we take a broad approach. In so doing, we hope to provide a useful contextual background for the other articles in this volume that focus on changes in the CRA's implementing regulations, and more specific aspects of the CRA, its coverage and effectiveness.

In 2007, the CRA celebrated its thirtieth anniversary. At its enactment, the CRA was a response to the perception of many that depository institutions had failed to meet the credit needs of their communities and that this failure was encouraging urban flight and the deterioration of cities. Reasons expressed for the limited access to or availability of credit included social reasons (discrimination in lending practices), economic reasons (limited information on credit; limited access to capital), and regulatory reasons (prohibitions on interstate branching and mergers; interest rate ceilings).

The intent of the CRA was not to address each and every limitation of the banking system with respect to access of credit. It had a particular focus, and Congress carefully evaluated some of the benefits provided by government to the banking community before determining that CRA coverage, which would impose some costs on institutions, might best be applied to those receiving benefits from the federal government. At the time of its enactment, Congress determined that CRA regulations would apply only to federally insured depositories including commercial banks and savings associations (savings and loans and savings banks, henceforth S&Ls). As noted recently by Federal Reserve Chairman Ben Bernanke, "The obligation of financial institutions to serve their communities was seen as a *quid pro quo* for privileges such as the protection afforded by federal deposit insurance and access to the Federal Reserve's Discount Window."[2]

In 1977, households typically saved by keeping deposits in institutions covered under the newly enacted CRA. Most borrowing by households was conducted with these same institutions. The CRA-regulated depositories, in turn, were generally locally-based, and the industry was relatively unconcentrated. These characteristics have all changed dramatically in the intervening thirty years since CRA's passage.

The changes in household behavior discussed here reflect the response of individuals to an expanded array of financial services, arising primarily from the relaxation of regulations that affect institutions' offerings of products and the locations of their activities. Three changes in the financial landscape, in particular, are of note, and all of these, arguably, have encouraged or allowed financial institutions to seek economies of scale or scope in the provision of services to communities.

First, several important legislative changes freed commercial banks and savings associations from regulatory constraints in terms of the types of activities in which they could participate and the geographies in which they

1 *We thank Lemene Wakjira for her excellent work in checking the data and preparing the charts for this paper. We also thank Christopher Smith for her assistance with the tables. The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Board of Governors of the Federal Reserve System or its Staff, or Freddie Mac or its Board of Directors.*

2 *Chairman Ben Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges," (Speech at the Community Affairs Research Conference, Washington, D.C., March 30, 2007).*

could operate. The first major phase of deregulation took place in the period 1979 through 1982. During these years there was a rapid increase in interest rates, driven primarily by a change in monetary policy that attempted to reduce inflation by targeting bank reserves rather than interest rates. This caused S&Ls to face negative interest rate spreads in the funding of their long-term mortgage assets. Further, Regulation Q usury ceilings on savings deposits meant that S&Ls faced disintermediation from lost deposits as households moved their deposits into higher-paying mutual fund accounts.

In an effort to improve the competitiveness of the S&Ls, two important acts were passed. The Depository Institution Deregulation and Monetary Control Act of 1980 allowed S&Ls and credit unions to offer checkable deposits and compete directly with the commercial banks for these deposits. It also phased out Regulation Q ceilings on savings deposits (over six years) and allowed payment of interest on S&L demand deposits. The 1982 Garn-St.Germain Depository Institutions Act allowed savings associations to offer money market deposit accounts and super negotiable order of withdrawal (NOW) accounts with limited checking features. Federally chartered savings associations could also make consumer and commercial loans, and offer floating and adjustable rate mortgages, expanding their permissible activities.

A decade later, the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted mergers and acquisitions of financial institutions across state lines. Reigle-Neal was passed partially as a response to the S&L crisis of the 1980s, and partially in recognition that asset size is a factor in the financial health of banks and that healthy banks positively affect the stability of the banking system.

As a result of the passage of these three acts, financial institutions gained newfound abilities to increase in both scale and scope. Commercial banks and savings associations have taken full advantage of this opportunity, and the industry has evolved substantially since 1977.

Second, the emergence of national credit repositories and the subsequent development of statistically-based credit models have led to the rapid growth of automated underwriting systems for all types of lending. This lowered the historic reliance of lenders on the local knowledge of their customer bases and provided economies of scale in both underwriting and the assessment of credit. Both of these also encouraged industry concentration, as well as the growth of a national secondary market for mortgages and other assets.

Third, there was a rapid growth of secondary markets for financial products on both sides of the financial institution balance sheet. This had two key effects on financial institutions.[3] First, because of secondary market funding, financial institutions now have more alternatives for obtaining capital and have been able, in many instances, to obtain their funding at lower cost than through deposit growth. Instead of relying primarily on a (local) deposit base for raising funds, institutions can rely on warehouse lenders and brokers for short-term capital, and can use securitization and a broad base of investors for long-term funding. Second, the secondary market allows lenders to pool loans from anywhere in the country and sell these securities through the secondary market. This increases the liquidity of lenders' assets, dramatically reduces localized variations in lending rates and the availability of credit, and reduces credit risks through geographic diversification. The growth of the secondary market, therefore, encouraged economies of scale and stimulated the growth of non-depository institutions not covered under the CRA.

These changes, in total, have led to significant alterations in the financial landscape facing the typical United States household. Since the time of the CRA's passage, households' savings/investment and borrowing options have expanded, both in terms of products and in the types of institutions offering these services. Although CRA-regulated institutions still play a dominant role in financial markets, many new, non-covered institutions have entered the marketplace. Moreover, financial institutions have grown substantially in scale. The result is that households' financial activity is increasingly conducted with institutions not covered under the CRA, and the institutions with which they do business are increasingly national in scale rather than confined to a local footprint.

These changes by themselves, of course, do not speak directly to Congress' concern that financial institutions meet the credit needs of their communities. We spend some time, therefore, considering how financial institutions' service to their communities may have changed in the face of this evolving financial landscape.

3 *The securitization of mortgages had, arguably, the largest impact on the growth of nonbank financial entities, but growth in other asset-backed securities also meant that deposit-taking was not essential for lending.*

The rest of this paper is structured as follows. We start with a brief discussion of our data and empirical approach. We then consider changes in household balance sheets (savings and borrowing behavior) since the passage of the CRA. We follow this with a discussion of market share effects, focusing on differences in deposits and lending behavior by different types of institutions, including those that are CRA-regulated and those that are not. We turn next to an examination of the measurement of CRA performance over time. Finally, we conclude with some thoughts about the current financial environment.

II. The Approach and the Data

We provide a series of charts to illustrate the effects of the changing financial landscape on CRA-regulated institutions and their success at meeting the credit needs of their communities. The charts themselves are based on data that are available for download through the Federal Reserve Banks of Boston and San Francisco. Underlying these charts and data are a series of consistent assumptions and empirical approaches that we outline in this section.

We consider all federally insured commercial banks and savings associations to be the CRA-regulated institutions. By this we mean that they must meet obligations set forth under the CRA. Generally we distinguish among the CRA-regulated institutions by separately looking at the top 25 banking organizations (top 25) as measured by total dollars of domestic deposits each year (including all the depositories and affiliates that belong to the organization), other large institutions (with "large" indicating at least $1 billion in assets) and small institutions (where "small" indicates less than $1 billion in assets).[4]

As envisioned at its inception in 1977 and, today, the CRA encourages federally insured banking institutions to help meet the credit needs of their communities in a way consistent with the safe and sound operation of those institutions.[5] The financial institution itself is given the ability to define its "community" or the areas in which its performance will be assessed. This has become known as the institution's assessment area.[6] For purposes of this paper we do not have access to the assessment areas as defined by each institution, so we approximate each institution's assessment area to include the counties in which an institution, in its annual regulatory filing, reports that it has a banking office.

Under the CRA, various performance tests are applied to measure each institution's performance, particularly in its assessment area. The performance criteria used to assess the institution are flexible, and examination for compliance focuses on both the quantity and the quality of the institution's CRA qualifying activities.[7] The CRA distinguishes between retail activities, regarded as the traditional business of banking, and other community development activities meant to meet the credit or revitalization needs of lower-income borrowers or lower-income neighborhoods. The regulations focus on four categories of community development, including affordable housing, community services, economic development through either small business or small farm lending, and the revitalization and stabilization of low- and moderate-income geographies. For large institutions, evaluation also provides sub-ratings on activity-based tests for lending, investment, and service.

As a practical matter, assessing the full range of these performance distinctions is beyond the scope of this article. We primarily focus, therefore, on traditional lending activities, particularly residential mortgage and small business finance, for which geographic data

4 *Unlike the top 25, the large and small institutions are defined only in terms of the institution itself and not the entire organization to which they belong. Top 25 organizations are separated out because they are the organizations most likely to seek regulatory approval for acquisitions or mergers for which their CRA rating is relevant. The further distinction between institutions under or over $1 billion in assets is chosen because institutions above that level are generally subject to a different CRA performance evaluation. In practice, this distinction has been determined by the "current" value of such assets, but in our charts we use an inflation-adjusted threshold normalized to the price level at the end of 2007 for substantive consistency.*

5 *For an overview of the history of the CRA, see Griffith L. Garwood and Dolores S. Smith, "The Community Reinvestment Act: Evolution and Current Issues," Federal Reserve Bulletin (vol. 79, April 1993), pp. 251-67. For a discussion of recently proposed and current regulations, see Robert B. Avery, Glenn B. Canner, Shannon C. Mok, and Dan S. Sokolov, "Community Banks and Rural Development: Research Relating to Proposals to Revise the Regulations that Implement the Community Reinvestment Act'," Federal Reserve Bulletin, (vol. 91, Spring 2005), pp. 202-235, available at www.federalreserve.gov/pubs/bulletin.*

6 *Assessment areas are self-defined geographies drawn to include census tracts, counties, or metropolitan statistical areas (MSAs) that encompass an institution's deposit-taking facilities, such as its branches and, if applicable, its automated teller machines (ATMs).*

7 *We provide information that reflects the quantity of lending and change over time in activities, but we do not attempt any discussion of the quality of performance.*

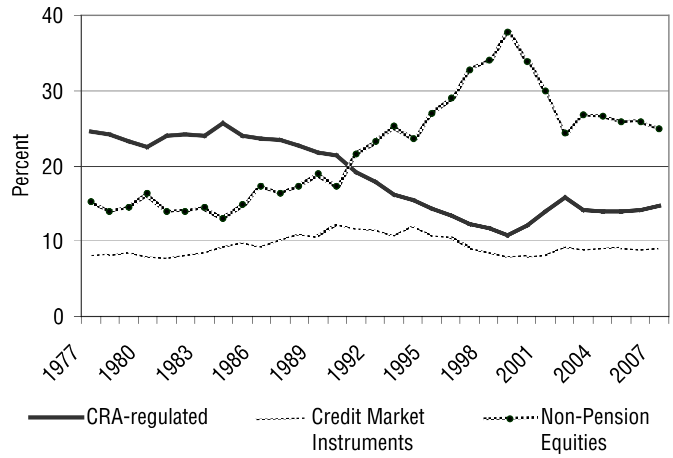
reporting is mandated for most institutions under the CRA. Within such lending, we look at the percentage of loans made to borrowers in low- and moderate-income (LMI) census tracts. This approach mimics a common performance measure used by CRA examiners. For residential mortgage lending, we also include in our measure loans to LMI borrowers, regardless of whether they reside in LMI geographies.[8]

The CRA generally measures performance in a flow rather than stock framework. That is, it considers the flow of deposit-taking and lending activity within a year when assessing performance, not the stock of liabilities and assets on institutions' year-end balance sheets. Nonetheless, data limitations force us to use a combination of stock and flow measures in creating our charts and tables. We provide data on deposit-taking and lending activity over the thirty-year period since the passage of the CRA (1977 through 2007), which are by necessity of a stock nature. We give a considerable focus to mortgage lending, both because of its importance and the ready availability of the Home Mortgage Disclosure Act (HMDA) data. HMDA data are provided on a flow basis (yearly originations), but are available only from 1990 through 2007. We also provide information on small business and farm lending that has been reported on a flow basis for the larger CRA-regulated institutions since 1996.

III. Changes in Household Behavior

Over the past 30 years, households have been presented with many savings and lending alternatives. As financial regulations have changed, so too has households' behavior evolved. While we cannot fully document all of the changes over the past three decades in terms of the proliferation of savings and lending vehicles, we do provide information on some select assets and liabilities of households. In Exhibits 1 - 3, we present information on stocks of household financial assets, including checkable and savings deposits (Exhibit 1), and outstanding stocks of consumer loans (Exhibit 2) and mortgage debt (Exhibit 3).

Exhibit 1
Shares of Households' Financial Assets



Consumer deposits are important for the CRA for two reasons. First, as suggested earlier, deposit insurance is often viewed as the *quid pro quo* for the CRA. Second, consumer deposits play a role in the performance tests for CRA examinations.

In 1977, at the time of the enactment of the CRA, households held 25 percent of their financial assets in the form of checking, time and savings deposits in CRA-regulated institutions. The household share of financial assets held in such institutions has declined substantially since that time (see Exhibit 1), reaching a low of 11 percent in 1999 and then rebounding somewhat to 15 percent in 2007.[9] Some of this decline may have resulted from the expanding array of other deposit-type vehicles available to consumers from non-CRA-regulated institutions. Households' shares in credit market instruments (about one-third of which are money market mutual funds), for example, rose by about one percentage point over this period. Most of the decline, however, appears to stem from a switch in households assets toward the holding of non-deposit-type vehicles. In particular, the holdings of non-pension equities (including direct stock holdings and mutual fund shares) rose from 15 percent of households' financial assets in 1977 to a peak of 38 percent in 1999, and then declining to 25 percent in 2007.

8 *Census tract income categories are determined by the ratio of a census tract's median family income to the median family income of the relevant surrounding area as measured at the last Decennial Census. The categories are: 0-49 percent (low), 50-79 percent (moderate), 80-119 percent (middle), and 120 percent or more (upper). Similar categories are used to classify individual residential mortgage borrowers based on their income (as reflected in the mortgage underwriting) compared to a contemporaneous measure of the median family income of the surrounding area as estimated by the Department of Housing and Urban Development.*

9 *Exhibit 1 provides the share of Household sector financial assets held as deposits (and other financial assets) from the Federal Reserve Board's Flow of Funds, Table B.100e. The deposit figure was adjusted to exclude credit union deposits obtained from Flow of Funds Table L115. The Household sector in the Flow of Funds accounts includes nonprofit organizations such as foundations and universities.*

Exhibit 2
Dollar Holdings of Consumer Loans

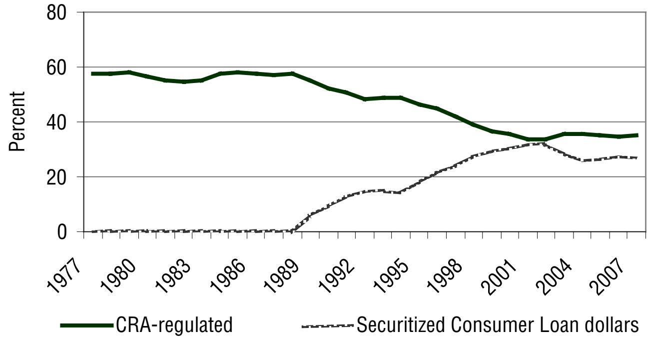
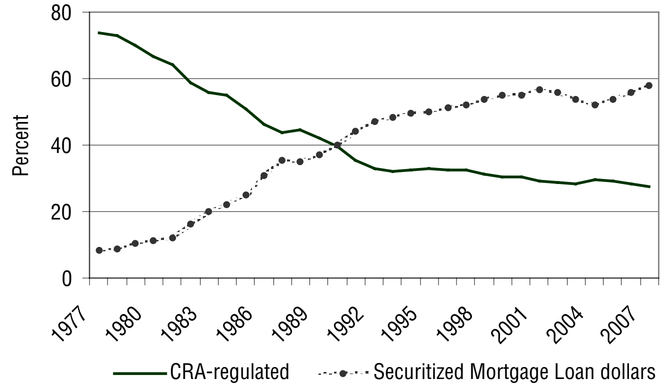


Exhibit 3
Dollar Volume of Home Mortgage Debt Outstanding



During this same period, households changed considerably the types of institutions from which they hoped to borrow, particularly when they sought consumer loans and mortgages. For example, the share of U.S. consumer debt outstanding (as measured in dollars) held at commercial banks and savings associations fell from 57 percent in 1977 to 35 percent by the end of 2007 (Exhibit 2).[10] During that same period, the share of consumer loans securitized remained at zero until 1989, increased to reach a level of 27 percent in 1998, and has remained at roughly that same level.

Exhibit 3 provides equivalent information on the change in mortgage debt.[11] The share of U.S. home mortgage debt outstanding held at commercial banks and savings associations fell from nearly three-fourths (74 percent) in 1977 to only slightly more than one-fourth (28 percent) by the end of 2007. At the same time, the percent of home mortgage debt outstanding that was securitized in the secondary market through the use of either mortgage-backed securities (by the government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac) or privately through asset-backed securities increased from only nine percent in 1977 to 58 percent in 2007.

The trends observed in the CRA-regulated institutions' share of consumer and mortgage loans likely are due to two key factors. The first is that, beginning in the 1980s and throughout the next two decades, institutions not covered under the CRA increasingly entered into competition with depositories for all forms of household borrowings (and savings). One such example is credit unions. Compared with commercial banks and S&Ls, the role of credit unions in the financial landscape remains relatively small. Moreover, they are not the largest competitors of CRA-regulated institutions. They remain interesting, however, because they have federally insured deposits but are not covered under the CRA. The data indicate that credit unions have increased their share of household deposits (increasing from four percent in 1977 to almost ten percent in 2007) and home mortgage lending (rising from about one-half of one percent of mortgage assets in 1977 to three percent in 2007). However, the credit union share of consumer lending simultaneously declined from 14 percent in 1977 to nine percent in 2007.

The second key factor that explains changing patterns in loans to households is the rapid growth in loan securitization. The secondary market dramatically increased the investor base for these assets, and reduced the relative importance of a deposit base for purposes of funding loans to consumers. In the mortgage market, for example, the rapid growth in volume and liquidity of the mortgage-backed securities (MBS) issued by Freddie

10 The data for this exhibit come from the Federal Reserve Data Release Table G19, also part of the Flow of Funds, table L222, lines 1, 6, 7 and 10. All consumer debt as measured in these data is owed by the household sector.

11 The data for this exhibit come from the Flow of Funds Table L218, lines 1, 11, 12, 18 and 19. Home mortgage debt is calculated as all residential mortgage debt, including 1-4 family and farm houses. Home equity loans are included in these data. Most home mortgage debt is owed by the household sector (about 94 percent in 2007).

Mac and Fannie Mae has meant that wholesale lenders, through a broker network, can originate loans to distribute as securitized assets. Under this model, mortgage lenders need not rely at all on traditional checkable or savings deposits for funding, but rather can borrow the funds needed to make loans using a line of credit from a warehouse lender, originate mortgages, combine and sell them into secondary market securitized pools, and use these proceeds to repay the line of credit. This method of interjecting capital into the credit market effectively bypasses the localized deposit collection and lending activity model that was central to mortgage funding at the time of the CRA's passage in 1977.

It is likely that all of these changes have had both significant and subtle impacts on lending and deposit-taking by CRA-regulated institutions. In the next section, we explore how these changes may have impacted institutions of different size classes in different ways.

IV. Changes in the Structure of Financial Institutions

Like households, financial institutions were also responding to changes in both the legislative and regulatory environments that allowed for growth and consolidation across the country. To illustrate some of these changes, we provide a series of charts that show the changing market share of CRA-regulated institutions grouped by asset size.

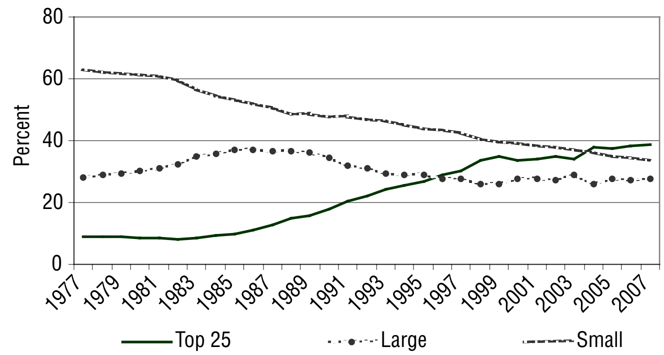
A. Offices and Deposits

In order to look at market shares, we need to define a unit of measure for the financial institution. One such measure, the "office," is generally used as the unit of accounting for depositories covered under the CRA and other regulations.[12] Deposits held by an institution must be assigned to a particular office, and the office location is used to define the geographic reach of the institution within their self-defined assessment area. This is critical not only to the Lending Test under CRA examinations, but also to the branch Service Test where particular focus is paid to offices in LMI neighborhoods.

One way to track the localized focus of institutions, therefore, is to consider trends in the average number of offices per institution—the greater the average number per institution, the more widespread (less localized) the activity. In 1977, fully 54 percent of the nation's 18,834 federally-regulated commercial banks and savings associations were unit institutions—that is, they had a single location, with a single office, and no branches.[13] By 2007, however, the share of unit institutions had fallen to only 24 percent (out of 8,605 federally insured banking institutions). The last 30 years, moreover, have led to the concentration of assets among the largest institutions. In 1977, for example, there was an average of 3.5 offices per institution. By 2007, this figure had more than tripled to 11.5 offices per institution.

Exhibit 4

Market Share of Offices

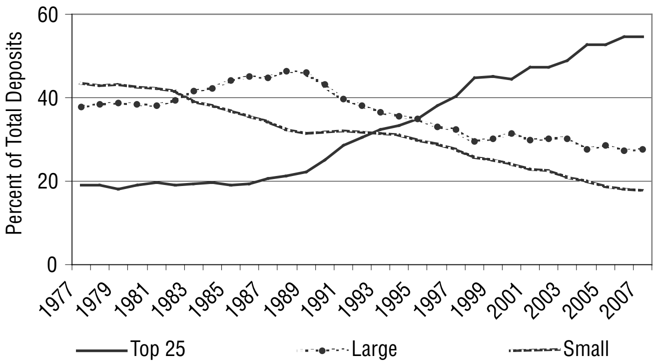


The increasing concentration of the banking industry is illustrated by trends in the market shares of offices owned by institutions of different size classes as shown in Exhibit 4. Beginning in the mid-1980s, the share of offices held by the top 25 organizations steadily increased while the share of offices held by small institutions declined. Clearly, the top 25 institutions have commanded an increasing share of offices as they have grown more geographically dispersed in their activities. Interestingly, we do not observe a dramatic drop in the share of offices of the large institutions, which is consistent with the considerable share of banking activity these institutions retain in the United States.

12 *While state law sets the definition of what constitutes an office, generally it includes the institution's self-defined main office and any branches (but not stand alone automated teller machines or ATMs). An institution with four branches operates a total of five offices.*

13 *The information here (and in Exhibits 4, 5 and 6) is based on annual June 30th Summary of Deposits (Federal Deposit Insurance Corporation (FDIC)) and Thrift Financial Reports (Office of Thrift Supervision (OTS)) offices filings. Data since 1994 are available at http://www2.fdic.gov/hsob/hsobRpt.asp. Data for earlier years are based on the authors' calculations using information from the national archives and Federal Reserve Board records. Data include offices in U.S. territories.*

Exhibit 5
Market Share of Deposits

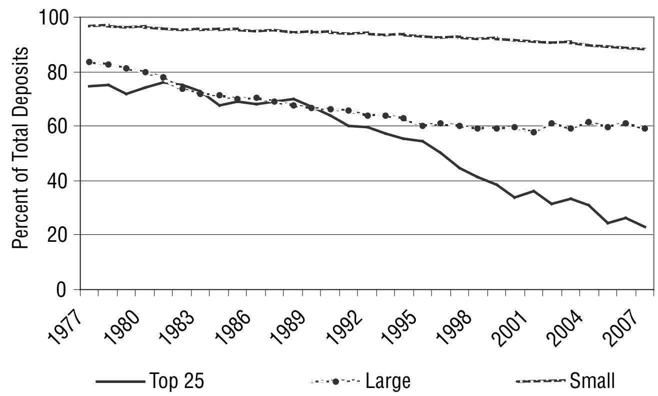


Trends in the concentration of deposits mirror those of offices. As evidenced in Exhibit 5, the market share of total deposits held by top 25 CRA-regulated organizations grew significantly from under 20 percent in 1977 to over 50 percent by 2007. At the same time, from 1977 to 2007 the share of deposits held by small institutions fell from over 40 percent to under 20 percent. The largest institutions have been getting larger, and the industry is, therefore, becoming more concentrated.

The growth in the size of CRA-regulated institutions over the past 30 years was accompanied by a more geographically dispersed focus of these same institutions. Depositories were largely locally-based at the time of the CRA's passage in 1977, consistent with the CRA's focus on allocating lending within a geographic market. However, as noted above, deposits became increasingly concentrated in larger institutions over the past 30 years. Accompanying this increase was a reduction in the share of deposits that institutions collected in the same MSA as their main office. This latter trend is illustrated in Exhibit 6.

In 1977, all three groups of institutions (by asset size) collected the vast majority of their deposits in the same MSA as their main office. This largely remained true of small institutions through 2007. However, the share of deposits collected in the MSA of their main office for large institutions declined consistently, and the share for the top 25 depository organizations declined from over 80 percent in 1977 to under 25 percent in 2007. Some of this decline is an artifact of the decline in the number of institutions relative to offices (thus fewer main offices). However, most of the decline reflects a real increase in geographic reach of larger institutions, much of it expanding across state lines. In 1977, for example, there were no nationwide depository institutions. By 2007, most of the top 25 organizations had truly become national organizations, drawing deposits (and lending) in markets across the United States.

Exhibit 6
Concentration of Deposits in same MSA as Main Office



Collectively these changes in industry structure have had significant implications for the CRA. When originally passed, the CRA was designed for an institution operating in a single urban market and for an environment with a large and diverse set of financial institutions. As just shown, this model no longer applies to much of the marketplace which is increasingly dominated by a small number of very large institutions that operate in many different markets.

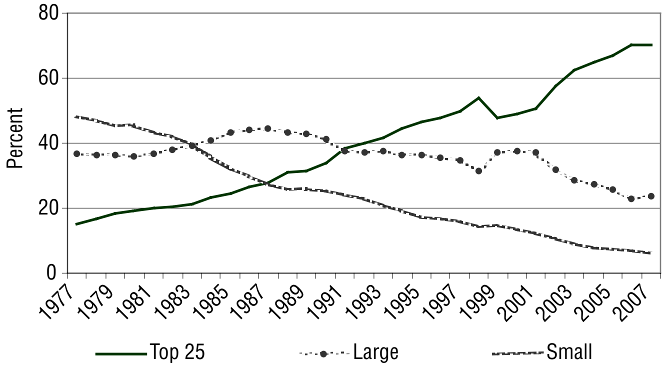
B. Lending Activities

Not surprisingly, the concentration in deposit collection over the past 30 years has been associated with increased concentrations in consumer lending. Exhibit 7 shows the share of consumer loan dollars held by depositories of different size classes over the period 1977 through 2007.[14] Again, we see rapid growth in the dominance of the top 25 organizations, from holding 15 percent of consumer loan dollars in 1977 to holding 70 percent in 2007. This was accompanied by a concomitant decline in the share of consumer loan dollars held by small institutions, from nearly 50 percent in 1977 to under ten percent in 2007.

14 The information in Exhibits 7 and 8 is calculated from end-of-year Call Report (commercial banks and some savings banks) and Thrift Financial Reports (S&Ls and other savings banks) data. Some data for the late 1970's and early 1980's had to be imputed by the authors because of changes in the information collected in the reports.

Exhibit 7

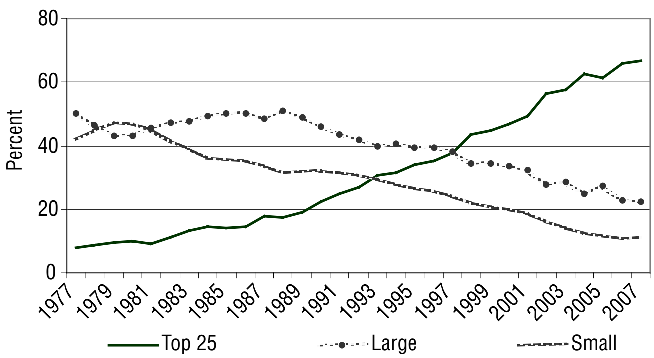
Market Share of Consumer Loan Dollars



Similar trends are apparent in the shares (in dollars) of single-family (one- to four-unit) residential mortgage lending held by institutions of different size classes (Exhibit 8). Again, we see dramatic growth in the share of mortgage dollars held by the top 25 CRA-regulated organizations, accompanied by declines in the shares held by both large and small institutions.

Exhibit 8

Market Share of 1-4 Family Home Mortgage Dollars

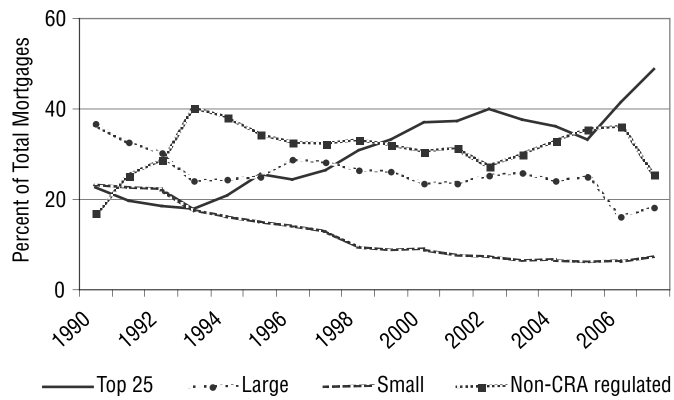


Not only has mortgage lending among depositories become more concentrated over the past 30 years, the share of mortgages originated by institutions not covered by the CRA has increased. We track this trend using HMDA data, which allow us to consider changes using a flow concept (originations) that is arguably more consistent with the focus of the CRA than the stock concepts thus far discussed. Unfortunately, the use of HMDA restricts us to going back only to 1990; before that point HMDA reporting only applied to CRA-regulated institutions.

Exhibit 9 shows the share of total mortgage originations for the top 25 organizations, large institutions, small institutions, and institutions not covered by the CRA.[15] Non-covered institutions include independent mortgage companies and credit unions. The increasing share of mortgage originations by the top 25 organizations is quite evident, as is the declining share of originations by small institutions. Among mortgages originated by CRA-regulated institutions, therefore, mortgages increasingly are originated by depositories with a large (often national) footprint.

Exhibit 9

Mortgages Originated by Institution Type



Also evident is the dramatic increase in the share of originations by non-CRA-regulated institutions in the early 1990s, from 17 percent in 1990 to a high of 40 percent in 1993. Since then, while the share of mortgage originations by these institutions has trended somewhat downward, it has generally remained over 30 percent.

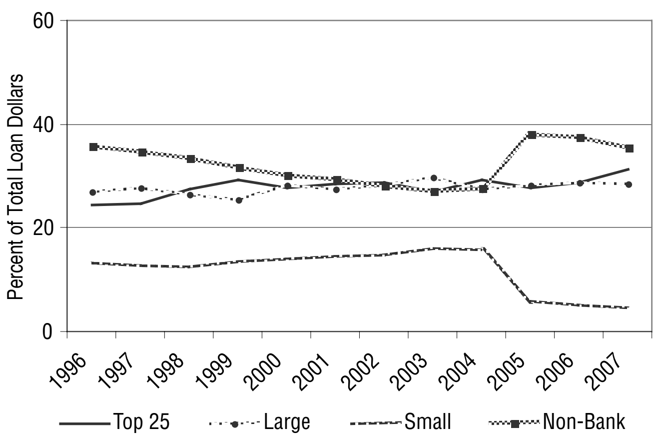
The rise in the importance of mortgage originations by non-CRA-regulated institutions was coincident with the rise in importance of securitization (as shown in Exhibit 3) and the increasing role of subprime lending, a large share of which originated with independent mortgage companies. Regardless of its cause, the increased role of mortgage originations by non-covered institu-

15 *Data are calculated based on single family, first lien mortgage loan originations reported annually under HMDA. Data here, and in other exhibits using HMDA data, are based on loans rather than loan dollars and exclude loans in U.S. territories and those for which geographic data are missing. Lien status is only reported since 2004. Prior to that year, we assume a threshold of loan size above and below $50,000 in 2007 real dollars to distinguish first and junior lien loans. HMDA data include originations only by depositories with offices in an MSA and distinguish between loans extended directly and those extended by a subsidiary or affiliate of the depository. Depositories with assets below $30 million are not required to report. Exhibit 9 includes loans extended by subsidiaries and affiliates when computing institution or organization loans.*

tions reflects an important trend. At the time of the CRA's passage, CRA-regulated institutions with local footprints originated the vast majority of mortgages. Since then, and especially starting in the mid-1990s, institutions not subject to CRA regulations increasingly originated mortgages in competition with CRA-regulated institutions. Increasingly, therefore, mortgage lending expanded out of the reach of CRA regulation, although this trend shows signs of reversing with the collapse of the subprime mortgage sector in 2007.

The CRA does not, however, focus only on mortgage lending. Regulatory changes to the CRA in 1995 placed increased emphasis on performance measures related to small business and small farm lending, defined as loans of $1 million or less for small business and $500,000 or less for small farm.[16] Data on this lending from 1996 through 2007 are shown in Exhibit 10.

Exhibit 10
Dollars of Small Business and Farm Loans held by Depositories



Market trends in small business and farm lending look markedly different from those of consumer and mortgage lending. The top 25 market share of consumer loan dollars outstanding rose by over one-half from 1996 to 2007, and almost doubled for home mortgage loan dollars outstanding over the same period (earlier shown in Exhibits 7 and 8). In contrast, the market share of the dollars outstanding of small business and farm loans for the top 25 rose only from 24 to 32 percent over the same period. Moreover, the absolute share of the small business and farm market of the top 25 was only about one-half their share of the consumer and mortgage loan market in 2007. Clearly, small business and farm lending makes up a decreasing relative percent of the lending by top 25 institutions, while growing to a relatively larger role among small institutions.

V. Changes in CRA Performance Measures

CRA performance can be assessed across many dimensions. All CRA-regulated institutions are judged on their lending activity. The Lending Test includes measures for many types of loans, including home mortgage, small business, and small-farm loans. Larger institutions also receive ratings for service and investment activities.[17] The Service Test evaluates institutions' retail banking delivery systems and institutions' community development services, innovativeness and responsiveness. The Investment Test considers qualified investments with assessment area community development as their primary purpose. All these tests are combined into an overall CRA rating.

Tracking trends in CRA performance tests can provide useful insights into how well the law is working, a topic we pursue in this section. We focus on four quantitative metrics of performance. First we consider a metric related to the Service Test. Next, we turn to two metrics related to the Lending Test—lending in LMI areas and lending in and out of the institution's assessment area. Finally we look at institutions' overall CRA ratings.

A. The Service Metric

One of the questions asked under the CRA is how well regulated institutions are serving their communities. One commonly used CRA Service Test metric is

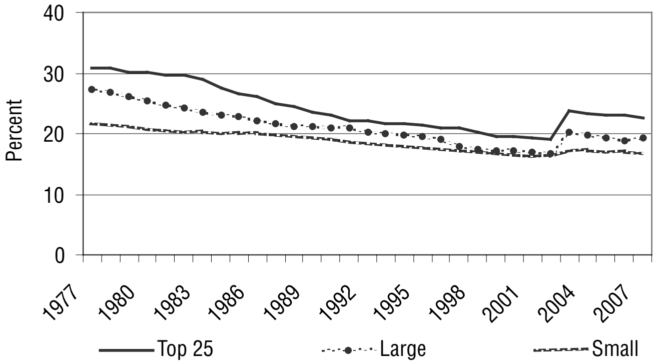
16 *Starting in 1996, larger institutions were required to report annually on their small business and small farm loan originations by census tract. Larger institutions for this purpose were defined to be those with over $250 million in assets or over $100 million in assets and part of an organization with over $1 billion in assets. These regulations were amended in 2005 to require reporting only of institutions with $1 billion or more in assets (although smaller institutions can, and do, report voluntarily). Unfortunately smaller depositories are not required to report small business and farm origination data, so it is impossible to discern market trends from the flow data. However, since 1993 all-sized institutions have been required to report balance sheet data on small business and small farm loan dollars outstanding using the same loan definitions as the origination data.*

17 *Larger institutions, for this purpose, were defined to be those with over $250 million in assets or over $100 million in assets and part of an organization with over $1 billion.*

the percentage of offices in LMI tracts. The trends in this percentage between 1997 and 2007 are shown in Exhibit 11.[18]

Exhibit 11

Share of Offices in LMI Tracts



Trends in the LMI share of offices do not seem to vary significantly with asset size of institution. As is clear, however, the percent of CRA-regulated institutions' offices in LMI census tracts decline modestly throughout the 30-year period. There is a striking increase in this share in 2003, but this likely reflects the change in definition of the LMI census tracts in that year, as well as, possibly, the increased activity by depositories in lower-income areas as credit standards were relaxed.

Interpreting the decline in the share of deposits or banking offices in LMI census tracts as a reflection of the CRA may be problematic. Of concern, there were roughly an equal proportion of banking offices and population in LMI census tracts in 1977, but by 2007 the office share was lower than the population share (20 percent versus 26 percent). On the other hand, however, the absolute number of banking offices in LMI census tracts increased by 25 percent over the 30 years since CRA's passage.

Thus, the decreased share of LMI offices reflects higher office growth in middle- and high-income tracts rather than office closures in LMI areas. Moreover, the growth of offices into these non-LMI census tracts may have actually increased the ability of institutions to serve their communities. In particular, the relaxing of state branching laws that allowed institutions to increase their geographic reach may have allowed institutions with main offices in commercial districts, which were nominally LMI but sparsely populated, to expand into the residential communities where their LMI and other customers lived.

B. The Mortgage Lending Metric

The CRA was meant to encourage institutions to meet the lending needs of borrowers in their assessment areas, and particularly those of LMI neighborhoods and LMI borrowers. Lending tests look at both metrics separately, but for ease of exposition we have combined these two lending activities and refer to this as LMI lending.

Exhibit 12 uses HMDA data to provide the LMI shares of mortgage originations over time.[19] As was the case with offices, these data show a trend that is largely undifferentiated by type of institution. Unlike offices, however, there is a fairly consistent upward trend in the percent of LMI lending by CRA-regulated institutions over this period, albeit the trend seems largely to have leveled out after 2004.[20]

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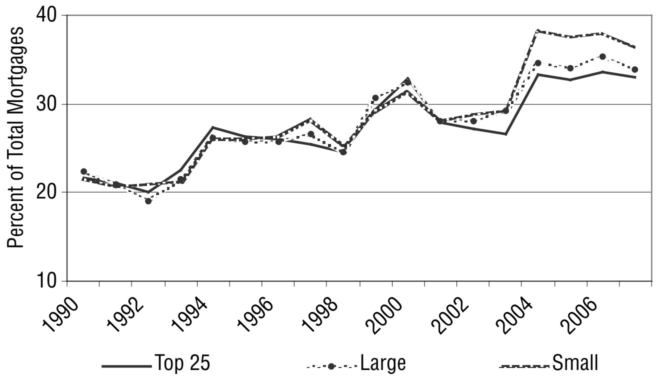
18 *These data are drawn from the Summary of Deposits and Thrift Financial Reports information used for Exhibits 4-6. Each office was geocoded and placed in both a 1990 and 2000 census tract based on its geographic coordinates. We excluded from the calculations all offices in census tracts with less than 1,000 people in urban areas and 500 people in rural areas. These offices are disproportionately in central business districts with deposit figures reflecting business not personal accounts. The 2000 census tract designation was used to classify offices into an LMI income class for reporting years 2003 through 2007. The 1990 tract designation was used to classify offices for all previous years. In practice, 1980 tract classifications were used under the CRA for reporting years 1982 to 1991 and 1970 tracts for 1977 to 1981. A number of rural areas were not assigned tracts in the 1980 and 1970 Census; consequently we chose to use the 1990 tract designation for this period.*

19 *CRA evaluation includes mortgage purchases as well as mortgage originations. We focus on originations here but provide data on purchases as well in the linked website data file. Data definitions are the same as those used in Exhibit 9.*

20 *There is some "lumpiness" of the data due to the fact that LMI income classes for census tracts are changed only every ten years and are sensitive to MSA boundaries. This accounts for much of the increase in LMI lending from 2003 to 2004 when MSAs based on the 2000 Census were introduced (a similar pattern is evident in 1994 which MSAs based on the 1990 Census were first used). Exhibit 12 shows data for both LMI borrowers and census tracts. If the data are limited to LMI census tracts, CRA-regulated institutions in total originated about ten percent of their loans in LMI tracts in 1994 versus 17 percent in 2007, figures that support the view of an increased amount of LMI lending.*

Exhibit 12
Share of LMI Mortgage Lending



As a consequence, LMI borrowers and tracts are receiving a greater share of the mortgage activity of CRA-regulated institutions, while contributing a reduced share to these institutions' deposit base. Moreover, these trends start from a point where the case could be made that LMI customers were underserved. For example, the 1990 Census shows that 16 percent of all owner-occupied single-family homes were in LMI tracts, versus a ten percent overall average LMI-tract share for CRA-regulated lenders in 1994. By 2007, the average CRA-regulated lender share of loans in LMI tracts had risen to 17 percent, a figure equal to the 2000 Census percent of owner-occupied single-family homes in LMI tracts. Arguably, therefore, there has been a positive high-level trend in CRA performance.

However, while there appears to be strong evidence that LMI mortgage customers have enjoyed an expansion of service from CRA-regulated lenders in the last 15 years, it is not clear how much of this, if any, can be attributed to the CRA. While CRA-regulated lenders increased the share of their LMI mortgages from 26 percent in 1994 to 34 percent in 2007, non-CRA regulated institutions increased their share of lending to such customers by a similar amount, from 29 percent to 35 percent. Moreover, within CRA-regulated organizations, the growth in LMI share (from 27 percent in 1994 to 35 percent in 2007) was somewhat greater in subsidiary/affiliate lending, which is only voluntarily considered for CRA evaluation, than it was for lending directly done by CRA-regulated depositories (26 percent to 33 percent).

The similarity of changes in the share of lending going to LMI customers for lenders facing different regulatory environments suggests that either the growth of LMI lending stems from market rather than regulatory forces, or that other regulatory forces beyond the CRA may have played a role. One such regulatory change that might have contributed to the growth of LMI lending by non-CRA regulated lenders over this period was the enactment of affordable housing goals for Fannie Mae and Freddie Mac by the Congress in the mid-1990s.

Similar to the quantitative lending activity requirements under the CRA, albeit not so deeply targeted, Fannie Mae and Freddie Mac face annual percentage of business requirements on their purchases of mortgages that serve LMI borrowers, borrowers in underserved areas, and special affordable populations.[21] Mortgages that satisfy CRA requirements qualify under the affordable housing goals, and may be counted toward these requirements if purchased by Fannie Mae or Freddie Mac. However not all mortgages counting toward the affordable housing goals satisfy CRA requirements or are originated or purchased by CRA-regulated institutions. So, although the CRA and the affordable housing goals of Fannie Mae and Freddie Mac both encourage LMI lending, some of this activity may occur outside CRA reporting channels.[22]

We next turn to the share of mortgage lending that institutions do within their own assessment areas. CRA requirements pertain primarily to activities within institutions' assessment areas, so an increase in the share of activity outside assessment areas is of potential concern. Exhibit 13 illuminates this aspect of CRA performance.

21 *Underserved areas are currently defined in metropolitan areas to be census tracts with median incomes less than or equal to 90 percent of area median income, or tracts with minority population greater than or equal to 30 percent and median incomes less than or equal to 120 percent of area median income. Slightly more flexible guidelines apply for underserved rural areas. Special affordable populations are currently defined as borrowers with incomes less than or equal to 60 percent of area median income, or borrowers with incomes less than or equal to 80 percent of area median income that are located in a census tract that has a median income that is less than or equal to 80 percent of area median income.*

22 *The growth patterns of LMI lending raise some interesting questions that we can only note, but not answer here. Looking at the market as a whole (all HMDA lenders), all of the increase in the incidence of LMI lending from 1994 to 2007 resulted from an increase in lending to borrowers in LMI tracts (10 percent in 1994 to 17 percent in 2007). There was no increase at all (indeed a modest decrease) in the incidence of lending to LMI borrowers who were not in LMI tracts. Further, the difference in the growth in the incidence to lending to LMI tracts and LMI borrowers outside such tracts would have been even larger if measured to 2006 before the collapse of the subprime market. On the surface this evidence suggests that LMI tracts were previously underserved and have now caught up. Yet there was very little change in the percentage of owner-occupied units in LMI tracts from 1990 to 2000 censuses. If the 2000 Census data on owner-occupancy does not reflect the potentially strong growth of housing in LMI areas post-2000, it is possible that these areas may remain underserved.*

Exhibit 13

Share of Mortgages in Assessment Area

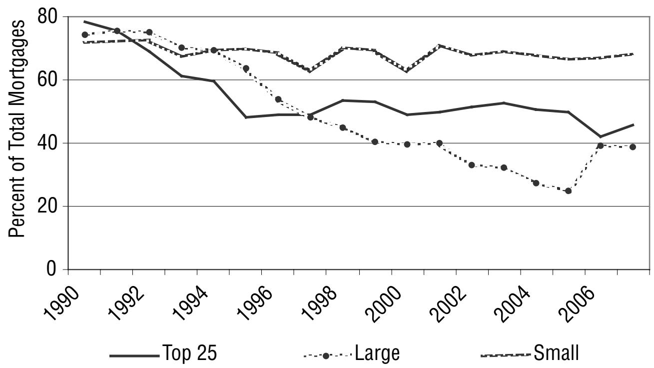
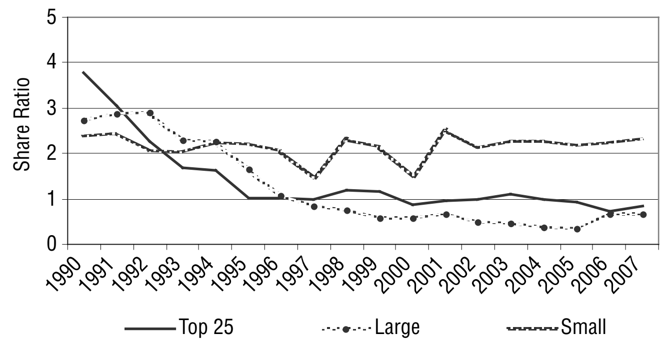


Exhibit 14

Ratio of LMI Lending that is in/out of Assessment Area



We find that small institutions have continued to originate a fairly large share of mortgages within their assessment areas (around 70 percent). Not surprisingly, however, the growth in the size of the top 25 organizations is associated with a decline in the percent of mortgages they originate within their assessment areas. In particular, the top 25 organizations fell from almost an 80 percent share in 1990, to originating only 46 percent of their mortgages within their assessment area after 1994. The share of lending in assessment areas also declined for large institutions, dropping from slightly over 70 percent in 1990 to less than 30 percent in 2005. Since then, however, there has been a surge back up to nearly 40 percent in lending in assessment areas among large institutions in 2006 and 2007.

The concentration of activity among larger CRA-regulated institutions (as shown in Exhibit 9 earlier) raises a potential concern because a reduced share of mortgage activity in assessment areas accompanies it (as shown in Exhibit 13). To further explore this concern, we turn in Exhibit 14 to a comparison of LMI mortgage lending by institutions within and outside their assessment areas.[23] Ideally, from a CRA perspective, the share of LMI lending in assessment areas will be greater than or equal to the share of LMI lending out of assessment areas. There is, therefore, potential reason for some concern if the opposite is the case.

Exhibit 14 shows that small institutions generally perform well by this metric, consistently providing LMI mortgage lending within their assessment areas at rates twice that outside their assessment areas. In contrast, top 25 and large institutions show a decline in this metric throughout the mid-1990s. Since the mid-1990s, the top 25 have leveled off to a ratio where their LMI lending rates are about equal within and outside their assessment areas. In even starker contrast to small institutions, large institutions now originate LMI mortgages at a lower rate within compared to outside their assessment areas.

Overall, therefore, trends among different-sized institutions almost balance each other out. In particular, the increase in the share of lending going to LMI customers from all CRA-regulated institutions lending within their assessment areas (27 percent in 1994 to 34 percent in 2007) is virtually the same as the change in the share of such lending outside their assessment areas (26 percent in 1994 to 33 percent).

Potentially troubling, nonetheless, is the dramatic decline in mortgage lending within assessment areas by the top 25 and large institutions. By this view, increased concentration has reduced overall mortgage lending within assessment areas, arguably reducing the coverage of the CRA. Moreover, because much of the out-of-assessment area lending is associated with affiliates of the larger institutions, it may not be subject to scrutiny under the CRA.

23 Direct lending by depositories is counted as being in the assessment area in our analysis if the loan is originated in a county in which the depository has an office. Loans originated by affiliates or subsidiaries of depositories are counted as being in an assessment area if they are originated in a county in which any depository member of the same organization (e.g. bank holding company) has an office. In practice, institutions have discretion in how they treat loans originated by non-depository subsidiaries or affiliates under the CRA, and may choose to count or not count such loans.

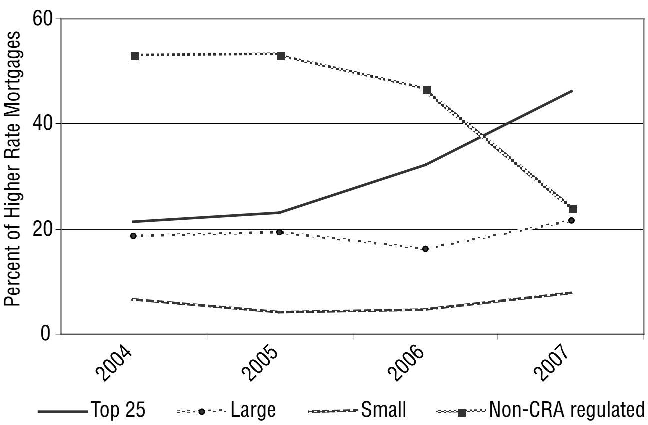
C. Higher-Rate Mortgage Lending

Since 2000 there has been a dramatic increase in mortgage originations by subprime lenders. Much of this activity has been conducted by independent mortgage companies, which are not depository institutions and so not subject to the CRA. Disproportionately, these lenders originate loans at rates substantially higher than those offered by prime lenders.

Considerable regulatory scrutiny has been directed towards these higher-rate loans, generally defined as loans originated above the HMDA rate-spread reporting threshold.[24] It has been a particular focus within the context of the CRA, because higher-rate mortgages disproportionately appear to be originated in LMI census tracts. The CRA's intent has been to promote LMI lending within assessment areas. However, the intent has never been to encourage LMI lending only at higher-rates than borrowers with higher incomes, or in higher income communities, can obtain.

Exhibit 15 provides the distribution of the higher-rate mortgage originations across CRA-regulated and non-CRA-regulated (independent mortgage banks and credit unions) institutions. The data needed to assess higher-rate mortgage lending are reported in HMDA only starting in 2004, so the time series is necessarily short.

Exhibit 15
Higher-Rate Mortgages



The exhibit shows that until 2006 the largest share of the higher-rate mortgages came from institutions not subject to the CRA. During this same period, not surprisingly, small institutions originated a smaller share of higher-rate loans and top 25 organizations and large institutions originated a proportionately larger share.[25]

In 2007, however, the subprime market collapsed and 169 lenders (almost all non-CRA-regulated) stopped reporting in HMDA.[26] This led to a dramatic decline in the volume of higher-rate mortgage lending (not shown), as well as a decline in the share of higher-rate mortgages originated by institutions not covered under the CRA.

From a CRA perspective, the 2007 changes are, arguably, welcome news. In particular, CRA-regulated institutions, rather than those outside the CRA regulatory structure, are increasingly responsible for the origination of higher-rate loans. Because of this, CRA-regulated institutions, and regulators, may have an increasing opportunity to strike the appropriate balance on how best to serve borrowers in this market niche.

D. Small Business and Farm Lending

Larger institutions are subject to lending performance tests related to their small business and small farm lending. Examiners typically use similar tests to those used for mortgage lending, comparing LMI to total lending and lending within and outside of assessment areas. However, unlike with mortgage lending there is no direct analog to a LMI borrower for a business, so typically only the business' location is used to determine its LMI status.

Exhibits 16, 17 and 18 present data on small business and small farm loan originations for the period 1996 to 2007, using the same metrics as used for mortgages in Exhibits 12, 13 and 14. Exhibit 16 shows overall trends in LMI lending over the period; Exhibit 17 presents evidence on lending in- and out-of-assessment areas; and

24 *HMDA requires the reporting of first lien loans where the annual percentage rate is 300 basis points more than a comparable Treasury rate. See Robert B. Avery, Kenneth B. Breevort, and Glenn B. Canner, "The 2006 HMDA Data," Federal Reserve Bulletin, (vol. 93, December 2007), pp. A73-A109 for an example of the discussion of the HMDA higher-rate loans.*

25 *There have been arguments made in the media that some inappropriate high rate lending may have stemmed from CRA-related pressure to lend to LMI customers. However, in 2006, at the height of the subprime boom, 43 percent of the loans by non-CRA regulated lenders to LMI customers were high rate, as compared to 39 percent of CRA-regulated lenders lending outside their assessment areas and only 18 percent for CRA-regulated lenders lending within their assessment areas. On the other hand, the overall incidence of LMI lending across these three groups was about the same. This suggests that differences in the overall incidence of high rate lending did not stem from a differential focus on LMI customers by CRA-regulated institutions, but rather from the choice of product offered to such customers.*

26 *See Robert B. Avery, Kenneth B. Brevoort, and Glenn B. Canner, "The 2007 HMDA Data," Federal Reserve Bulletin (December 2008).*

Exhibit 18 gives the relative propensity for LMI lending for assessment area versus non-assessment area loans.[27]

Exhibit 16

Share of LMI Small Business and Small Farm Lending in LMI Census Tracts

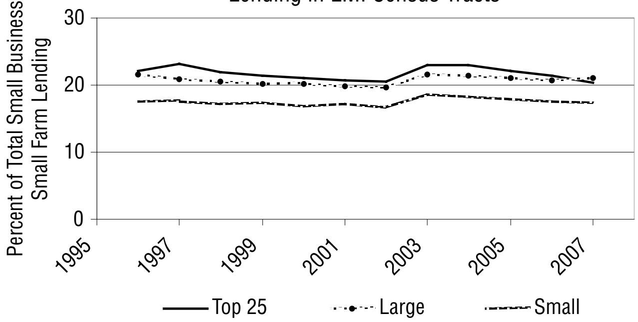


Exhibit 17

Share of Small Business and Small Farm Lending in Assessment Area

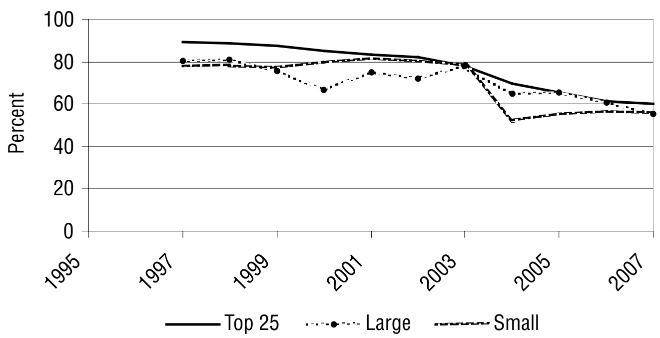
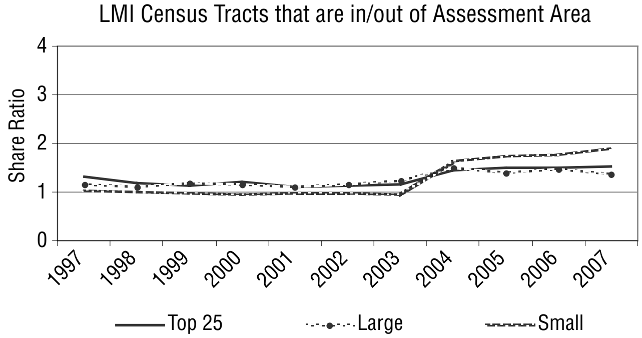


Exhibit 18

Ratio of Shares of Small Business and Small Farm Lending in LMI Census Tracts that are in/out of Assessment Area



The data for small business loans show a somewhat different pattern than those shown for mortgage loans. Exhibit 16 shows a largely constant level of LMI lending over the ten-year period, although there is, arguably, a slight decline among top 25 institutions. In-assessment area lending shows a clear decline for all-sized institutions, especially so starting in 2004 (Exhibit 17). CRA-regulated institutions show an equal propensity toward LMI lending both in- and out-of-assessment areas through 2003. Starting in 2004, however, institutions originate a higher share of LMI loans in their assessment areas.

Overall, these trends are small in comparison to those for mortgages and there are significant differences by size of institution. Of potential concern is the reduction in in-assessment area lending by CRA-regulated institutions. Mitigating this, however, is the fact that in-assessment area lending shares are higher than those for mortgage lending. Moreover, the within-assessment area LMI lending rate shows a relative increase at precisely the time when in-assessment shares decline, explaining why overall LMI lending shows almost no trend. On the basis of these trends, therefore, arguably there is little reason for focus or concern regarding the small business and farm lending performance of CRA-regulated institutions.

E. Overall CRA Ratings

Finally, we turn to an analysis of overall CRA ratings. Under the revised final CRA regulation that became effective July 1, 1995, as under the earlier regulation, CRA-regulated institutions are to be assigned one of four statutory ratings. Every institution's rating—either Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance—is posted and includes a written evaluation explaining the rating.[28] The public release of this information about CRA performance continues to be an important aspect of the regulations. The CRA rating is especially important because the regulatory agencies consider an institution's CRA record when evaluating its application for deposit insurance, or for a charter, branch or other deposit facility, office relocation, merger or acquisition. For our analysis, therefore, we focus on the Outstanding and less than Satisfactory (Needs to Improve or Substantial Noncompliance) CRA ratings—the former

27 Unlike mortgage loans, the figures in Exhibits 16-18 are based on loan dollars rather than loans. Many very small business loans reported in the CRA data are in reality credit card loans issued to business owners. In order to not give these loans too much weight, the figures are dollar rather than loan-weighted.

28 Ratings information is available at http://www.ffiec.gov/cra/ratings.htm.

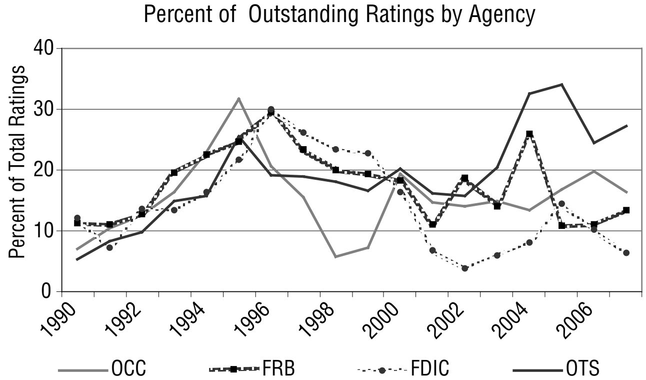
because it implies the least difficulties for institutions, the latter because it implies the most.

Each CRA-regulated institution is assigned a primary federal banking agency regulator that conducts its CRA exam. The Office of the Comptroller of the Currency (OCC) is primary regulator of commercial banks with national bank charters, including most of the top 25. The Federal Reserve Board (FRB) is the primary regulator of state-chartered commercial banks that are members of the Federal Reserve System. The Office of Thrift Supervision (OTS) is the primary regulatory authority over most savings associations, and the Federal Deposit Insurance Corporation (FDIC) has primary authority over state-chartered, non-FRB-member commercial banks and some federally-chartered savings banks.

Exhibit 19 provides information, by regulatory agency, on those institutions receiving Outstanding ratings from 1990 – 2007. The exhibit shows that, since 2000, a considerably larger share of OTS-regulated institutions has received Outstanding ratings as compared to FDIC-regulated institutions.

Exhibit 19

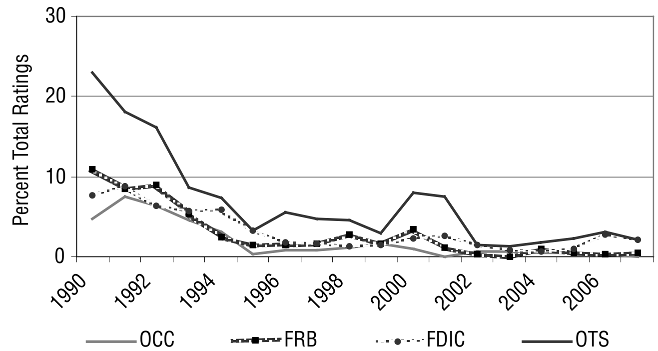
Percent of Outstanding Ratings by Agency



Regulatory agencies also differ in the percent of less than Satisfactory CRA ratings they give. Exhibit 20 indicates that a small share of institutions continues to receive either Needs to Improve or Substantial Noncompliance ratings, but that the share of those with poor ratings (since 1995 when the regulation changed) is marginally highest for OTS-regulated institutions.

Exhibit 20

Percent of Unsatisfactory Ratings by Agency



It is not only the regulatory supervision process that varies with CRA ratings. The size of the institution also seems to matter. Exhibits 21 and 22 present information parallel to that in Exhibits 19 and 20, but separated by size of institution rather than regulatory agency. The largest organizations (top 25) clearly perform best as measured by their share of Outstanding ratings, and their differential above large and small institutions increased substantially starting in 2003. Arguably this reflects the importance that the largest institutions place on good performance ratings in an effort to reduce CRA impediments to mergers or acquisitions.

Exhibit 21

Percent of Outstanding Ratings by Institution Size

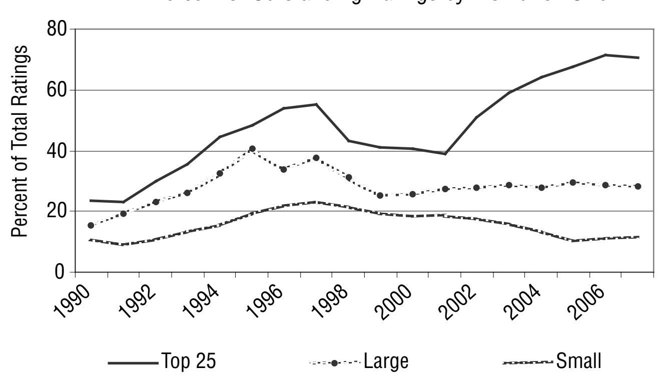


Exhibit 22
Percent of Unsatisfactory Ratings by Institution Size

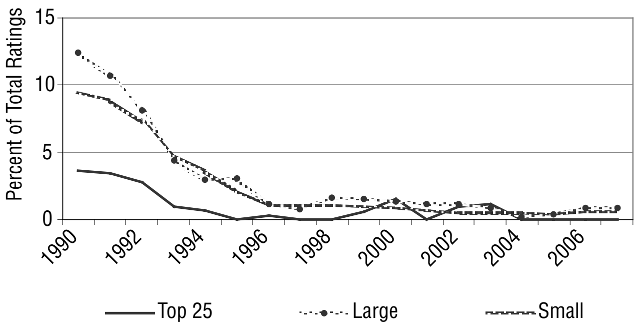


Exhibit 22 shows that the top 25 institutions have historically been less likely to receive unsatisfactory ratings. Since 1996, however, there has been little difference in the unsatisfactory rate across institution size, with levels generally ranging under one percent. This may reflect "satisficing" behavior on the part of depositories, ensuring that they at least do not receive an unsatisfactory rating given the increased public scrutiny of CRA performance.

VI. Concluding Comments

Since the passage of the CRA in 1977, the financial market has evolved in several ways that have potentially critical implications for the CRA. First, the share of financial activity covered under the CRA has declined substantially. This occurred for two key reasons: (1) the growth of financial institutions not covered by the CRA, and (2) the reduction in in-assessment area activity by the larger CRA-regulated institutions. Second, the footprint of financial institutions has increased dramatically. No longer is financial activity largely locally-based. Instead, institutions that operate across several states, if not nationally, conduct most financial activity. Third, there has been an increase in LMI lending, although much of this occurs outside of assessment areas and it is debatable how responsible the CRA is for this trend.

We leave it to others to fully assess the implications of these changes for the CRA. We note, however, that today we are arguably in the midst of the most dramatic financial changes of the past several decades. We conclude, therefore, with some observations of how these changes may affect CRA-regulated institutions.

First, we expect to see that CRA-regulated institutions will regain market share. This reflects several recent changes. Independent, non-chartered investment banks no longer exist—they have either merged with depositories, or become bank-chartered institutions. The collapse of the subprime mortgage sector means that institutions not covered under the CRA have lost significant market share. Finally, with the current credit and liquidity crisis, borrower confidence has fallen to historic lows, and the importance to households of keeping deposits in federally insured institutions has grown. These trends, arguably, will all serve to give the CRA increased leverage and importance.

Second, we expect increased concentration among CRA-regulated institutions. The current financial crisis has already led to a number of mergers and acquisitions, and we expect this trend to continue. The impact of this trend on the overall performance of CRA-regulated institutions is far from certain. On a positive note, as concentration among CRA-regulated institutions has increased, so too, arguably, has overall CRA performance (although, as we have noted, such trends are less apparent in small business lending and may be due to other market forces). Potentially troubling, however, is that increased concentration in mortgage lending, if historical trends continue, could reduce the overall share of in-assessment area mortgage lending, arguably reducing the impact of the CRA. Further, much of the lending of larger institutions—even if done in assessment areas—has been done through affiliates rather than directly by depositories and thus may be subject to a different degree of regulatory scrutiny. How these forces balance out will determine whether CRA regulations have an increased or decreased impact on the marketplace.

Finally, underwriting standards have tightened significantly in primary, secondary, and mortgage insurance markets, likely significantly reducing the share of higher-rate mortgage originations. This may mean that there is less access to credit for LMI borrowers and in LMI neighborhoods. If that trend is observed, the importance of the CRA may increase as it mandates focus on these otherwise less well served areas. This may be abetted by the changes to the affordable housing goals for Fannie Mae and Freddie Mac included in the Housing Economic Recovery Act of 2008, which more closely align the purchase goals of Fannie Mae and Freddie Mac with those of the CRA. ■

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The Community Reinvestment Act: Outstanding, and Needs to Improve

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With Michael A. Stegman
The John D. and Catherine T. MacArthur Foundation

The Community Reinvestment Act (CRA) of 1977 responded to charges of redlining and discrimination by financial institutions. It induces depository institutions to "help meet the credit needs of the local communities in which they are chartered" in a manner "consistent with the safe and sound operation of such institutions."[1] With these guiding principles and broad regulator discretion as to how to implement them, the act has proven flexible and adaptable over time.

Much has been written in both critique and defense of the CRA.[2] Critics suggest that this government meddling distorts markets, but evidence from CRA-covered institutions indicates that the act has led to an increase in related lending activities in minority and low- and moderate-income neighborhoods without negatively impacting profitability.[3] In the wake of the subprime meltdown, this debate has taken on a new dimension: some blame the CRA for the crisis,[4] while others—including the Comptroller of the Currency and the CEO of Bank of America—dismiss the notion.[5] As former Federal Reserve Governor Randall S. Kroszner recently asserted, "the evidence does not support the view that the CRA contributed in any substantial way to the crisis in the subprime mortgage market."[6]

In this piece, we present our own evidence that CRA activity can be undertaken in a safe, sound, and profitable manner, but we also go further. Our opinion, based on a CRA-related mortgage program and data on the CRA Service Test (along with observations on the prevalence of check cashers and payday lenders in low-income geographies), is that there has been rather too little CRA. The recent subprime crisis puts into stark relief the misalignment between the intent of the CRA and the reality of the financial services landscape. This paper examines aspects of the incentive mechanisms of the CRA, considering those that work well and those that should be adjusted to strengthen the act's effectiveness.

The CRA's Incentive Mechanisms

The CRA creates an "affirmative obligation" whereby

* *Special recognition goes to the work of Lei Ding, Jonathon Spader, and Allison Freeman.*

1 *United States Congress. Public Law 95-128: Housing and Community Development Act of 1977. 95th Congress, 1st Session. College Park: Potomac Publishing Company, Inc., 1977.*

2 *See Michael S. Barr, "Credit Where it Counts: The Community Reinvestment Act and Its Critics." New York University Law Review 75:600 (April 29, 2005): 101—233.*

3 *Robert B. Avery, Raphael W. Bostic and Glen B. Canner, "CRA Special Lending Programs," Federal Reserve Bulletin (November 2000): 711—31, available at http://www.federalreserve.gov/pubs/bulletin/2000/1100lead.pdf discusses impact on lender profitability; Joint Center for Housing Studies, Harvard University (JCHS), "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System" (Cambridge Massachusetts, March 20, 2002), available at http://www.jchs.harvard.edu/research/crareport.html documents lending patterns; Barr (2005) contains a further summary of studies.*

4 *See Stan Liebowitz, "The Real Scandal - How feds invited the mortgage mess,"The New York Post (February 5, 2008), available at http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm?page=0; and Richard Cravatts, "Unintended fallout of loan crisis", Opinion/OpEd, The Boston Globe (July 26, 2008) available at http://www.boston.com/bostonglobe/editorial_opinion/oped/articles/2008/07/26/unintended_fallout_of_loan_crisis/.*

5 *Emily Flitter, "In Election's Aftermath, CRA Stays a Flash Point," American Banker 173.233 (Dec 4, 2008):1.*

6 *Randall S. Kroszner, "The Community Reinvestment Act and the Recent Mortgage Crisis." Speech given at the Confronting Concentrated Poverty Policy Forum, Board of Governors of the Federal Reserve System, Washington, DC, December 3, 2008, available at www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm.*

institutions seek to provide evidence of positive actions taken.[7] While the act gives each of the four supervisory agencies leeway in setting rules for evaluating compliance,[8,9,10] each examination results in a publicly available narrative report and a rating: Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance. The public serves a complementary evaluation function, using CRA examination results, publicly available lending data such as Home Mortgage Disclosure Act (HMDA) data, and an institution's performance vis a vis any CRA agreements it has entered. Through access to examiner reports, the public also regulates the regulators. In these ways, advocates, community groups, and private citizens have had a major hand in implementing the act.[11]

Yet there remains a lack of equal access to credit for certain communities and minority groups, a gap that appears to have been exploited by high-cost and predatory lenders. While the CRA is not a total solution to such problems, it is worth noting that in the history of the CRA, as of a 2005 report, only eight applications for actions by institutions subject to the CRA had been denied out of 92,177 applications submitted,[12] and that out of over 60,000 exams since 1990, 96 percent received a Satisfactory or Outstanding grade, while only 0.4 percent earned a rating of Substantial Noncompliance.[13] Such data indicate that more could be done within the jurisdiction of the CRA.

We now provide evidence related to two of the tests involved in CRA-based action—the Lending Test and the Service Test—to shed light on how the act influences institutions' behavior as intended and how it could better address current realities.

The Lending Test and CRA Special Mortgage Programs

CRA performance can be measured under three categories of activities: lending, service, and investment, with the Lending Test carrying the most weight.[14] The Lending Test tallies the amount and proportion of loans made within an institution's CRA assessment area, and how those loans are distributed across neighborhoods and borrowers of different income categories.[15] "CRA-related" refers to loans made by CRA-regulated institutions in low- and moderate-income (LMI) neighborhoods, or to LMI households or small businesses with revenues below $1 million, within their assessment areas.[16] The

7 *Certain violations of fair lending laws may be counted against institutions as well, see Richard D. Marsico, "The 2004-2005 Amendments to the Community Reinvestment Act Regulations: For Communities One Step Forward and Three Steps Back," Clearinghouse Review 39:534 (2006); NYLS Legal Studies Research Paper No. 05/06-25, available at SSRN: http://ssrn.com/abstract=902430.*

8 *The act requires "each appropriate Federal financial supervisory agency to use its authority when examining financial institutions." US Congress. Public Law 95-128.*

9 *The FDIC conducts about 60 percent of examinations; followed by the OCC, the Federal Reserve System, and then the OTS. Source: Federal Financial Institutions Examination Council (FFIEC) "CRA Ratings Database," available at http://www.ffiec.gov/craratings/Rtg_spec.aspx, accessed November 18, 2008.*

10 *See Marsico, "The 2004-2005 Amendments to the Community Reinvestment Act Regulations." This summary of the 2004-2005 changes to the act illustrates the jurisdiction that the agencies have in implementing the act. For example in 2004 and 2005 these agencies issued consequential amendments—some of which differed from agency to agency, so that now "the four federal banking agencies that enforce the CRA have significantly different CRA regulations" (541).*

11 *Anne B. Shlay, "Influencing the Agents of Urban Structure: Evaluating the Effects of Community Reinvestment Organizing on Bank Residential Lending Practices," Urban Affairs Review 35:2 (1999): 247—78.*

12 *Barr, "Credit Where it Counts: The Community Reinvestment Act and Its Critics."*

13 *The OTS gave the most Substantial Noncompliance ratings, to 8.2 percent of examinees over the 1990-mid 2008 period while the OCC gave this lowest rating to only 2 percent of its examinees. (FFIEC CRA Ratings Database).*

14 *The smallest institutions undergo only a Lending Test, while "intermediate small" banks are subject to both a Lending Test and a Community Development Test. Ben S. Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges." Speech given at the Community Affairs Research Conference, Board of Governors of the Federal Reserve System, Washington, DC, March 30, 2007, available at http://www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm.*

15 *Generally, assessment areas are comprised of "one or more MSAs or…contiguous political subdivisions" (generally meaning a town, city or county). Institutions can designate smaller assessment areas provided that they "not arbitrarily exclude low- or moderate- income geographies or set boundaries that reflect illegal discrimination." Federal Financial Institutions Examination Council (FFIEC) "Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment," (July 12, 2001), available at http://www.ffeic.gov/cra/qnadoc.htm.*

16 *This conforms to the terminology used in Avery, Bostic and Canner, "CRA Special Lending Programs."*

Lending Test also favors the use of innovative or flexible lending practices "in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies."[17]

In response to this call for innovative lending practices, most CRA-covered institutions develop "CRA Special Lending Programs," usually related to home mortgage lending. According to the profile of CRA Special Lending Programs, a large majority (83 percent) of these programs involve changes to underwriting standards. The three most common variations are: reduced cash required to close (through lower down payment and/or lower cash reserve requirements); alternative measures and/or lower standards of credit quality; and flexibility in assessing repayment ability (through higher debt ratios and/or flexible requirements for employment history). The majority of programs combine neighborhood and borrower targeting. In line with the CRA's emphasis on safety and soundness, 93 percent of responding organizations described their programs as profitable or breakeven.[18]

In this volume, former Federal Reserve Governor Randall Kroszner notes that "only six percent of all the higher-priced loans were extended by CRA-covered lenders to lower-income borrowers or neighborhoods in their CRA assessment areas." Federal Reserve researchers also report that subprime mortgages made in CRA-eligible neighborhoods perform at least as well as those made in similar non-CRA-eligible neighborhoods, that a large national affordable mortgage program has substantially lower defaults than the subprime segment, and that the majority of recent foreclosure filings have occurred in non-CRA eligible middle- and upper-income neighborhoods.[19]

Beyond such aggregate findings, researchers have found it difficult to analyze CRA special programs at a more granular level. It is hard to identify such loans in broad datasets in the manner that, for example, subprime or FHA loans can be identified. However, we at the UNC Center for Community Capital have access to a unique proxy involving more than 45,000 mortgages made to LMI borrowers: The Community Advantage Program (CAP).

Using CAP to Identify Significant Behaviors in CRA-Regulated Lending

In 1998, Self-Help Ventures Fund, in partnership with the Ford Foundation and Fannie Mae, introduced the Community Advantage Program (CAP). By establishing a new secondary market outlet for affordable and CRA-type loans, the program sought to help thousands of low-income households build wealth through homeownership and to show that lending to low-income homeowners presents an acceptable level of risk. Participating lenders could develop their own customized programs, and then sell the loans to Self-Help.[20] A landmark $50 million grant from the Ford Foundation provided the capital support to enable Self-Help to guarantee the loans and sell them to Fannie Mae "with recourse." In this way, Fannie Mae could fund loans that otherwise did not meet their underwriting requirements.

Working secondary markets are vital to sustaining any mortgage activity, but capital markets are often poorly aligned with CRA lending. By providing liquidity for loans originated primarily under programs that made them ineligible for direct sale to Fannie Mae or Freddie Mac, CAP expanded the capacity of participating lenders to make loans under such programs.

As of the end of 2007, thirty-six lenders had participated in CAP, ranging from small, local institutions to national banks. The program had funded 49,800 home loans totaling $4.5 billion. All but two of the participating lenders were CRA-covered depository institutions.[21]

Because CAP provides a unique opportunity to evaluate the benefits and costs of affordable mortgage lending, the Ford Foundation commissioned the UNC Center for Community Capital to perform a multi-year study of the program's outcomes and impacts. In the following paragraphs, we present several findings from

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17 Federal Financial Institutions Examination Council (FFIEC), "A Guide to CRA Data Collection and Reporting," (January 2001), available at http://www.ffiec.gov/cra/guide.htm.

18 Avery, Bostic and Canner, "CRA Special Lending Programs."

19 Glenn Canner and Neil Bhutta, Memo to Sandra Braunstein "Staff Analysis of the Relationship between the CRA and the Subprime Crisis" (November 21, 2008), available at http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf.

20 Fannie Mae added a standardized Self-Help product to its My Community Mortgage product suite that could be underwritten via Desktop Underwriter that came more broadly into use by the end of 2004.

21 One was a credit union, the other a mortgage banking subsidiary of a non-CRA covered financial services company. These contributed only a small share of the total lending.

our CAP research that shed light on how the market has responded to the CRA.

As mentioned above, under CAP, lenders developed their own guidelines and, consistent with the profile of CRA Special Lending Programs, all included at least one of the typical exceptions to standard underwriting rules: reduced cash to close, credit flexibility, and flexibility assessing ability to pay.[22] Nearly 90 percent of the programs featured exceptions in at least two of these areas, and more than half featured exceptions in all three. Like other CRA Special Lending Programs, CAP uses a combination of community and borrower targeting, and although the requirements differ slightly from the CRA's,[23] 94 percent of CAP loans are CRA-eligible.[24]

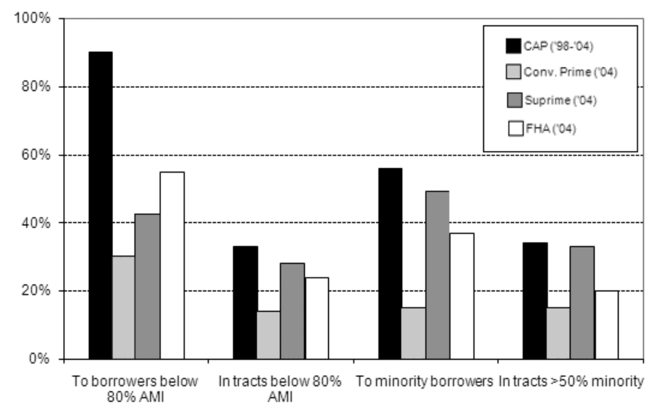
As such, CAP loans may be taken to reflect the broader field of "special CRA programs," defined as "programs that banking institutions have established specifically to enhance their CRA performance."[25] CAP loans also reflect a direct response to the CRA by participating institutions. CAP experiences thus provide unique insight into both the reach and performance of special CRA lending programs and the behavior of participating institutions in response to the act.

How CAP Loans Serve the Market

How do these loan programs fit within the broader mortgage market context? Consistent with the general experience of CRA Special Lending Programs, they make up a very small share of CRA-related lending.[26] Still, they provide financing to an underserved market segment. Over the period from inception to 2004, the average loan amount of $88,290 went to a home buyer with an average income of $33,924; the average CAP borrower had an income of 62 percent of the area's median income (AMI). Forty percent of the borrowers were minorities. More than a third of the borrowers had origination credit scores below 660, and more than half of the loans had an original loan to value ratio of 97 percent or higher.

Compared to other product lines—conventional prime, high-cost subprime, and FHA—CAP is more focused on LMI borrowers, and also on borrowers living in LMI areas, minority borrowers, and borrowers living in high-minority areas. Subprime lending lines up most closely with CAP, except that it is notably less directed at LMI borrowers (42 percent of subprime loans versus 90 percent of CAP), due in part to the fact that there is no income limit on subprime lending (See Chart 1).[27]

Chart 1: Types of Loans by Income and Minority Status



Taking various features of each borrower and loan into consideration, we estimate that 88 percent of CAP loans have at least one major feature that would have made them otherwise ineligible for prime, conventional funding. Through CAP however, borrowers were still able to finance homeownership with prime loan features:

22 *Typical examples of each of these guidelines taken from a number of different programs: Borrower contribution of the lesser of $500 or one percent of purchase price with no reserves required; LTVs up to 103 percent; FICO floor of 580; if no score, use alternatives ways to document 12 month history of making payments; allowable debt to income ratios of 43 percent, or up to 45 percent with less than 25 percent payment shock (that is, new payment no more than 125 percent of current rent or house payment).*

23 *To qualify for the CAP program, borrowers must have income of no more than 80 percent of the area median income (AMI), or 115 percent if they are a minority borrower or are purchasing in a census tract that is low-income (<80 percent of AMI) or high-minority (>30 percent).*

24 *"CRA-eligible" means loans made to LMI borrowers or in LMI areas, regardless of assessment area.*

25 *Avery, Bostic and Canner, "CRA Special Lending Programs," 713.*

26 *In "CRA Special Lending Programs," Avery, Bostic and Canner surveyed the 500 largest financial institutions in 1999. Of the 143 respondents, 73 percent had at least one special CRA program, and 89 percent of the volume of loans originated through special programs was originated through mortgage lending programs. Among institutions offering special programs, mortgages extended under these programs accounted for 18 percent of all CRA-related mortgages for the median institution. Among all institutions, the median was four percent.*

27 *This analysis compares the demographic profile of all CAP loans originated 1998-2004 to all HMDA originations of first-lien, purchase money mortgages, for owner-occupied 1-4 unit properties for 2004.*

30-year, fixed-rate loans with an average interest rate of 7.3 percent; prohibited prepayment penalties; and, for the vast majority, retail-originated loans. The relatively low credit scores and high loan-to-value and debt-to-income ratios common among CAP loans suggest that, in the absence of a program like CAP, these borrowers would not have qualified for a mortgage or would have been constrained to the high-cost subprime market.[28]

CAP's Shifting Role: Creating Access and Subprime Alternative

A recent CAP analysis[29] provides empirical evidence about the changing role of this community reinvestment lending over the past decade. We compared HMDA and CAP data at the census tract level for years when CAP loans were originated to years when no CAP loans were made. We found that in the early years of the program most CAP loans (75 percent) reflected new financing made available under prime terms and conditions. The remainder acted as a direct substitute for FHA loans within the same tract.

This image of community reinvestment lending reverses with the dramatic growth of the subprime market from 2003 to 2006. Analysis with respect to this later period suggests that, increasingly, community reinvestment lending supplanted high-cost originations. In fact, by 2004-2006, nearly two out of every three CAP loans substituted for a high-cost origination, while one-third appears to have created access to new credit. This shift mirrors the changes in policy discussions during this period as concerns shifted from fair access to credit towards access to fair credit. If the CRA was originally conceived to bring credit where there was none, it may have also functioned to keep some borrowers out of the subprime market in the later period.

Though CAP and subprime lending may serve similar borrowers, the next issues under consideration must be whether there are substantive differences between CAP and subprime and what these differences might mean for the financial health of borrowers and lenders. Some heralded the subprime surge into minority and LMI markets as a democratization of credit, while others saw it as a separate and unequal form of credit that threatened household and community financial security. Today, we know that high risk, non-prime mortgages bode ill not only for borrowers and their neighborhoods but also for the safety and soundness of institutions.

Risky Borrowers or Risky Products?: Borrower and Institutional Health

At the second quarter of 2008, 30 percent of subprime loans were past due. The subprime serious delinquency rate (90 or more days delinquent or in foreclosure) was over five times that for CAP.[30] But these overly generalized comparisons do not take into account differing borrower profiles. Here again, the CAP dataset allows for a risk-adjusted performance analysis to provide insight into whether the higher default experience associated with subprime loans is an inevitable result of lending to more underserved borrower types, or whether an effect is created by the mode of lending.

Ding, Quercia, Li, and Ratcliffe[31] empirically examine the relative risk of subprime mortgages and loans in the CAP program, using propensity score matching to construct a sample of comparable borrowers with similar characteristics but different loan products. They find consistent evidence that, for borrowers with similar characteristics, the estimated default risk is much lower with a CAP (prime-term) loan than with a subprime mortgage. The estimated cumulative default rate for a 2004 subprime loan is about four times that of a CAP loan, controlling for risk characteristics; for a 2006 subprime loan, the cumulative default rate is about three-and-a-half times that of a comparable CAP loan to a comparable borrower.

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28 Typical risk profiles of subprime loans can be found in several studies: Anthony Pennington-Cross and Souphala Chomsisengphet, "The Evolution of the Subprime Mortgage Market," Federal Reserve Bank of St. Louis Review (Jan/Feb 2006): 31—56; Pennington-Cross, Anthony and Giang Ho. (2006). "The Termination of Subprime Hybrid and Fixed Rate Mortgages." Working Paper 2006-042A (Federal Reserve Bank of St. Louis, July 2006), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=918098; Michelle Danis and Anthony Pennington-Cross "The Delinquency of Subprime Mortgages." Journal of Economics and Business, Vol. 60 No. 1-2 (2008): pp 67—90.

29 Jonathan Spader and Roberto G. Quercia, "Community Reinvestment Lending in a Changing Context: Evidence of Interaction with FHA and Subprime Originations," Working Paper (Chapel Hill, NC: UNC Center for Community Capital, Forthcoming), available at www.ccc.unc.edu.

30 Subprime delinquency figures from the Mortgage Bankers Association of America national delinquency survey for second quarter 2008.

31 Lei Ding, Roberto Quercia, Wei Li, and Janneke Ratcliffe, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," Working Paper (Chapel Hill, NC: UNC Center for Community Capital, 2008), available at http://www.ccc.unc.edu.

The results suggest that the higher default risk of subprime loans is significantly associated with the characteristics of the loan product and the origination channel (see Table 1). In particular, the broker channel, adjustable rate features, and prepayment penalties common with subprime loans contribute substantially to the elevated default risk. CAP loans contain none of these features. As Table 1 shows, the default rate for a 2004 subprime loan with an adjustable rate, retail originated and without prepayment penalty is 1.6 times that for a CAP loan made that same year to a similar borrower. Adding broker origination and a prepayment penalty, however, increases the default risk of the subprime loan to 5.3 times that for the CAP loan.

Table 1: Estimated Relative Default Rate[32]
(Subprime Loans Compared to CAP Loans)

Suprime Loan Feature			Default Rate of Subprime Loans vs CAP	
ARM	Prepay Penalty	Broker	2004 Origination	2006 Origination
●	○	○	1.6 times	1.26 times
●	●	○	3.3 times	3.3 times
○	○	●	5.9 times	3.04 times
○	●	●	5.7 times	3.6 times
●	○	●	4.2 times	3.8 times
●	●	●	5.3 times	4.0 times

The CAP experience thus adds to the body of empirical evidence that CRA-motivated lenders, like those involved in CAP, offer loan programs to underserved (low-income and minority) markets in direct response to the CRA, in a manner consistent with the safety and soundness principles embedded in the act. The CAP experience also highlights the contrast between CRA mortgages and much of the lending to a similar market by the unregulated, subprime sector. Similar findings were obtained by a recent Federal Reserve working paper: California loans originated by CRA-regulated institutions were significantly less likely to default than those originated by non-CRA-regulated institutions, even after controlling for borrower and loan characteristics.[33] Although CRA loans may have acted as a substitute for subprime loans on the front-end, they have performed starkly better in terms of safety and soundness for borrowers and lenders alike.

Not Enough CRA?

In 2005, 49 percent (about one-half) of black borrowers and 41 percent of Hispanic borrowers obtained high-cost subprime loans, compared to just 21 percent (about one-fifth) of white borrowers. In communities where more than half the population was minority, 40 percent of all mortgages made in 2005 were high-cost subprime loans, compared to 23 percent of those made elsewhere. The discrepancy is nearly the same for those areas where median income was 80 percent or less of AMI compared to those with higher incomes (39 percent versus 24 percent). Study after study finds high-cost and/or subprime lending to be more prevalent in the very areas targeted by the CRA.[34] This begs the question: if the CRA is so successful, why did high-cost subprime lending concentrate in the very markets that the act seeks to serve?

In one of many indications that CRA-regulated lenders have not adequately met "the credit needs of the local communities," the Joint Center for Housing Studies provides examples of how CRA-regulated lenders held disproportionately lower market share in the low-income and/or high-minority portions of their assessment areas.[35] Mian and Sufi document how areas of "high latent demand" in 1996 (those with the highest mortgage denial

32 The predicted cumulative default rate is defined as 90-day delinquency as of 24 months after origination for a borrower with a FICO score between 580-620 and holding a mortgage originated in 2004 or 2006, with the mean value of other regressors. The estimation is based on regression results to be found in the forthcoming working paper. The subprime default is compared to the level of default for CAP loans, which are retail originated, fixed-rate loans without prepayment penalty.

33 Elizabeth Laderman and Carolina Reid. "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown," Working Paper (San Francisco, CA: Federal Reserve Bank of San Francisco, November 2008), available at http://www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf.

34 See Lei Ding, Janneke Ratcliffe, Roberto Quercia and Michael A. Stegman, "Neighborhood Patterns of High Cost Lending: The Case of Atlanta," Journal of Affordable Housing & Community Development Law 17: 3 (Spring 2008): 193–217 for a case study and review of the literature; see maps of all congressional districts comparing the location of high minority tracts, low-income tracts, and market share of subprime loans, available at http://www.ccc.unc.edu/?id=subprime&t=Subprime%20Lending%20and%20Low-Income%20Communities.

35 See page 85 of Joint Center for Housing Studies, Harvard University, "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System."

rates) subsequently experienced sharply higher growth in mortgage originations and later in defaults related to mortgages originated for sale to third parties other than the mortgage GSEs. It is not surprising that the likelihood that any area is identified as having "high latent demand" is strongly correlated to lower socioeconomic conditions and higher minority populations.[36] These examples indicate a persistent inadequacy in the supply of productive and sustainable capital to lower-income and minority markets; and suggest that the surge in subprime lending was, in large part, a response to this gap.

Taken together, the evidence leads us to conclude that the CRA Lending Test does motivate more prime-term lending in target communities, but often only incrementally more, and that the original conditions that motivated the act endure. As former Federal Reserve Chairman Alan Greenspan recently declared, the subprime market "is now over,"[37] but the market failure that it exposed is not, and is likely to be exacerbated by the erosion of property values, home equity, and credit histories in those markets where subprime lending was most prevalent. To whatever extent this market failure allowed the subprime boom to take root, the importance of working to correct such disparities now seems even more clear.

The CRA Service Test: The Answer Is Better CRA

We now turn to the provision of retail services, which falls under the purview of the Service Test. This test evaluates the "availability and effectiveness of a bank's system for delivering retail banking services."[38] It considers the distribution of branches and their openings and closings, non-branch systems for delivering banking services (such as ATMs and bank-at-work programs), the types of services offered, and the degree to which services are designed to meet customer needs, all with respect to the income level of the areas served. It favors innovations in activities such as low-cost accounts, credit counseling, savings initiatives, etc.[39] A recent example of the potential of the CRA to stimulate retail financial services that really "meet the credit needs" of the community comes from the FDIC: participants in a pilot program for an affordable alternative to payday loans receive favorable CRA consideration.

However, there is ample evidence that in many communities, the need for basic financial services is poorly served by mainstream banks, even as fees for checking and savings accounts increase.[40] The decline and relative under-representation of bank branches in low-income and minority neighborhoods is well documented.[41] On a visit to a predominantly African American community in Atlanta, a Federal Reserve Governor noted that "not a single financial institution was within view," a situation that "occurs far too frequently in predominantly minority communities."[42] In 1999, when *Savings for the Poor: the Hidden Benefits of Electronic Banking* was written, it seemed that developing technologies held the promise to increase access to banking services for the poor. For example, ATMs could cut the cost of bank transactions by

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36 Atif R. Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis," Working Paper (Social Science Research Network, October 30, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072304.

37 Steve Bills, "Greenspan Comments on Crunch," American Banker 172:222 (November 16, 2007):17.

38 FFIEC, "A Guide to CRA Data Collection and Reporting."

39 Michael Stegman, Kelly Cochran and Robert Faris, "Creating a Scorecard for the CRA Service Test," Policy Brief No. 96 (Washington, DC: The Brookings Institution, March 2002).

40 United States Government Accountability Office (GAO) "BANK FEES: Federal Banking Regulators Could Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts," GAO-08-281 (January 2008), available at http://maloney.house.gov/documents/financial/consumer/20080303GAOBankFees.pdf.

41 See, e.g., Michael A. Stegman, Savings for the Poor: The Hidden Benefits of Electronic Banking. Brookings Institution Press (Washington, DC: Brookings Institution Press, 1999); Michael A. Stegman, Marta Rocha and Walter Davis, "The Role of Technology in Serving the Unbanked," Working Paper (Chapel Hill, NC: UNC Center for Community Capital, 2005), available at http://www.ccc.unc.edu/ documents/ccRoleTechnologyServingUnbanked.pdf (pages 9 - 11); Stephen M. Graves, "Landscapes of Predation, Landscapes of Neglect: A Location Analysis of Payday Lenders and Banks." The Professional Geographer 55:3 (2003):303—17, California State University, Northridge, available at http://www3.interscience.wiley.com/journal/118872858/abstract; Anthony Kolb, "Spatial Analysis of Banks and Check-Cashing Locations in Charlotte, NC," Working Paper (Chapel Hill, NC: UNC Center for Community Capital, 1999), available at http://www.ccc.unc.edu/documents/ KolbSpatialAnalBankCheckCashNC.pdf; J.S. Pollard, "Banking at the margins: a geography of financial exclusion in Los Angeles," Environment and Planning A 28 (1996):1209–32 accessed November 18, 2008, at http://www.envplan.com/epa/fulltext/a28/a281209.pdf; and John P. Caskey, Fringe Banking, Check-Cashing Outlets, Pawnshops and the Poor (New York, NY, Russell Sage Foundation, 1994).

42 Randall Kroszner, "Fed Aids Minority-Owned Banks (Conference Notes)," National Mortgage News 32.46 (August 25, 2008): 4.

75 percent. But an analysis of ATM locations found that, particularly in cities' "inner rings," high-minority tracts and lower-income tracts had fewer ATMs per capita, and were more likely than their low-minority or high-income counterparts to have no ATMs.[43]

Meanwhile, much as the subprime mortgage boom flourished in underserved markets, a parallel, high-cost market has emerged in retail financial services as well. The last several years have witnessed an explosive growth in the nonbank or fringe financial services industry: payday lenders, check cashers, rent-to-own furniture stores, etc. There are now more check cashers and payday lending outlets than there are McDonald's restaurants, Burger Kings, Target stores, JC Penney's locations, Sears, and Walmarts combined.[44]

An estimated 49 percent of the population is classified as un- or underbanked. These individuals are disproportionately minority, lower income, and renting.[45] Neighborhood characteristics also play a role, with researchers finding that areas with a greater minority share of population and/or lower income are relatively underserved by bank branches and overserved by check cashers and/or payday lenders.[46] In this alternative market, the costs to consumers are high. A Brookings Institution study calculates that lower-income families may spend up to several thousand extra dollars annually for basic financial services.[47]

There is wide agreement that the CRA Service Test offers only weak incentive to reverse this trend, even though it is arguably the aspect best-aligned with the original spatial premise of the CRA.[48] For one thing, the Service Test is open to a high degree of subjectivity and interpretation, making it relatively easy to earn a passing grade. An analysis of almost 2,000 CRA examinations conducted between 1996 and 2002 revealed that only 11 out of 1,500 banks reviewed received a Needs to Improve and none earned a Substantial Noncompliance rating. The study also found inconsistencies across regulatory agencies. It concluded that the Service Test was often used as a 'grade inflator' to boost an institution's overall CRA rating: "…under-performing banks—those on the border between a Needs to Improve and a Satisfactory rating overall—are more likely to receive higher Service Test scores than other institutions…. The higher than expected Service Test scores often gave banks just enough cumulative points (11) to eke out a Satisfactory rating overall."[49] Furthermore, subsequent increases in the asset threshold of exempt institutions in 2005 means that 88 percent of all OTS-regulated institutions and 96 percent of all FDIC-regulated institutions are now exempt from the Service Test.[50]

Updating the CRA

With respect to both mortgage lending and retail financial services, it appears that dual-market problems persist, despite the existence of the CRA. Reverse redlining exists in part because redlining still exists. Of course, the CRA by itself could not have prevented the subprime crisis and cannot single-handedly address discrimination in the provision of capital. Thus, it works in conjunction with many other laws (such as the Equal Credit Opportunity Act, the Fair Housing Act, and the Home Mortgage Disclosure Act).

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43 Stegman, Rocha and Davis, "The Role of Technology in Serving the Unbanked."

44 Howard Karger, Shortchanged: Life and Debt in the Fringe Economy, (San Francisco, CA: Berrett-Koehler Publishers, Inc., 2005).

45 Center for Financial Services Innovation (CFSI), "The CFSI Underbanked Consumer Study, Underbanked Consumer Overview & Market Segments Fact Sheet" (June 8, 2008) available at http://www.cfsinnovation.com/research-paper-detail.php?article_id=330366.

46 See, e.g., Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," Economic Development Quarterly 17:1 (February 2003): 8–32; Mark L. Burkey and Scott P. Simkins. "Factors Affecting the Location of Payday Lending and Traditional Banking Services in North Carolina" Review of Regional Studies 43.2 (2004): 191—205; Graves, "Landscapes of Predation, Landscapes of Neglect: A Location Analysis of Payday Lenders and Banks"; Kolb, "Spatial Analysis of Banks and Check-Cashing Locations in Charlotte, NC."

47 Matt Fellowes, "From Poverty, Opportunity: Putting the Market to Work for Lower Income Families" (Washington, DC: The Brookings Institution Metropolitan Policy Program, 2006).

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

49 Stegman, Cochran and Faris, "Creating a Scorecard for the CRA Service Test," 5.

50 Stegman, Rocha and Davis, "The Role of Technology in Serving the Unbanked."

But our evidence reveals that the CRA is an outstanding (if imperfect) tool. Certainly, the act was not a cause of the current crisis; in fact, it may have mitigated it by keeping many households and banking institutions out of trouble. Further, with adjustments, the CRA can be a key part of the remedy for what is certain to be an upcoming, long-term withdrawal of credit from the hardest hit markets. To summarize some of the things that work well:

- The act's fundamental emphasis on maintaining "safety and soundness."
- The built-in adaptability of the act.
- The incorporation of private participants in defining community needs, regulating "from below," and keeping the regulators accountable.
- Making activity data available in the public domain. This public good not only informs advocacy, it also enables research and continued assessment and refinement of the act.
- The application of tangible goals coupled with effective reporting tools (i.e., HMDA) has had an important hand in improving the provision of sustainable and affordable mortgage financing in particular.

The CRA's Challenges

We now look at specific challenges for the CRA, largely due to the act's failure to keep up with developments in the financial services marketplace. Sanctions are limited and parts of the incentive mechanism, in particular the Service Test, are weak; it overlooks harmful practices; and it does not apply to a great number of financial service activities. In the following paragraphs, we illustrate several of these points and end with a discussion of ways in which the CRA could be strengthened.

Weakening enforcement, limited sanctions—Despite the ongoing need and some promising successes, there are indications that the CRA's influence is declining. In 2008 testimony to the House Financial Service Committee, Ron Homer of Access Capital Strategies lamented, "over the last five years I have noticed a waning of interest on the part of banks in seeking CRA lending and investment opportunities."[51]

The number of exams has fallen dramatically while the share of favorable grades has risen.[52] Furthermore, except for public relations, it is hard to gauge the marginal value of obtaining an Outstanding grade rather than a Satisfactory. As the financial services industry becomes more and more consolidated, opportunities for its biggest negative reinforcement tool—challenges to mergers—are dwindling. In fact, in the current, crisis-driven flurry of consolidation, it appears that the CRA will play virtually no role, and there is a question of how the surviving institutions will be held to its standards.

We noted that the Service Test is fairly ineffectual, highly subjective, and applies only to the largest institutions. It does not account for the many financial services that could potentially serve the "needs of the community," including, for example, small dollar credit and education lending and the expanded services that banks can now offer under the Gramm-Leach-Bliley Act (GLBA).

Harmful practices—The CRA does not discourage counter-productive behaviors by covered institutions though CRA-covered institutions play a role in creating the dual market and have sometimes benefited from it. "Free checking" accounts, which can receive favorable CRA consideration, frequently feature extremely costly courtesy overdraft "protection." In fact, depository institutions charged consumers $36 billion in fees for savings and checking accounts in 2006 and government investigation documented difficulties obtaining fee disclosures at many banks' branches and internet sites.[53] High bank charges are also the primary justification used by the payday lending industry to charge APRs of nearly 400 percent on short-term loans. Furthermore, many banks provide capital to support these high-cost services, acting as wholesale providers of funding, money management services, etc. As Howard Karger attests, "Today's fringe economy is heavily dependent on mainstream financial institutions."[54]

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51 *Ronald A. Homer, "The Community Reinvestment Act: Thirty Years of Accomplishments but Challenges Remain." Statement for the House Committee on Financial Services, February 13, 2008, available at http://www.house.gov/apps/list/hearing/ financialsvcs_dem/ homer021308.pdf.*

52 *According to the FFIEC's CRA Ratings Database, the annual number of exams is roughly one-third the level of that in the early to mid-1990's, and each agency has handed out a diminishing share of Needs to Improve and Substantial Noncompliance ratings which averaged 4.1 percent of ratings since 1990, but only 1.6 percent since 2006.*

53 *GAO, "BANK FEES: Federal Banking Regulators Could Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts."*

54 *Karger, Shortchanged: Life and Debt in the Fringe Economy, 13.*

What's not covered—In 1977, CRA-covered institutions made most of the mortgages and held most of the household savings in the United States. Over time, independent mortgage companies made an increasing share of mortgages, the share of Americans' long-term savings held by CRA-covered institutions declined substantially, and money store businesses came to constitute a large market for basic financial services catering to less affluent households. It is outside the scope of this paper to explore the issue of extending CRA-type rules to other institutions, but we point out that rationalizing the regulatory environment could greatly advance the act's mission. Moreover, regulators have the opportunity to consider such a change as new types of institutions seek federal financial support.

In any case, the lack of regulatory consistency is not just a problem among different types of institutions, but across units of a single institution. Affiliate activity is only included in the CRA exam at the regulated institution's option, creating a loophole that Dan Immergluck illustrates: "If an affiliate redlined lower-income communities, a bank would certainly choose not to have its activities included in its exam. If it happened to be an active lender in lower-income communities, the bank could, after the fact, earn a sort of 'extra credit' by simply opting to include the affiliate's activities….They could funnel their mortgages to upper-income neighborhoods through their mortgage companies and leave the programs geared to low- and moderate-income borrowers in the bank itself."[55]

Moreover, to the extent that banks ration prime credit to certain markets, they create profit opportunities for subsidiaries to market high-cost alternatives. In fact, affiliates of CRA-regulated institutions accounted for 12 to 13 percent of high-cost mortgages.[56] Another loophole concerns certain illegal practices on the part of a bank's affiliate: these will count against the institution only if the bank elects to have its affiliate's lending activity included in the exam, and then only if the illegal activity occurs within the regulated institution's CRA assessment area.[57]

Vertical disintegration in the mortgage market further contributes to misaligned incentives, but we should recognize that many of the various functions required to create, fund and service mortgages are performed somewhere in the span of CRA-covered institutions. For example, there is no scrutiny of how the mortgage servicing function is helping to meet the credit needs of the target communities. In a similar vein, as the GLBA removed walls between financial service providers, more CRA-relevant activities could be evaluated. And, if insurance companies acquire thrifts to access federal assistance,[58] what are the implications for the insurance activities of those institutions?

Then there is the matter of assessment areas. Consolidation, regulatory change, expansion and technology have loosened the geographic constraints once faced by traditional branch banking. As Federal Reserve Board Chairman Bernanke points out, "for some institutions, the concept of 'community' is no longer as clear as it was when the CRA was enacted."[59] It is telling that loans extended by depositories outside their assessment areas were more likely to be higher priced than loans originated within their CRA assessment areas.[60]

We are certainly not breaking new ground to suggest that, despite its built-in flexibility, the CRA has not fully kept up with changes in the industry. Recognizing both the successes of the CRA and its shortcomings in light of these changes is the key to successfully modernizing the act.

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55 *Dan Immergluck, Credit to the Community; Community Reinvestment and Fair Lending Policy in the United States (Armonk, New York: M.E. Sharpe, 2004), 155.*

56 *Canner and Bhutta, "Staff Analysis of the Relationship between the CRA and the Subprime Crisis."*

57 *See Marsico, "The 2004-2005 Amendments to the Community Reinvestment Act Regulations."*

58 *See Ronald D. Orol, "Insurers find path to bailout billions; Acquisition of troubled thrifts offers access to TARP funds," (MarketWatch, Nov 18, 2008), available at http://www.marketwatch.com/m/story/ef7d2a9b-3040-48fc-8da8-f71fd8436e81/0.*

59 *Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges."*

60 *Sandra L. Thompson, "The Community Reinvestment Act: Thirty Years of Accomplishments, But Challenges Remain." Comments made before the Financial Services Committee, U.S. House of Representatives; Washington, DC, February 13, 2008, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/thompson081308.pdf. See also Kevin Park, "Subprime Lending and the Community Reinvestment Act," Working Paper (Joint Center for Housing Studies, Harvard University, November 2008), available at http://www.jchs.harvard.edu/publications/governmentprograms/n08-2_park.pdf.*

Recommendations

In keeping with the spirit of the CRA, our recommendations are provided as broad principles, rather than prescriptive and detailed rules, most of which can be taken up at the regulator level.

- Keep the act fundamentally intact, and seek to build on its strengths.
- Level the regulatory playing field by expanding the scope of activities considered to include affiliates and certain activities outside of the assessment area construct.
- Fine tune the measurements to remain in step with shifting markets. Extending credit that undermines financial security should receive negative (and certainly not positive) consideration. Enhancing the range of possible sanctions to include both positive and punitive consequences will give regulators greater flexibility to implement the act. For example, regulators can vary terms and conditions for bank borrowing, and offer benefits that can partially offset perceived and real costs of expanding services.
- Strengthen the Service Test by evaluating delivery channels based on measures of effectiveness; assessing the quality of outreach and disclosure; incorporating more quantitative measures and benchmarks; and restoring coverage of the Service Test to more institutions.
- Revitalize the public's role. Particularly in light of the current priorities of regulatory agencies, the public can play an important and cost-effective part in advancing the act. This will require that institutions and regulators provide deeper data on a broader set of activities.

In closing, we return to our example of the Community Advantage Program as evidence that, in the long view, meeting the banking and credit needs of the community reinforces and is consistent with safety and soundness. The current mortgage crisis offers some evidence that failure to serve communities' needs can be extremely costly. As Thomas Friedman points out: "We got away from the basics—where the lender and borrower maintain some kind of personal responsibility for, and personal interest in, whether the person receiving the money can actually pay it back…. We need to get back to collaborating the old-fashioned way. That is, people making decisions based on business judgment, experience, prudence, clarity of communications and thinking about how—not just how much."[61]

In the face of financial crisis, Robert Shiller urges strengthening of the social contract.[62] The CRA should be seen as a way to encourage the pursuit of long-term, broad-based strategies for successful and profitable community investment, versus short-term profits that may come at the expense of the broader community. If the CRA can be refined and adapted to the current market context in order to emphasize the former and discourage the latter, it can better fulfill its potential for positive impacts on both communities and institutions. ■

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61 *Thomas L. Friedman, "Why How Matters," New York Times (October 14, 2008), available at http://www.nytimes.com/2008/10/15/opinion/15friedman.html?_r=2.*

62 *Robert Shiller, The Subprime Solution How Today's Subprime Crisis Happened, and What to Do about It (Princeton, New Jersey: Princeton University Press, 2008).*

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It's the Rating, Stupid: A Banker's Perspective on the CRA

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The Community Reinvestment Act (CRA) of 1977 has survived more than three decades of restructuring of the banking industry, of sporadic changes in the regulations, and of an evolution of best practices in community development. The CRA has seen many successes but is now in need of a major overhaul if it is to continue to play a meaningful role in strengthening low- and moderate-income (LMI) communities. This article frames a number of issues that should be considered as part of any process to alter the CRA or expand it to other industries.

I have worked in community development for more than 22 years both in government and in the private sector. As head of Community Development at JPMorgan Chase, where I spent the past 19 years, I witnessed major shifts in how banks oversee their CRA programs and how these changes have affected the way they meet their CRA obligations. While I have been on both sides of the table, as banker and government official, my purpose here is to provide a banker's perspective to illuminate the forces that have affected the CRA and to suggest some principles that could make it more effective.

The first section of this article provides a brief overview of the evolution of the banking and regulatory worlds, while the second highlights some of the problems that have led to inconsistent treatment, trade-offs, and unnecessary or unintended costs of regulations. While some of these problems are inherent in any regulatory process, some are particular to the CRA and so may be easier to reform.

Based on this analysis, the last section outlines some principles that might help guide the future direction for the CRA. Suggested approaches include: more clarity of focus; reevaluating trade-offs implicit in using quantitative versus qualitative tests in the examination process; and redesigning or eliminating some tests and tailoring those remaining to the strengths and skills of the different types of banks. Given the growing disparity over time between the intent of the CRA and those bank activities that receive credit during CRA exams, it is also critical to find a way to facilitate regular updating of the regulations to reflect changes in the structure of the banking industry, in the products it offers, and in the consensus on best practices for community development.

Some Key Facts About the CRA and the Structure of the Banking Industry

The original mandate of the CRA remains unaltered: to encourage federally insured banks and thrifts (hereafter referred to simply as banks) to help meet the credit needs of their communities, including LMI neighborhoods, in a manner consistent with safe and sound banking practices. Subsequently, Congress has added a few key features relevant to the analysis in this article. The 1989 legislation passed in reaction to the savings and loan crisis included requirements to make public the CRA rating based on four categories: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. With the legalization of interstate banking in 1994 came the requirement that regulators issue separate subratings for each multistate metropolitan area and for each state in a bank's assessment areas—that is, those geographies where the bank takes deposits. (Note that deposits in any location may include not only the deposits of local customers but also those of individuals and companies located elsewhere in the United States or internationally. For example, headquarter branches are often the booking location for the accounts of large corporations.) The overall rating for a bank is computed by weighting each of the state and metropolitan ratings according to the locality's share of the institution's total deposits. The 1999

* *The views and opinions expressed in this article are solely those of the author and do not necessarily reflect those of the Ford Foundation.*

legislation to modernize the financial services industry, Gramm-Leach-Bliley, added the condition that a financial holding company must have at least a Satisfactory rating to apply for additional powers. In general, these changes have enhanced public engagement and the accountability of the regulatory system.

Congress left it to the four banking supervisory agencies to interpret and implement the CRA's single-sentence mandate. These four regulators—the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation—work jointly through the Federal Financial Institutions Examination Council (FFIEC) to issue regulations. Each regulator conducts regular exams of the banks under its respective jurisdiction to test for compliance with the CRA and issue ratings. The regulators also evaluate the performance of banks when they apply to merge, open a branch, acquire another institution, or add powers. As part of this process they can hold public hearings to gather additional information not otherwise available. When the regulators deem that a bank fails to comply with the CRA, they can give the institution a less-than-Satisfactory grade on its exam or even delay or deny its application.

The broad discretion granted the regulators has meant they must often accommodate conflicting demands. Community advocates have pushed for tougher requirements and enforcement and many groups have issued reports highly critical of the regulators. Meanwhile, the banking industry has pressed for a decrease in the regulatory burden. Bankers would also like more predictability in the exam process, more precision as to how the ratings are determined, and a more consistent application of the regulations across agencies and even across examiners within each agency to minimize discrepancies from one exam to the next.

Bankers have also sought phase-in periods to incorporate regulatory revisions into their business plans so that they do not lose credit for activities already undertaken. The length of time to complete an exam, often 18 months or longer for a large bank, can create problems when the results reflect a new interpretation of the rules. Since exams are generally administered on a three-year schedule, CRA managers have found themselves having to revise their business plans, often substantially, halfway through the cycle. Finally, regulators themselves want to use their staff more effectively to complete exams in an efficient and timely manner since mergers that have expanded the footprints of large banks have resulted in an increase in the number of geographies that need a separate rating.

The net result of these various pressures has been a greater reliance on quantitative measurements of production volume. A major step in that direction occurred in 1995, when the CRA regulations were rewritten to emphasize "production over process." A three-part test for large retail banks was adopted with 50 percent weighted on lending, 25 percent on community development investments, and 25 percent on retail (i.e., branch locations) and community development services (e.g., financial education). Included in the Lending Test are both home mortgages and small-business loans with community- development lending used only to enhance the lending score—a curious treatment given the intent of the CRA to strengthen LMI communities. The revamped regulations also introduced the concept of Performance Context which allows examiners to take account of local market conditions as well as a bank's business strategy to determine an overall rating. The new regulations also expanded the information available to the public beyond the mortgage data released under the Home Mortgage Disclosure Act (HMDA). Data must now be collected for small-business, farm, and community development loans, and the regulators have devised quantitative tests to measure the adequacy of a bank's loans, investments, and services.

Meanwhile, the large banks have continued to expand, and competition between them and nonbanks has intensified, leading to constant cost cutting and increased scrutiny of product-by-product profitability. CRA programs in these large banks have likewise grown, especially in response to the new focus on volume. As a result, specialized production units have become increasingly visible internally and thus subject to new costs and constraints. These units are now more likely to have to fully bear the time and expense of the standard array of bank audit, compliance, credit, and budget processes. CRA products in general are more likely to be vetted based on the same profitability thresholds as elsewhere in the bank, and staffing levels for CRA activities are regularly reviewed with a focus on nonincome-driving positions. Justification for those CRA activities that do not generate sufficient profits, or any profits at all, now requires a clear showing of their contribution to the bank's CRA rating seperate from whether they are making a difference in the community.

Major technological advances have also made the banking industry more efficient and expanded the markets they can economically serve, increasing access to banking services for LMI individuals and small businesses. ATMs are now ubiquitous and online banking allows account access from most any computer. Innovations in information technology have made highly scalable origination, production, and servicing platforms both feasible and cost effective. Automated underwriting and credit scoring have led to faster decisions and better and less costly risk assessment, which in turn has enabled banks to make smaller loans and to vary pricing based on the riskiness of the borrower. (Although the recent credit crunch may be forcing a recalibration of the risk inherent in lending to a borrower with a given set of characteristics, these systems offer a way to array borrowers along a risk continuum and vary pricing accordingly.) Such advances have allowed the banks to serve people and businesses with a wider range of credit histories, often at lower cost, making them more affordable to LMI individuals and small businesses.

How the CRA Works/Does Not Work Today

This next section lays out some of the issues and problems that have arisen with the CRA and how they have affected the way CRA programs operate, particularly in the larger banks.

The Mission/Intent of the Statute

Subsidizing Products and Services

Missing from the statute or the regulations is a clear statement on whether the CRA's affirmative obligation to expand access to credit also requires banks to permanently subsidize products or services. (The imposition of the CRA is often justified by the special benefits banks receive by being publicly chartered and being eligible for deposit insurance. I leave it to others to determine whether banks receive an incremental profit that should be seen as a basis for the CRA to impose costs on banks.) While the development of new products and markets generally requires some up-front expenditures, ambiguity over whether a bank is expected to continue to provide a product or service that loses money or earns at a rate below the bank's minimum threshold has hurt both the credibility of the CRA and drained resources from other areas that could benefit more from the CRA. Without the prospect of profit, banks are unlikely to make major investments to promote and produce a product on a sustained basis.

Forcing a bank to lower its prices to satisfy a regulatory requirement can give pause even to those who support the idea of an affirmative obligation to find ways to build a business around helping to meet the credit needs of the LMI community. For example, I once had to explain to a senior bank official how our well-developed marketing strategy for home mortgages combined with state-of-the-art products designed to serve the LMI community would not yield a sufficient market share to achieve an Outstanding rating in the CRA exam. He was dumbstruck when I told him that we would need to offer significant subsidies (amounts as high as $8,000 per loan are not uncommon in the marketplace) to write down the interest rate, closing costs, or otherwise reduce the cost to the customer. While he had willingly embraced the principle of serving LMI communities, and indeed had devoted special resources to develop and serve this market, he could not accept that a bank should be forced to offer discounts such that the more loans that were made, the higher the overall loss. Similarly, some banks have felt forced to open branches in LMI communities that are already being served. Indeed, some of these new branches not only have turned out to be unprofitable, but their addition has even undermined the economics of the other preexisting branches. In these circumstances, the CRA only reinforces the false impression that serving these markets inevitably has to be unprofitable.

Subsidies that Expand Access to Credit

In many cases, banks have found it necessary to accept lower-than-normal fees or rates and/or absorb the higher costs of structuring a deal as part of expanding access to credit. Specialized personnel are required to deal with a project complicated by many layers of financing (including federal, state, and local funding) or developed by a local community-based organization that may lack experience in structuring deals or overseeing the construction process. But regulators have not necessarily provided incremental CRA credit commensurate with the additional expense burden. There should be no surprise, then, that the banks favor "standard" deals that also qualify under the CRA but require less or no implicit subsidy. In contrast, even direct support made through philanthropic community development grants receives credit under the Investment Test. However, the weight they receive is often insignificant because the dollar volume of grants often pales in comparison to the dollar volume of investments.

More Activities, Less Weight

Regulators are under constant pressure to broaden the coverage of the CRA, but it is clearly impossible for a single statute and regulatory scheme to resolve all the issues facing LMI communities. In practice, the greater the variety of activities desired, the less weight each gets, thus opening the possibility that some activities will not yield a sufficient payoff to warrant any significant attention by the banks. A recent attempt by the regulators to hold out the potential of CRA credit to spur banks to ramp up their foreclosure-prevention activities provides an illustration of this problem. Unfortunately, foreclosure prevention can only qualify as another community development service, a category that appears to receive only five percent weight in a bank's overall rating. (The other four-fifths of the Service Test, which accounts for 25 percent of the overall rating, relates to the equitable distribution of retail branches.) Moreover, the limits on income (LMI) and geography (assessment areas) inherent in the CRA make it a poor instrument to spur the type of broad-based actions required. Nevertheless, the banks have been well motivated to take action on their own.

Quantification

Numbers Have Become More Important Than Quality

The 1995 rewrite of the regulations steered the CRA toward rewarding dollar and unit volumes rather than focusing on rewarding those deals that do the most to strengthen and revitalize communities. The newly available data on mortgages, small business, and community development loans show this as a growing trend. While this change in approach seemed consistent with the desire of banks for more consistency and predictability, of advocates for setting higher standards of performance, and of regulators to streamline and standardize their reviews, the result turned the exams into more of a quantitative checklist.

This focus on numbers even spilled over into CRA "commitments." During the application process for the regulatory approval of mergers and acquisitions, it was for a time common for banks to announce volume targets for the newly combined institution for mortgage, small business, community development, and other loans and activities. The amounts of these pledges sometimes, but not always, resulted from negotiations with one or more community groups. The increased emphasis on dollar and unit volumes can be seen in the significant jump in the size of pledges made by a number of banks. For example, from the 1995 Chase/Chemical merger to the 2004 merger with Bank One, the size of the commitment rose 40-fold from $18.1 billion (over five years) to $800 billion (over ten years). However, this larger number mainly reflected the inclusion of additional types of loans rather than any significant growth in their specialized core community development program.

Tests Encourage Unproductive Behavior

Although at first the development in 1995 of a more quantitative approach to evaluating performance under the Lending, Investment, and Service Tests of the exam seemed to be an improvement, over time it has become clear that many of the methods chosen to measure performance were fatally flawed. In hindsight, the tests failed to account both for the extent of the opportunity for profitable business and the degree to which a market was otherwise well served. The examiners are technically able to use the Performance Context to adjust the results of their quantitative tests, but numbers still seem to dominate the exam results.

One set of tests that have proved problematic were those based on "market parity." In the case of mortgages, a bank's share of the LMI market would be tested against its share of the non-LMI market. Initially, the adoption of parity seemed appropriate because it appeared to produce the desired result. In fact, however, the market for LMI mortgages had already been growing due to new and innovative underwriting standards that emerged in the wake of the release in the early 1990s of expanded HMDA data. As adoption of these new and innovative underwriting criteria spread across the banks and eventually to Fannie Mae and Freddie Mac, the market became more competitive and thus better served. Nevertheless, the pressure from the CRA continued. As the regulations encouraged banks to achieve even higher LMI market shares, they were forced to offer loans at below-market prices. In rare cases, perhaps banks also may have lowered credit standards, despite the violation of "safety and soundness," as mandated in the 1977 act and the culture of most banks and regulators.

The challenge of achieving LMI market-share targets was made worse by the growth of the nonbank subprime mortgage companies, which captured a large share of that business. Those banks without a subprime lending unit found it increasingly difficult to originate enough loans to achieve their "fair" share of LMI mortgages; even banks with a subprime business often fell short. As a result, many banks turned to a third option: buying LMI loans already originated. Indeed, this approach had been sanctioned by the regulations to encourage growth of a secondary market. Over time, it became clear to bank executives that it was cheaper to trade loans than to subsidize their origination. A well-intentioned policy to persuade banks to meet the credit needs of the LMI community now encouraged the trading of loans that had already been made. A new business was born, though it did nothing to expand access to credit.

Other parity-type tests compare loan performance to nonmarket standards—so-called demographic tests. In evaluating the distribution of branches, for example, the share in LMI neighborhoods is compared to the percent of the population that is LMI. This use of parity has been even more problematic since it ignores any notion of economic viability. To encourage branching in LMI communities is very different from expecting every bank to allocate branches based on the distribution of the population, without regard for the size of the business opportunity or the recognition that people often bank where they work, or access banking services through ATMs, online, or on the phone. The test applies regardless of the circumstances.

Even tests that simply measure the volume of investments or community development loans have created issues by not having clear criteria. For example, when banks have pressured examiners for a standard of how much investment is required for an Outstanding or how much community development lending is required to enhance their rating under the Lending Test, the regulators have responded that the banks need to look to the evaluation of their peers whose exam results have already been made public. While bankers generally suspect that there are unstated standards for community development loans and investments based on a ratio of tier-one capital, the regulators deny such a simple relationship. In addition, the way tier-one capital is allocated accross geographies is problematic. Regulators rely on the distribution of deposits, which, as noted earlier, is not necessarily related to the location of the depositors. When, for example, the headquarter branch of a bank is assigned a disproportionately large amount of tier-one capital based on the amount of corporate or international deposits that are booked there, the expected level of investment or community development lending also rises regardless of the local business opportunity. Banks have found themselves serving a market where the potential falls short of the sum total of the expectations that regulators have for all the banks in a locality.

Although it may seem reasonable to push banks to grow their investment portfolio, it makes no sense to push them to make investments that neither benefit the community nor make a minimal profit. Perhaps the worst case was investments in SBICs, which were granted a "safe harbor" and so received a flurry of investments shortly after the issuance of the 1995 regulations as banks strove to meet the new Investment Test. Overall, these investments had little or no impact on LMI communities and provided little or no return to the banks.

The lack of reasonable, clear-cut criteria has also placed greater reliance on examiners and examiner training and has made it hard for CRA officers to set internal goals. An examiner may expect more than is reasonably possible in a given market, which only makes the CRA officer's job harder. This fact also makes it harder to determine if the benefits of an Outstanding exceed the costs (see discussion below).

While the addition of such qualitative criteria as innovation, complexity, responsiveness, and Performance Context were intended to allow for more nuanced judgments, the reality has been disappointing. These criteria all make sense if the mission of the CRA is to encourage banks to expand access to credit—consistent with their strategy, skills, and the varying opportunities that exist in each local market. In practice, however, quantitative tests tend to dominate the exam process perhaps because examiners either lack the authority to give qualitative factors the appropriate weight or because they naturally gravitate toward quantifiable measures that are easier to defend. It may just be hard to sustain the importance of qualitative factors when the quantification option exists. The result has been that projects that have great community impact may not go forward simply because a bank will not receive credit sufficient to justify the effort required.

It's the Rating, Stupid

Banks have increasingly focused on only those activities that count toward the rating, regardless of their impact on strengthening communities. As a result banks generally limit the availability of CRA products that do not achieve minimum profitability thresholds. For example, mortgage products that require subsidy or mortgage counseling grants are rarely offered outside a bank's assessment area. Similarly, loans that require the specialized skills of a community development lending officer are rarely done outside a bank's assessment area, even though the market may be underserved and the borrower is otherwise a regular customer. The result has limited the availability of financing, especially in smaller and more remote communities. Even within assessment areas, the increase in cost pressures combined with the movement toward a quantitative checklist has led banks to focus only on the exact types of loans that count for the rating and take a pass on other loans that would strengthen the community.

A Shrinking Universe of Products

More Reliance on Products with Economies of Scale

Over time, CRA programs at the larger banks have gravitated toward using mainstream business units (their mortgage companies, retail branch networks, etc.) in part in response to the need to meet the higher-volume targets. Further contributing to this trend has been the ability to leverage existing mass-market underwriting, production, and servicing platforms and the increasing cost of operating a separate CRA production facility. In the end, the skills, products, and systems of a bank's mainstream business units have often proved sufficient to attain the desired CRA rating. These units generally have achieved the volume required at minimum cost and, in some cases, at a profit. Only in the case of community development services has it been difficult to rely solely on a mainstream unit to meet the goal. The good news for the LMI community is that these products are generally well marketed to reach a broad customer base and benefit from investments in new technology, which leads to product improvements and, in some cases, even declining prices.

On the downside, the more that mainstream units have built their business around high-volume products, the more difficult it is to develop products or services expressly for the LMI marketplace. This reliance on mainstream business units has also complicated banks' internal management of their CRA programs. Now the CRA officer must negotiate goals with each of their bank's mainstream business units. Not surprisingly, the managers of these units resist anything that impairs profitability or undermines their business strategies.

Harder to Develop Niche Products or Do Complex and Innovative Deals

Business unit managers are reluctant to develop what they perceive to be unprofitable local or niche products. Even with community development real estate loans, where each loan is separately evaluated and underwritten, obtaining approval for unorthodox loans often depends on experienced credit officers who understand, for example, how government involvement can help to mitigate risk. As the number of credit officers with this special expertise has fallen, the process of justifying the credit quality of these loans has become continuous and unrelenting, despite a proven track record of high credit quality. As a result, loan officers migrate away from complicated, one-off deals that often do the most to expand access to credit.

Adding to the difficulty of developing niche or specialized products has been the passage of Sarbanes-Oxley, which imposed stricter accounting standards following the Enron debacle. For example, some banks use their foundations to make zero- or low-interest loans, much in the tradition of PRIs—Program Related Investments—made by private foundations. Now these programs have been brought under the bank's standard loan documentation, review procedures, and borrower-by-borrower limits on maximum credit exposure. The result has been to reduce the ability to use these programs for such purposes as predevelopment loans or low-cost funding for third-party loan pools.

As LMI products have devolved to mainstream businesses, the number of banks with separate, specialized units to meet the production requirements of the CRA has diminished. These units often served as a source of innovation. Two factors seem to account for the change: first, their production may no longer be necessary to meet the volume targets; and second, their ability to turn a profit on lending activities has been hurt by the increased costs resulting from greater scrutiny for credit quality, profitability, and other compliance requirements. By their nature, these units have always faced profitability challenges because their loans tend to be smaller and more complex—often with funding from multiple layers of government—and generally involve less-sophisticated borrowers. These units have also absorbed the costs inherent in incubating new products, which, in many cases, eventually migrated to mainstream businesses. Such products range from mortgages that responded to the characteristics of the LMI borrower to loans under the Small Business Administration (SBA) Express program.

Even where separate, specialized units continue to exist, they are finding it increasingly difficult to attract the required resources to develop new products. While active support from the top of the institution played a critical role in the establishment of these special units, the adoption of a more quantitative checklist approach to the CRA has seemingly contributed to the marked decrease in engagement by senior management at many banks.

More Difficult to Form Working Partnerships

Some of the best innovations spurred by the CRA have come as a result of working partnerships between banks, community-based organizations, and government. These partnerships have benefited by having people with the ability and authority to assemble complicated deals and the personal relationships necessary to develop trust between banks and community-based organizations. Working with other banks has also become harder as competition and rivalry for CRA credit has made it more difficult to collaborate.

Since centralized community development units often took the lead in working with others to help find creative ways to finance affordable housing and, more generally, community development, their absence leaves a void. With all business units under cost pressure, it has also even become more difficult to draw upon expertise from elsewhere within the bank to help with this task. Moreover, staff cuts have made it more difficult for the remaining bank employees to devote significant commitments of time to community activities.

The Growing Disparity Between the Regulations and the Real World

Markets Have Changed

Over time, some previously underserved markets have become better served. The pressure from the CRA, along with technological advances that have automated much of the approval process and lowered costs, has brought more products to the LMI marketplace. By the late 1990s, for example, many banks offered standard mortgages that worked for LMI borrowers. Similarly, prior concerns about the ability of small businesses to get loans have been, at least partially, addressed by new technology, which has allowed risk-based pricing and a lowering of minimum loan sizes. Yet, the CRA continues to push banks to focus on these same markets even though it may no longer be helping to expand access to credit but, rather, encouraging banks to take actions that make these markets uneconomical to serve.

Community Development Best Practices Have Changed

As financial markets and the banking world have continued to evolve, CRA regulations and Q&As (a vehicle used by regulators to explain how to apply the regulations to specific situations) have struggled to keep pace. The problems created by this delay are accentuated as best practices in community development have also evolved, gravitating toward a focus on mixed-income and mixed-use projects and comprehensive approaches that include workforce development, jobs, education, health, and safety. For example, in order to receive credit for an affordable housing loan outside a LMI census tract, a majority of the occupants must be low and moderate income. Yet, the current thinking is that mixed-income projects provide the best environment for low-income families, and some governments even use inclusionary zoning to reward builders if they include 10–30 percent subsidized units in projects that are otherwise market rate. In some communities, these projects create the preponderance of affordable housing, but banks often receive no credit (not even proportional credit) for the low- and moderate-income units constructed. (Update: on January 6, 2009 the regulators put out for comment a proposed Q&A that would allow for proportional credit.)

The treatment of grants is another example where the rules may not reflect the best practice to strengthen communities. Many grants for activities that are critical to the success of communities are given little weight or do not count at all. At best, they are included under the Investment Test, so their dollar volume pales in comparison to the dollar value of investments. Interestingly, although grants are more costly in that they do not offer the possibility of a direct monetary return, they earn less CRA credit than investments that can continue to qualify under the Investment Test in subsequent exams as long as they remain in the bank's portfolio.

Regulatory Drift

As with any regulatory system, ongoing interpretations and clarifications in response to requests from banks and advocates have resulted in a further disjunction between the CRA rules and reality. For example, letters of credit and loans/investments to third-party intermediaries have resisted efforts to align the regulations with common-sense approaches to strengthen communities. Letters of credit back bonds that finance affordable housing. Even though they are integral to the financing and have the same credit risk as a direct loan, the regulations treat letters of credit separately and the examiners appear to give them less value.

As for third-party intermediaries (such as CDFIs), they often offer specialized expertise that no single bank would find economical to do on its own in providing lending or investment products to the LMI community across wide geographies that include smaller communities in rural and urban areas. In these cases, they provide an excellent way for small banks to diversify risk across a larger geography than the bank could do on its own—presumably a good idea from a safety and soundness perspective. Yet, loans and investments to these third-party funds are valued less than direct loans and investments, unless the third-party has all of its activities within the bank's assessment areas. Although examiners interpret the rules differently, the latest attempt to clarify has been stalled as the agencies continue to disagree over the size of "a broader statewide or regional area that includes the bank's assessment area," and how much weight to give loans or investments that fall outside a bank's assessment area. This lack of guidance has led banks to retreat from multi-investor, multigeography loans or investment pools. (Update: On January 9, 2009, the regulators finalized a Q&A that explicitly recognizes the importance of nationwide funds and provides examiners with some additional flexibility to give credit for investments in them.)

Perpetuation of Inconsistent Treatment

Sometimes different regulators come to different decisions with regard to the CRA eligibility of specific projects or classes of projects. However, rather than resolve these differences at the FFIEC level, these variations across agencies tend to linger. The problem of regulatory inconsistency is further aggravated by the efforts of some states to impose their own CRA-type regulation, which may or may not mirror the federal rules.

Cost/Benefit Analysis

CRA Costs

Since we often focus on the benefits of the CRA, it is too easy to forget its costs. We have already seen that the CRA can lead to below-market pricing, to extra production costs, and to unexpected and unintended consequences. Another set of costs that is not often appreciated is the expense incurred by the administration of the compliance process itself. Banks must assign special staff to oversee their compliance programs, including the gathering, processing, and publication of the required data. While these activities may sound routine, they can be expensive, particularly when additional fact checkers are needed to re-review thousands of loans to check the validity of data that, while they may be collected, are not critical to the approval process.

Moreover, the collection of data that are irrelevant to the loan-approval process can offend customers (for example, information on race or ethnicity), particularly when their anonymity cannot be guaranteed. Indeed, this has been a problem with HMDA data, where researchers have reported matching over 80 percent of the mortgages to actual street addresses using readily available data sources from third-party suppliers. Another concern is the potential cost from spurious lawsuits using publicly available data. From the government perspective, the CRA also imposes costs on the regulatory system to cover the staffing needed to review data and conduct exams of the banks.

A different type of cost results from the creation or reinforcement of negative perceptions of the viability of serving LMI markets. For example, the lack of profitability at many LMI branches that banks have felt a need to open and the need to subsidize LMI mortgages have reinforced and perpetuated the impression that serving the LMI community can never be profitable for banks.

Another unintended consequence of the CRA has been to dampen the enthusiasm of banks to enter LMI markets when the price the banks need to charge to cover their costs is higher than the advocates would like. Low-priced products for low-income customers certainly have appeal, but the reality of serving those customers sometimes requires higher prices, not lower ones. The result has been that banks simply back away and do not offer a product, even when they could do so at a price point that is lower than that of the current, nonbank providers.

While support for not-for-profit organizations has been critical to the productive partnerships between banks and the community, banks have felt at times under pressure to incur additional costs. Early in the life of the CRA, many banks had the impression that they could not obtain regulatory approval of a merger or acquisition unless they made all the advocates "go away happy." This sense, valid or not, of how the process worked helped create the notion that community groups had great leeway in what they could demand. Fortunately, the regulators have helped to address this concern as they have become better able to distinguish among the different groups and assess for themselves which ones and which issues are legitimate.

The Shrinking Net Benefit of an Outstanding

Many banks still seek an Outstanding rating despite significantly higher costs than for a Satisfactory. While it may be theoretically possible for a bank to achieve an Outstanding with only profitable activities, the reality is likely to be quite the opposite, thus regularly prompting senior management to question whether the higher rating is worth the expense. Estimating both the costs and benefits is difficult as the lack of clarity of what is required for an Outstanding usually leads to an overestimation of the cost, thus disadvantaging the Outstanding option. A further shortcoming is the lack of evidence that the highest rating draws new customers. An Outstanding rating can have value, though, in mitigating negative comments that are an inevitable part of the public process for reviewing applications.

One reason banks pursue an Outstanding appears to be the natural competitiveness to match or exceed their peers. Most, if not all, of the large banks have pursued this goal. In this light, the efforts by advocates to make it more difficult for banks to get an Outstanding may be counterproductive if ratings of Satisfactory become more common and thus more acceptable. As fewer banks pursue an Outstanding, fewer resources will be devoted to the costly process of developing and testing new ideas for products and services to serve the LMI community.

Principles for the Future

These observations on how the management of the CRA has evolved suggest a number of principles that could increase the CRA's effectiveness and lower its cost.

The Mission

Keep It Focused

The language in the 1977 CRA statute allows great flexibility, but it complicates the job of the regulators. Without more parameters limiting the scope, regulators will continue to be pushed to expand the CRA to cover more and more activities with the likely outcome that completing exams in a thoughtful and timely manner will be impossible and that some activities will simply be ignored as banks concentrate only on those activities that get significant weighting in the overall rating.

Also, the statute needs to give more clarity to such fundamental issues as to whether the goal of the CRA is to see that markets are well served or to make sure every bank has a certain share of that market regardless of profitability. At the same time, the statute should avoid specifying details that will likely need to be updated frequently to remain responsive to future developments in the industry and community development.

This concern for clarity should be considered as part of any legislation to expand the CRA to other industries. While the idea of imposing an affirmative obligation may sound appealing, a broad statement provides little guidance for what types of activities or products should be monitored or required.

The CRA is not a Panacea

While it may seem appealing to try to use the CRA to address a wide range of social and economic problems, such an effort can be self defeating, especially when the actions that need to be taken are known. The success of the CRA legislation has in part been due to its aspirational nature and the sparsity of specifics. However, in the case where it is clear what needs to be done, legislation that is more targeted is likely to be much more effective. Looking to the CRA as the solution may simply delay the adoption of the type of legislation or regulations that are needed. Furthermore, every extension of the CRA runs the risk of diverting attention and resources that are presumably already being effectively used.

This danger can arise both when broadening the role of the CRA for banks as well as when looking to expand its coverage to all players engaged in the same activity. For example, advocates have wanted to expand the CRA beyond LMI to explicitly cover race and ethnicity. Yet, legislation already exists to cover discrimination and the regulators conduct separate exams to test for compliance under the Equal Credit Opportunity Act and the Fair Housing Act. If these laws are inadequate then they should be amended. In any case, CRA examiners are required to take note of any compliance problems found in those fair lending exams in determining a bank's overall CRA rating. Looking to the regulators to add further tests and standards to the CRA for discrimination seems unlikely to add much value (especially since minorities are already disproportionately represented in LMI communities), and yet it would place more of a burden on the regulatory system and on the banks as it adds further complexity and delay in completing an exam.

Similarly, advocates seem to feel that expanding the CRA to other players in the mortgage business, e.g., brokers, would somehow be an effective way to address existing problems. However, there is a much more direct way to bring uniformity to the industry and that would be to enact specific, targeted legislation that clearly covers all the players in a mortgage transaction (and not just those that happen to be covered by the CRA) and lays out the necessary rules and procedures. If such special-purpose legislation is already in place but requires regulatory action, then the focus should be to ensure that the existing delegated authority is exercised as has happened recently with new regulations promulgated by the Federal Reserve.

Build on the Natural Strengths and Skills of Banks

While it seems obvious, it is worth noting that banks cannot solve all the problems of LMI communities. However, banks and bankers have many skills that are of value and by focusing on those, the CRA is most likely to meet with success. Bankers, like others, are best able to help when they are able to use their skills and experience to develop new products and services. Success in these efforts yields a sense of pride and a willingness to do more.

Is Credit the Right Focus?

It may be time to reexamine the mission embodied in the original statute that focuses only on credit as a way to revitalize and strengthen LMI communities. Given the increased availability of all types of credit at all income levels (at least until this latest credit crunch), it may be a good time to consider transaction, savings, or other products and services for the unbanked or underbanked.

Quantity versus Quality

Reconsider the Checklist Approach

Even with a clear mission, implementation can be daunting. As we have seen with the existing CRA, regulators have increasingly turned the examination process into a checklist based on numbers. While this practice expedites the exams, simplifies examiner training, and may offer a defense against inconsistency, it also has implications for product development and working with other banks and community groups. If the specialized units and the support of senior management are critical to the effectiveness of the CRA, then more emphasis is needed on innovation, responsiveness, complexity, and partnerships with community-based organizations and intermediaries.

Vary the Exam Criteria across Types of Firms and Geographies

Different types of banks have different capabilities, and the criteria used to judge their CRA performance should reflect those abilities. Although the Performance Context could be used to recognize these differences, it has not been well applied. The creation of additional industry subcategories, each with their own type of exam, may make it possible to increase the effectiveness of the CRA and reduce the regulatory burden. Large banks with national footprints have skills that differ from those of large regional banks, which in turn can be distinguished from small banks that serve either specific subsegments of large markets or are the only local bank serving the community.

Varying the CRA tests across geographies if regulation is extended beyond assessment areas should also be considered. For example, if the extension is based on the degree of mortgage lending in a community, then it may not make sense to apply the full three-part test in those geographies where the bank has, at most, one or more mortgage loan officers on the ground.

Reconsider the Role of Deposits from Nonlocal Individuals and Institutions

Since the geographical distribution of a bank's deposits are used both to weight the local/state ratings when calculating the overall rating for the institution and to allocate tier-one capital across geographies (as noted earlier, tier-one capital appears to be used as a gauge of how much community development lending and investing is expected from a bank), it may be more consistent with the original intent of the CRA to consider only those deposits (and its associated tier-one capital) that come from individuals or institutions in that community.

Fix or Eliminate Tests

Eliminating requirements and tests that push banks to intensify their efforts even in markets that are being well served should be considered. To paraphrase a long-known truism, "you get what you measure;" the design of a test is critical to accomplishing the intended goal. If you measure market share, then banks will compete for market share at the lowest possible cost, and thus may focus on activities that have little in common with the intent of the CRA. Moreover, poorly designed tests can have negative, unintended consequences that may more than offset any benefits.

Update the Regulations Regularly, but the Statute Only On Occasions When the Mission Needs To Be Clarified or Changed

Legislation versus Regulation

In a world where nothing stands still it makes sense to restrict the statute to the basic mission and leave the implementation to the regulations, updating them regularly to account for the changes in the products offered to the LMI marketplace.

Facilitate the Updating of the Regulations

To keep the regulations current and minimize the need for examiners to make difficult judgments during exams, a better process for revising the regulations needs to be developed. Changes need to be phased in slowly to allow the banks enough time to revise and execute their business plans for managing the CRA in advance of their preparations for the next exam.

Guard against Regulatory Drift

As the regulators continue to refine the definitions and create "bright lines," it is essential to check periodically for consistency with the mission of the CRA and not just with prior regulations and rulings. Otherwise the regulations can drift away from the goal of strengthening communities.

Incentives

Reward Costly Efforts to Expand Access to Credit

By their nature, efforts by banks to expand access to credit in LMI communities are costly, resulting in a lower profit margin or even a net loss. The government should consider providing incentives to offset these low margins. One approach would simply provide financial subsidies to close the economic gap as government has done in its long and successful record of subsidizing affordable housing. Alternatively, banks that achieve an Outstanding rating could be allowed some sort of financial (perhaps lower deposit insurance premiums) or regulatory relief (such as more time between exams, a safe harbor when applying for new powers, etc.). Similarly, the issue of incentives needs to be considered before imposing CRA-type requirements on other industries.

Weed Out Inappropriate Disincentives

Even if its incentives are costly, it is important that the regulations do not inhibit behavior that helps strengthen communities. If, for example, third-party intermediaries are a desirable way to expand access to credit for LMI communities, then the existing disincentives for lending or investing in multigeography funds need to be remedied. It is essential to ensure that a loan or investment made gets full credit. Similarly, if community development services provided by community groups are valuable, then grants for this purpose should receive more weight in the overall exam than is given to grants alone.

Accountability and Enforcement

If the CRA is to remain effective, accountability and enforcement are critical. Today, these occur through a combination of regulatory action and public comments designed to cast a spotlight on the records of both the banks and their regulators. When regulators conduct their regular examinations or their mandatory reviews of banks when they apply to merge, acquire, or gain new powers, the public, including the advocates, gets to play a role. However, if merger and acquisition activity diminishes, then the effectiveness of public involvement may diminish as enforcement is reduced to the publication of the CRA ratings, an event that no longer seems to garner much public attention. For other industries, the problem of ensuring accountability could be even greater if individual firms are not subject to regular supervision and examination.

Training and Consistency

Whether the examiners are following a quantitative checklist or have substantial discretion, comprehensive and continuous training is critical to ensure the consistency of outcomes across banks and over time.

Make Sure Benefits Exceed Costs

While the CRA has laudable intentions, the ultimate test of its worthiness is whether it yields social and private benefits that exceed its costs. The monetary costs to banks and regulators depend on the profitability of

CRA activities, the amount and type of data collection required, the difficulties of conducting and processing the exam, and the hiring of staff. The same assessment of benefits versus social and private costs should be conducted before any decision is made to add requirements for the banks or to expand CRA-like requirements to other industries.

Conclusion

The CRA is in need of a serious revamp. The last three decades have witnessed significant changes not only in the banking industry but also in response to the predictable pressures on and from the key stakeholders—the bankers, the community advocates, and the regulators themselves. One key result has been a movement toward more quantifiable measures of production. These measures have had unintended consequences as well, reducing the incentives for banks to offer products that can be more complicated and costly to produce but may be effective in expanding access to credit to LMI individuals and communities. Any reform that simply piles on additional requirements or expands CRA-like criteria to other industries without considering these past experiences would be missing an opportunity to make it more effective at potentially less cost.

LMI communities and individuals face a wide range of problems, but the CRA cannot solve them all. Some hard analysis is required in order to determine what the CRA does best and what, for example, might be better done by other, more targeted legislation or regulations that can more easily cover all the relevant players. Another direction for inquiry is whether the CRA should focus on bank products other than credit—for example, transaction or savings accounts. The revamped CRA should also be clearer as to the burden that it expects banks to absorb, and more specifically whether bank profitability and long-term sustainability should be criteria in determining what is expected. Given the reality that not all the activities required as a matter of public policy will be profitable, it becomes particularly essential to be clear about what earns credit under the CRA and to make sure the rewards and sanctions are aligned with those objectives. ■

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The Community Reinvestment Act at 30 Years

The American Bankers Association[1]

Banks are in the business of financial intermediation—of bringing together those with capital and those who need capital. We do not build communities on our own, but it is fair to say that few communities in America are built—and none prospers—without banks playing their important role of putting savings to work. That is to say, our role is to help individuals and businesses build communities, of all sizes—and we compete vigorously among ourselves for the privilege. Drill down in a CRA Public Evaluation and you will read about how we compete across all income levels and all neighborhoods. Accordingly, we at the American Bankers Association (ABA) are pleased to share our views and observations on the operation of the Community Reinvestment Act (CRA).

Although initially introduced with more prescriptive standards, the CRA ultimately was passed in a form that recognized that banks best serve their entire communities by making new capital and credit available, rather than by being limited to returning the resources of one narrowly defined service area back to that same service area. A neighborhood of limited means needs access to more resources than just what their residents currently can make available themselves. Similarly, other neighborhoods may produce a surplus of savings, significantly more than can be profitably invested close to home. As finalized, the CRA recognized that reality and afforded banks a more flexible framework within which to work to demonstrate their record of helping meet "the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions." In other words, there is an important balance in the statute that, if ignored, harms both the communities involved and the financial institutions that serve them.

No more succinct evidence that the CRA today better reflects banks' success in serving the credit needs of their local communities can be cited than to observe that 98 percent of banks and savings associations receive composite CRA ratings of Satisfactory or better. Some may scoff at this achievement, but the fundamental truth is that banks are tested—and disciplined—in the marketplace every day to demonstrate their responsiveness to the needs of their local communities. Those that do not serve the credit needs of their entire community do not prosper. It is therefore not surprising that the banking industry, alone in its extensive documentation of community service, excels at satisfying community credit needs.

The American Bankers Association believes that bank compliance with the spirit and letter of the Community Reinvestment Act is healthy, reflecting the fact that bankers, regulators, and community groups have all learned from one another over the past 30 years. Forging partnerships and developing a deeper understanding of the perspectives of all parties has led to an open and effective system that now more accurately reflects banks' involvement in serving their entire communities. This evolution has not been without difficulties, but it has led to improvements. In marking the milestone of the Community Reinvestment Act's 30th anniversary, we think that it is valuable to look back on its maturation, consider its current state, and look forward to its prospects.

Background

The Beginnings of the CRA

The Community Reinvestment Act was enacted by Congress in 1977 for the stated purpose of encouraging financial institutions to help meet the credit needs of their local communities. It is a relatively simple mandate to the banking regulators to assess the record of depository institutions in meeting the credit needs of their entire community. Since its enactment, there have been relatively few amendments to the law: requiring a

1 *The American Bankers Association (ABA) brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and to strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over two million men and women. ABA wishes to recognize the work of staff members James Ballentine, Richard Riese, Paul Smith, and Deanne Marino in preparing this paper.*

Public Evaluation; requiring multistate examinations to include state-by-state CRA analysis; allowing regulators to give credit for investments in minority- and women-owned banks; requiring Satisfactory or better CRA ratings in order for a bank holding company to become a financial holding company; and providing some modest regulatory relief for small banks. These amendments have not fundamentally changed the initial charge of the statute: regulators should encourage and evaluate the efforts of their regulated institutions to help meet the credit needs of their communities.

Revisions to the CRA regulatory process have been much more extensive. The initial attempt of bank regulators to meet the mandate of the act put the emphasis on process rather than outcomes. Banks were assessed on 12 factors that had more to do with getting through compliance wickets than with actually delivering credit into local neighborhoods to the citizens and businesses that needed the capital. The CRA examination process became a compliance paper trail for recording the business that banks would ordinarily do without a mandate.

The CRA Becomes an Open Process, More Changes as a Result

The CRA process now is more transparent. This was not always the case. Beginning with the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the process was opened to community members, shareholders, bankers, and the regulators themselves. As more stakeholders became aware of different pieces of the puzzle, some became dissatisfied. This dissatisfaction on the part of bankers, community activists, and regulators led to significant changes in the regulatory requirements under the CRA and to the examination process itself. Among the changes included in new regulations issued in 1995 were the recognition that CRA evaluations should be streamlined for small banks; that performance by larger banks could be achieved by providing loans, investments, and services; that all banks operated in a context taking into consideration their capabilities and their markets; and that what constituted community development should be pegged to activities with favorable impact on specified underserved market segments.

The CRA Today

The post-1995 CRA examination process reflects banks' contributions to their communities far better than the old examination procedures, fostering recognition of the level of community-based lending banks have always engaged in. This process better balances the documentation requirements and performance of large and small banks; it augments its mandate to include visibility into antidiscrimination acts of banks; and it preserves the primacy of financially safe and sound operations.

Transparent: The fact that you can read about the performance of every bank in this country is no small feat. The availability of the bank's CRA Public Evaluation is now combined with the regulation's open solicitation to the community to comment on the institution's CRA performance. This transparency in the CRA process offers significant opportunity for community residents and groups to comment.

Balanced: By differentiating between large banks and small banks, the regulations have better balanced documentation and reporting requirements with measurement of performance. More than 88 percent of the banking assets of the nation fall under the more detailed Large Bank examination procedures; at the same time, more than 90 percent of banks by number that represent less than 12 percent of industry assets are spared certain reporting burdens because their performance evaluated is based on simplified criteria. Nevertheless, more can and should be done in this regard.

Inclusive: The CRA is not an antidiscrimination statute in the way that the Fair Housing Act or the Equal Credit Opportunity Act prohibit discrimination in lending. The regulators have added to the CRA examination process a requirement that will account for any evidence of illegal discrimination in lending or other illegal consumer credit practices. The bank regulators have done so under the argument that illegal or discriminatory credit practices cannot be said to help meet the credit needs of a community, but rather the reverse. Banks and savings institutions, unlike other lenders, are regularly examined for their compliance with fair-lending and consumer-protection laws, such as the Truth in Lending Act and federal law that prohibits unfair or deceptive acts and practices. Agencies thus have a record of the bank's compliance with these laws when the regulator conducts a CRA examination. Mandatory inclusion in the CRA Public Evaluation of a negative finding by examiners, resulting in a downgrade in the CRA rating, brings greater visibility to the fair-lending record of banks and savings associations than is seen in other, less-scrutinized sectors of the mortgage market.

Financially Sound: The CRA emphasizes that serving the needs of the community must be consistent with the safe and sound operation of the institution. Banks are long-term institutions, invested in the long-term growth and prosperity of their cities, towns, and neighborhoods. A bank that sacrifices its financial health compromises its ability to serve its community. The history of CRA performance makes the point that sustainable progress on community development takes place only when banks and savings associations conduct their activities in a financially sound manner. The law and the regulations recognize this fundamental requirement—and the examination of institution performance cannot lose sight of this mandate when considering the context in which banks are evaluated.

The CRA process today is more reflective of the many ways that banks invest in and serve their communities consistent with a safe and sound operation.

CRA Process Improvement

The CRA examination process is one that has generally improved over time, in particular by balancing the burden between smaller and larger institutions, enlarging the range of lending that receives CRA credit in rural communities, and requiring consideration of discriminatory lending or violations of consumer credit-protection laws. Given the transparency of the evaluation process and the many avenues in which the interested public can comment, provide input, or criticize that public record, the CRA needs no other enforcement mechanism.

The CRA regulatory process must continue to evolve to meet changing markets and participants. We believe that improvements can be made in several major areas:

- Simplify the regulatory process to reduce any unnecessary burden, including updating the threshold for the Large Bank CRA exam program.
- Add flexibility to the regulations to encourage creativity and innovation by institutions to meet the credit needs of their particular communities, including financial education efforts.
- Recognize the value of the many ways in which banks support minority-owned depository institutions.

Simplify the Regulatory Process

In many ways, the CRA regulations and examination are still too complex. Bankers are required to know not only the ins and outs of the CRA regulations but also the more complex specifics of the supplementary guidance that regulators offer in the CRA Questions and Answers (Q&As). It is notable that the Q&As are considerably longer and more detailed than the CRA regulations, and they are much harder to use. The regulators have proposed a revision of the last Q&As from 2001 and they are now available for public comment.

Another example of the drift into complexity came with the recent revisions to the CRA regulations rebalancing the definition of a Small Bank so as to relieve such institutions from unnecessary burdens. Based on FDIC data, banks with over $1 billion in assets accounted for 88.3 percent of industry assets as of September 30, 2007. Proportionately and in absolute dollars, more banking assets are covered by the $1 billion large-institution test today than were covered in 1995 (80 percent), when the Small Bank/Large Bank distinction was first established and set at $250 million in assets. While this change was an excellent example of the evolution of the CRA regulations, we note that in making this change the banking agencies added an entirely new CRA examination: the Intermediate Small Bank CRA Examination. To go from the simplicity of two examinations—one for small banks and one for large banks—to three examinations, with the new one containing a wholly new approach to assessing community development activities, was simply an unnecessary complication of already-complicated regulations. Periodically updating the threshold so that it is pegged at a level that captures 80 percent of banking industry assets within the large-institution test, and eliminating the intermediate examination, would reduce burden without in any way reducing performance.

Add Flexibility

The regulations and examination process should encourage institutions to be responsive to changing markets rather than simply preserving a standardization to make measurement easier for the examiner. As a specific example, the definitions used to determine whether a loan, investment, or service is community development that qualifies for CRA credit are still too complex and narrow in scope. For example, bankers, members of Congress, and communities know that many of our citizens need a much higher level of financial literacy to function well in our complex economy. Many banks in fact participate in providing financial literacy training—training that benefits the entire community—by educating the general public on how to save, budget, use credit wisely, evaluate financial-services offers, and qualify to buy a home. Bankers also are leaders in bringing financial education programs into the schoolroom. However, under the CRA regulations, many of these factors are not recognized as having a CRA value, because the training does not fit the rather narrow restrictions requiring that any program document that a majority of the participants are low- or moderate-income residents. Frankly, proving such an impact can be daunting for bankers in the community. More important, this restriction fails to recognize how our financial markets have evolved and how broad the need is to establish financial literacy in all economic and educational strata of our society. In this case, and in others, CRA evaluations need to be more flexible to allow for—if not encourage—banks to be creative and innovative in meeting the credit needs of their communities.

Recognize the Value of Supporting Minority-Owned Institutions

The CRA review process needs to recognize more fully the value added through the specialized expertise bankers develop in meeting their community development needs. For example, minority-owned institutions were pioneers in helping underserved neighborhoods before the CRA existed, and their perseverance in serving those markets has made them worthy partners in leading further efforts to build stronger, more economically vibrant communities. It is past time for the agencies to adopt regulations that recognize—and thereby encourage—the investments in, and support of, minority institutions by majority institutions, something that Congress authorized 15 years ago but still is not implemented in the CRA process. While we welcome the additional guidance on minority-owned institutions included in the January 2009 Q&As, it is important to incorporate this in the actual rules.

Beyond the CRA

In the 30 years that have passed since the adoption of the CRA, the market for credit and for financial assets has continued to diversify. Although the CRA itself is tailored to the banking industry, its core concepts of helping to meet the financial needs of one's entire community, applying standardized but flexible criteria to measure performance, and providing public visibility for the resulting evaluation are applicable to other sectors. For example, credit unions have a specific charter mission to serve persons of modest means, but they are not subject to any regular, objective testing as to whether they are actually meeting their mission. This issue becomes increasingly important as many credit unions seek community-based charters. Of course, the CRA in its current regulatory detail should not be applied "as is" to other financial sectors; rather, we see that the appropriate level of objective, measurable performance documentation combined with a high degree of transparency can be a model for other regulators to encourage their depository institutions to demonstrate their commitment to the communities they are chartered to serve.

Conclusion

Bankers are committed to making credit available to the communities in which they operate. This commitment is part of the very business of banking. The CRA process documents and makes that commitment visible to the entire community. The many refinements that have been made over the last 30 years have improved this visibility. However, in striving to meet regulatory tests and processes in achieving this goal, institutions and regulators alike must embrace the challenges that the development of new technologies, delivery systems, and methods of operation present. ABA appreciates working together with bank regulators to face these challenges, and we seek to continue to work together to improve our effectiveness in this process while minimizing the unnecessary burdens that the process can sometimes impose. ■

A Tradable Obligation Approach to the Community Reinvestment Act

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In articles published in 1994 and 1995, I proposed that the Community Reinvestment Act (CRA) be modified to allow banks to trade their CRA obligations with one another in a manner analogous to cap-and-trade regimes used to address environmental pollution.[1] As in the environmental protection context, a tradable obligation approach to the CRA has the potential to enhance the provision of financial services to low- and moderate-income communities at lower cost than does the current command-and-control approach. This article revisits that proposal in light of developments in the financial services sector and in community development over the past decade, and assesses whether the proposal warrants reconsideration today.[2] I conclude that the proposal does warrant reconsideration, but I also discuss a number of empirical and practical questions that should be addressed before one can conclude that the proposal would in fact enhance the effectiveness of the CRA.

Although the objective of the CRA is to induce banks to provide services they otherwise would not provide to low- and moderate-income communities, the act is unclear with respect to whether it is intended to address market failures that impair the provision of financial services in these communities, or to redistribute wealth from bank shareholders to residents of these communities, or both.[3] A "tradable obligation" approach to the CRA is potentially attractive with respect to both rationales.

I. The Tradable CRA Obligation Proposal: A Market-Oriented Approach

The current CRA regime follows the conventional command-and-control approach to regulation. Banks are in effect required to serve low- and moderate-income communities throughout the areas in which they do business.[4] As discussed in Part II, this approach has drawbacks. Some banks may be less able to provide the same service to CRA-qualified communities than are other banks. From a social welfare point of view, banks that can provide the same service at lowest cost should be the ones that serve these communities. In addition, the CRA's mandate that a bank provide services throughout its area of operation (referred to as its "assessment area"), makes it difficult for banks to gain

* *I am grateful to Larry White for comments on an earlier draft.*

1 *Michael Klausner, "A Market-Oriented Reform Proposal for the Community Reinvestment Act," University of Pennsylvania Law Review, 143 (1995): 1561; Michael Klausner, "Letting Banks Trade CRA Obligations Would Offer Market-Based Efficiencies," American Banker, January 21, 1994.*

2 *For commentary on the proposal, see Jonathan A. Neuberger and Ronald H. Schmidt, "A Market-Based Approach to CRA," FRBSF Weekly Newsletter, May 27, 1994, 1; J. I. Brannon, "Renovating the CRA," Regulation 24, no. 2 (Summer 2001); Christopher A. Richardson, "The Community Reinvestment Act and the Economics of Regulatory Policy," Fordham Urban Law Journal, April 2002; Lawrence J. White, "Focusing More on Outputs and on Markets: What Financial Regulation Can Learn from Progress in Other Policy Areas" (November 2006). Networks Financial Institute Policy Brief No. 2006-PB-18, available at http://ssrn.com/abstract=947895; "The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain," statement of Lawrence J. White before the Financial Services Committee of the U.S. House of Representatives, February 13, 2008.*

3 *Congress's stated purpose in enacting the CRA was to have banks "meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions." U.S. Code, Title 12, Section 2901(b).*

4 *Technically, the CRA is not a requirement. It requires the bank regulatory agencies to assess whether a bank is "meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution" and to take that assessment into account in ruling on the bank's applications for mergers, branch openings, or expanded activities. Because banks may make such applications in the future and because a poor CRA rating has reputational costs for a bank, most banks treat the CRA as a requirement. For simplicity I will refer to the CRA as a requirement here.*

efficiencies that may be available through specialization in particular neighborhoods.

The tradable obligation approach would have two core elements. First, all banks would be assigned annual quotas of CRA obligations. These quotas would be stated in objective and verifiable terms for each type of financial product or service—for example, a quota for lending, a quota for investment, and a quota for other services. This approach is quite different from the current approach to CRA enforcement, which relies on broad standards and *ex post* evaluation by bank examiners. Reportedly, the increased specificity in CRA regulations that occurred in 1995 was difficult to achieve and may have exhausted the potential for specificity under the current structure of the CRA.[5] Nonetheless, with a tradable obligation regime, greater specificity in regulations may be possible. Under the CRA as currently administered, different standards apply depending on whether a bank is large or small, and on whether it is a retail, wholesale, or limited-purpose bank. In addition, bank examiners take into account the nature of a bank's business and the markets in which it operates. In a tradable obligation regime, however, the nature of the bank's business, its market, and the location of its operations would be less important than they are under the current approach. Because a bank could pay another bank to perform its CRA obligations, the obligations would not have to be tailored to each bank. Market trades would replace regulatory tailoring in matching banks' capabilities with CRA-qualified communities.

In addition, some customization of a bank's obligation would be possible. Rather than evaluating a bank's performance retrospectively, an examiner could make essentially the same assessment but use his analysis to prescribe a prospective obligation. For elements of CRA obligations that are not fully specified by regulation, the examiner would specify the bank's annual obligations in objective terms. Individual specification would depend on the needs of the community and the estimated costs of meeting those needs rather than the capabilities of the bank that is assigned the obligation.[6] A bank's annual obligation would remain constant until the next examination.

The mix between generalized and individualized obligations is a detail that would have to be worked out with experience. We might discover, for example, that the CRA's lending and investment requirements are more suitable for generalized quantification than is the service requirement. If so, lending and investment obligations could be set out more specifically by regulation, and the service obligation could be specified more individually by examiners.

The second element of a tradable obligation approach would be trading. Any bank would be allowed to pay another bank to take on its CRA obligations, in whole or in part. If Bank A can meet some or all of Bank B's CRA obligations, then Bank B could pay Bank A to do so. By allowing banks to pay others to take on their CRA obligations, a market for acquiring these obligations would develop. Some banks would choose to be suppliers of CRA services, others would choose to be buyers, and some might choose to be both. For example, a bank might make its requisite volume of CRA-qualified loans itself and take payments from other banks to make additional loans, but the same bank might pay other banks to fulfill its investment and service obligations under the CRA. Or a bank might make loans amounting to one-half its lending obligations and pay others to make the rest. As discussed below, maximum liquidity would argue for nationwide trading, but an interest in geographic distribution of CRA services would argue for trading within defined regions.

The tradable obligation approach, if successful, would harness market forces to promote better service to CRA-qualified communities at lower cost. Those banks that establish expertise in serving one or more CRA-qualifying communities could well see business opportunities in taking on other banks' CRA obligations. Other banks would impose a market discipline on these specialists by transferring their obligations to the lowest bidder and by providing CRA services themselves when opportunities arise that are less costly than paying another bank to do the job. The result would be markets for CRA services, with prices for CRA obligations established by supply and demand among banks.

This approach to the CRA mirrors the emissions trading approach provided for under the Environmental Protection Agency's Acid Rain Program, and cap-and-trade regimes that have been adopted to address carbon emissions. In the Acid Rain Program, polluters are

5 *Michael S. Barr, "Credit Where It Counts: The Community Reinvestment Act And Its Critics," New York University Law Review 75 (2005): 513.*

6 *That is, the objectives would be to have the needs of CRA-qualified communities met and to have the cost distributed fairly among banks.*

assigned quotas for the emission of sulfur dioxide and nitrogen dioxide. If a polluter can reduce its emission of one of these pollutants below its quota, it can sell the unused portion of its quota to another polluter for cash. Conversely, if a polluter wants to emit more than its quota, it must buy the unused quota of another polluter. Under this system, polluters have incentives to develop technologies and processes that produce high output for each unit of pollution emitted. Under the CRA proposal outlined above, banks would have similar financial incentives to meet the needs of low- and moderate-income communities.

II. Multiple Rationales for Tradable Obligations

The potential advantages of a CRA trading regime stem from three sources: the allocation of CRA obligations to banks best able to fulfill them; the promotion of specialization in serving CRA-qualified communities; and increased concentrations of lenders in CRA-qualified communities. Specialization and concentration could promote cost efficiencies, internalization of information-based market imperfections, and internalization of physical neighborhood externalities associated with CRA-qualified services.

A. Wealth Redistribution and the "Leaky Bucket"

To the extent that the objective of the CRA is to redistribute wealth from bank shareholders to residents of low- and moderate-income communities, the secondary objective should be to do so at minimal social cost. As Arthur Okun observed, when wealth is redistributed from rich to poor, there will be a social cost involved, so that $10 taken from the rich does not mean a full $10 given to the poor. There will be some leakage. In Okun's terms, any redistribution occurs via a "leaky bucket." Good public policy requires mechanisms that minimize the leakage.[7]

In the case of the CRA, if one bank is poorly equipped to provide financial services to CRA-qualified communities and another bank is well equipped to provide those services, then the cost of the redistribution will be lower if the latter bank does the job. One bank may be better than another at providing CRA-eligible services because of the experience and skills of its employees, or because of the nature of its other businesses. This is in stark contrast to the current approach to the CRA, which requires all banks to provide CRA-eligible services.

A tradable obligation regime would use market forces to allocate CRA responsibility to the banks able to provide CRA services at the lowest cost. In addition, as discussed below, it would promote the achievement of additional efficiencies for banks that choose to become providers of CRA services.

B. Asymmetric Information and Credit Rationing

The CRA responds to market imperfections as well and therefore has an allocative efficiency rationale in addition to a redistributive rationale. One market imperfection is the inherently asymmetric information between a lender and borrower. This asymmetry can lead to "credit rationing," a dynamic in which a lender rationally declines to make loans to particular groups of potential borrowers at any interest rate.[8] Low- and moderate-income communities are especially at risk of experiencing credit rationing. The CRA, as now implemented, responds to this problem by forcing banks to lend, but a CRA with tradable obligations may respond more effectively.[9]

When a bank makes a loan, it does so based on information regarding the default risk of the borrower. Borrowers, however, have better information regarding their default risk than the bank has, and the bank knows this. The bank can reduce this information asymmetry by making detailed, individualized lending decisions and setting interest rates on an individualized basis, but doing so is costly and may not be justified by the bank's expected return on loans. Therefore, banks always rely to some degree on aggregate determinations; they charge interest rates that reflect the average default risk of a type of borrower—based, for instance, on the borrower's current assets and income and on the size of the loan.

Credit rationing occurs when a lender must make lending decisions based largely on default-risk characteristics of a group of potential borrowers, rather than on each borrower's individual characteristics, and when

7 *Arthur Okun, Equality and Efficiency: The Big Tradeoff (Washington, DC: Brookings Institution Press, 1975).*

8 *Joseph E. Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information" American Economic Review 71 (1981): 393.*

9 *Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending by Depository Institutions, 1993,3, 8, 34, 36, 54; Julia A. Parzen and Michael H. Kieschnick, "Credit Where It's Due" (1992): 143–48, 173–78.*

the default risk of individuals in the group span a wide range. When a bank sets an interest rate for a certain type, or pool, of borrowers, some members of the pool will inevitably be overcharged with respect to their actual default risk, and others will be undercharged. Loans across the full range of borrowers in the pool should yield a risk-adjusted return for the bank in the aggregate. But especially if the divergence of risk within the pool is large, there is a danger that those who are less risky will decline the higher rate loan and seek alternatives such as rental housing rather than homeownership. If this occurs, the composition and therefore the average default risk of the pool as a whole will increase, and the bank will have to increase the interest rate it charges to borrowers remaining in the pool. This adverse selection spiral can continue to a point at which the increased revenue that would come from raising the interest rate further is more than offset by the increased default risk of borrowers that remain in the pool. If the bank believes that this will occur, it will rationally choose not to make loans at all to any borrower in the pool.[10]

The danger of credit rationing is substantial for low- and moderate-income communities. Credit rationing occurs because the cost to the lender of distinguishing between high- and low-risk borrowers is not worth the gain. Credit analysis entails fixed costs in assessing and monitoring the economic conditions of a neighborhood and becoming familiar with the neighborhood's residents and businesses. These costs are reflected in empirial evidence of economies of scale in lending within neighborhoods.[11] There are also significant fixed costs in evaluating any single loan application and monitoring repayment. The costs associated with a $50,000 loan are not very different from those associated with a $500,000 loan. Moreover, in CRA-qualifying communities, credit analysis and loan servicing is more costly than in other neighborhoods. Borrowers are less likely to have prior borrowing experience and are more likely to need assistance in making loan applications and repaying their loans. Information regarding their creditworthiness may not conform to the standards that banks use to assess creditworthiness in other parts of their business, and the response to a default may need to be different from the response in other settings.[12] These heightened fixed costs of lending in CRA communities must be spread over a relatively low volume of small loans.[13] Consequently, these communities are particularly vulnerable to credit rationing.

The CRA responds to the danger of credit rationing by forcing banks to make loans in low- and moderate-income communities. But by requiring banks to spread their services throughout the areas in which they operate, the current approach deters specialization in particular neighborhoods. Consequently, gains that might come from familiarity with a neighborhood and from economies of scale within a neighborhood are lost.

A tradable obligation approach to the CRA could respond more effectively to the asymmetric information problem by encouraging banks to specialize in lending to particular neighborhoods and using other banks' CRA obligations to lend in higher volumes in those neighborhoods, thereby developing economies of scale. Such specialized banks could develop the capacity to make more precise, individualized risk assessments and thereby avoid credit rationing. In addition, with higher volume, they could spread the fixed cost of serving a community over a greater volume of loans.

C. Information Externalities

A second market imperfection that affects lending is the presence of positive externalities that flow from information associated with past loans. Especially when making home loans, banks rely on appraisals, which are dependent on past sales of similar properties. Past sales, however, exist only because financing was available to earlier home buyers—and of course the appraisals that supported those earlier sales were based on yet earlier sales. The home loan market is thus dependent on a

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10 For a model of this phenomenon, see Stiglitz and Weiss, "Credit Rationing in Markets with Imperfect Information," 393; and Dwight Jaffee and Joseph A. Stiglitz, "Credit Rationing," in Benjamin M. Friedman and Frank H. Hahn, Handbook of Monetary Economics, 2:839, 853–60 (1990). In addition to the limits on raising interest rates inherent in the model, there may also be legal and political limits on banks' ability to raise interest rates. See John V. Duca and Stuart S. Rosenthal, "Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence of Rate Sorting and Credit Rationing," Journal of Real Estate Finance and Economics 8(1994): 99.

11 McKinley Blackburn and Todd Vermilyea, "The Role of Information Externalities and Scale Economies in Home Mortgage Lending Decisions," Journal of Urban Economics 61, 1 (2007): 71.

12 Parzen and Kieschnick, "Credit Where It Is Due," 143–48, 173–78.

13 Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending by Depository Institutions,1993, 7–8, 21, 34.

continuous series of comparable home sales.[14]

If home sales in a community are interrupted or their volume is substantially reduced, for whatever reason, a self-reinforcing dynamic can occur in which loans that should be made are not made, and sales that should occur do not occur. In order to support an appraisal on a home or other piece of real estate, an appraiser needs several recent comparable sales in the same community. Without those comparable sales, the appraisal will be less reliable and a lender may not finance the purchase at the seller's asking price. Unless the buyer can make up the difference with cash, or the seller reduces the price, the sale will fall through. The result is a further slowdown in sales and a concomitant reduction in information to fuel lending for future sales. This self-reinforcing decline in sales can occur regardless of the fundamental value of homes in a neighborhood or the potential of the local economy. What would otherwise be a transient decline in sales becomes a protracted period of illiquidity and decline in real estate values. Making the situation even worse, physical deterioration may occur as would-be sellers defer upkeep and leave homes and shops vacant.

Appraisals are used in some commercial lending as well, but in addition, banks monitor their outstanding loans to acquire information regarding business conditions in a community. That information is used to make current loan determinations. Consequently, once commercial lending dries up in a community, there will be an impediment to reviving it, and a downward spiral can occur just as in the housing market.[15]

Downward spirals stemming from what otherwise would be transient slowdowns can occur in any market, but low- and moderate-income communities are especially vulnerable. Home buyers in these communities are less likely to have additional cash to make up the shortfall between the amount a bank is willing to loan and the price a seller is willing to accept. Similarly, businesses are less likely to have the internal funds to fill a shortfall in commercial lending. Regulatory intervention, therefore, could be beneficial.

The CRA responds to the danger of such a downward spiral by forcing banks to make loans. But, again, in contrast to a tradable obligation approach, the CRA requires banks to spread their activities throughout the area in which they operate. As a result, it deters specialization and market concentration, both of which can reduce the impact of lost information externalities that occur as a result of a slowdown in home sales and lending. A bank is more likely to learn about a neighborhood, and will have more sources of information, if it can concentrate resources there as opposed to spreading those same resources across all areas in which it operates. The bank will therefore be less dependent on information flowing from a continuous stream of past home sales and commercial loans. Furthermore, if a bank has a larger market share in a neighborhood, it will reap more of the positive information externalities that it produces by continuing to lend despite a slowdown in sales. Because a tradable obligation approach to the CRA would promote specialization and concentration, it has the potential to reduce the vulnerability of low- and moderate-income communities to local interruptions in sales and lending.

D. Neighborhood Externalities

In addition to information-related market imperfections, there are physical externalities that can impair lending in low- and moderate-income communities. The value of any property is dependent on the condition of neighboring properties. Thus, the deterioration of a neighborhood will reduce the value of even well-maintained properties. Consequently, a lender may decline to make loans in a neighborhood that is in decline or that it fears will go into decline, regardless of the quality of particular homes being offered for sale or the creditworthiness of particular loan applicants. A reduction in lending will exacerbate the deterioration. Conversely, lending can have positive externalities on a neighborhood, as proceeds are used to rehabilitate properties.[16]

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14 Leonard I. Nakamura, "Information Externalities: Why Lending May Sometimes Need a Jump Start," Business Review, Federal Reserve Bank of Philadelphia (January–February 1993), 3–7; William W. Lang and Leonard I. Nakamura, "A Model of Redlining," Journal of Urban Economics 33 (1993): 223–24; David C. Ling and Susan M. Wachter, "Information Externalities and Home Mortgage Underwriting," Journal of Urban Economics 44 (1997): 317; Paul S. Calem, "Mortgage Credit Availability in Low- and Moderate-Income Minority Neighborhoods: Are Information Externalities Critical?" Journal of Real Estate Finance and Economics 13 (1996): 71; Blackburn and Vermilyea, "The Role of Information Externalities and Scale Economies in Home Mortgage Lending Decisions," 71.

15 William W. Lang and Leonard I. Nakamura, "Information Losses in a Dynamic Model of Credit," Journal of Finance 44, 3 (1989): 731–44.

16 For discussions of neighborhood externalities, see Jack M. Guttentag and Susan M. Wachter, "Redlining and Public Policy," New York University, Graduate School of Business Administration, Salomon Brothers Center for the Study of Financial Institutions, (1980): 39; Board of Governors of the Federal Reserve System, Report to Congress on Community Development Lending by Depository Institutions, 1993, 9.

Once again, the CRA responds to this problem with forced lending across a bank's entire assessment area. Forced lending can help, but it would help more if a bank could concentrate its lending on particular neighborhoods and thereby internalize the positive externalities of continued lending.

A tradable obligation regime would promote concentration within neighborhoods. Consequently, it could allow banks to lend in sufficient volume within a neighborhood to internalize at least some neighborhood externalities that their own lending creates.

E. Summary

As discussed in Section IV, there are a number of caveats and questions that must be addressed before a tradable obligation regime for the CRA ought to be adopted. Leaving those issues aside for the moment, however, the potential virtue of a tradable obligation approach to the CRA is that market forces would be harnessed to accomplish several objectives. First, the most efficient providers of financial services to low- and moderate-income communities would emerge in each community. Second, banks that serve a particular CRA-qualified community would tend to specialize in that community. Third, there would be a greater concentration in banks serving particular CRA-qualified communities, meaning that each bank would provide a higher volume of service than it does under current law.

As a result of this specialization and concentration, banks would be well positioned to make more individualized credit decisions and thereby avoid credit rationing. They would also internalize the information externalities generated by their own lending and thereby better weather periods of illiquidity. Further, by bearing a greater cost of physical neighborhood externalities and reaping a greater benefit from positive externalities associated with lending, banks serving a community would have a greater stake in averting its physical deterioration and more to gain by working to promote its rehabilitation.

III. Developments Since the 1990s

I originally proposed this tradable obligation approach to the CRA in 1994. The question now is whether anything has changed that makes it worth further consideration. Part III discusses developments since the 1990s that potentially make the proposal more attractive than it was in the 1990s, while Part IV discusses continuing concerns.

A. The Effect of Out-of-Area Lending

The CRA, enacted in 1977, was designed for a banking industry in which a bank's market is largely local and defined by the areas in which the bank has brick and mortar branches at which it collects deposits. A bank's obligation under the CRA is to meet the needs of low- and moderate-income communities where the bank is physically located. Since the CRA's enactment, its geographic orientation has become increasingly ill-suited to the evolving banking market.[17] Today, the area in which a bank makes loans is often quite different from the areas in which the bank has branches or even ATMs. Yet a bank's assessment area for CRA purposes is still based on the physical locations from which it collects deposits (including ATMs). Consequently, the impact of the CRA is relatively weak in areas that receive relatively high volumes of out-of-area bank loans.

A tradable obligation approach to the CRA could avoid this problem by broadly defining the region, or assessment area, for which a bank has CRA obligations. That region could extend beyond the areas in which the bank is physically located. Because a bank would not be required to perform all CRA services itself, and because trading would be permitted within assessment areas, a larger assessment area would provide for a more liquid market for CRA obligations.

B. Mortgage Lending by Nonbanks

Another change that has occurred since 1977 is the dramatic expansion of the mortgage lending market to include institutions other than banks. The CRA applies only to banks, which at the time of enactment were the primary providers of home loans. Today, however, mortgage brokers and mortgage bankers originate more loans than banks. Thus the CRA has applied to a relatively small fraction of the home loan market.

The CRA in its current form could be expanded to nonbank mortgage lenders. But to the extent that some of these lenders are not well suited to serve low- and

17 For a discussion, see "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System," a report of The Joint Center for Housing Studies, Harvard University (2002), 15, 27–31. For a contrary view, see Barr, "Credit Where It Counts, 513.

moderate-income communities, it would be more cost effective to allow these institutions to transfer their CRA obligations to institutions that can fulfill them more efficiently.

C. *The Growth of Community Development Financial Institutions*

Another element that could make a tradable CRA obligation regime attractive is the growth of Community Development Financial Institutions (CDFIs) across the country.[18] CDFIs provide a wide range of financial services in lower-income communities, including services that banks provide under the CRA. The CRA has helped fuel the growth of CDFIs by inducing banks to finance them and to collaborate with them in serving CRA-qualified communities.

A tradable obligation regime could potentially enhance collaboration with CDFIs and enhance the delivery of financial services to the communities in which they operate. First, CDFIs could enter the market for tradable obligations and take on banks' CRA obligations. This could be an ideal case of a specialized bank taking over the CRA obligations of other banks and providing better service to the community. Most CDFIs are not banks, which raises the question whether nonbanks should be able to enter the market for taking on banks' CRA obligations. One concern would be a lack of regulatory follow-up to ensure that the obligations are fulfilled. If a transferee of CRA obligations is a bank, its examiner could ensure that it has fulfilled all obligations that it takes on. There may be a reason, therefore, to limit the market for CRA obligations to banks. But once this market exists, more CDFIs might well become banks in order to go into the business of taking on CRA obligations and thereby expanding their services.[19]

A CDFI would need additional capital to fund expanded services. Some of that capital would come from amounts paid by banks that transfer their CRA obligations to the CDFI. But more would be needed. That additional capital could come from collaboration with banks. For example, a CDFI might enter into an arrangement with a bank in which the CDFI takes on some of the bank's obligations and, in addition, assists the bank in making loans that would allow the bank to fulfill some of its own CRA obligations. Alternatively, the bank could make a large equity investment in a CDFI, fulfilling its own investment obligation under the CRA and perhaps those of transferor banks as well. Collaboration with CDFIs can count toward a bank's CRA rating under the current system, but by allowing banks to focus on particular neighborhoods rather than spreading their CRA activities throughout their assessment area, a tradable obligation approach would allow a CDFI to work with fewer banks with higher volume from each. The transaction costs of this arrangement may be less than the transaction costs of working with many banks, each of which devotes fewer resources to the relationship. With a CDFI as the hub of a financial service network in a community, the problems of information asymmetry, information externalities, and neighborhood externalities could be addressed in much the same way that South Shore Bank addressed those problems when working alone on Chicago's South Side in the 1980s.[20]

IV. Caveats and Questions

Although a tradable obligation approach to the CRA has the theoretical potential to enhance the delivery of financial services to low- and moderate-income communities, legitimate questions can be raised regarding how the program would be implemented in practice. This section briefly raises some of those questions.

A. *Objective Description and Quantification of CRA Obligations*

A tradable obligation regime would require objectively specified CRA obligations. One question that should be investigated is the extent to which this can be accomplished. As described above, each bank's CRA obligations need not be fully defined by regulation. Instead, bank examiners could specify a bank's obligations at the time of examination, much as they do today in evaluating a bank's past performance. Nonetheless, even if individually specified, each bank's obligations would have to be specified objectively. For a trading regime to succeed, clarity in three respects

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18 See "CDFIs: Providing Capital, Building Communities, Creating Impact: A Publication of the CDFI Data Project" (2006).

19 Alternatively, nonbanks that perform CRA services could be brought into the CRA regulatory process. Beyond having nonbank CDFIs perform CRA services, one could imagine other nonbanks—Wal-Mart, for example—doing so.

20 See Ronald Grzywinski, "The NEW Old-Fashioned Banking," Harvard Business Review (May–June 1991): 87.

would be necessary. First, a bank that has transferred a CRA obligation would need clarity with respect to how much of its entire set of CRA obligations it has transferred and what obligations remain. (This would be true as well when a bank performs a CRA obligation itself.) Second, a transferee bank would need clarity regarding what it must do at the margin beyond performing its own CRA obligations in order to fulfill the obligations transferred. Third, the CRA examiner would need clarity with respect to what has occurred in order to verify that the trade resulted in the transferee bank actually fulfilling the transferor bank's CRA obligation. For a quantifiable obligation, such as an obligation to make loans, these conditions may be relatively easy to meet. But for a less quantifiable CRA service, it may be more difficult to ensure that a trade is adding services at the margin.

Ideally, all types of CRA obligations would be objectively specified in order to allow them to be traded. But if this is not possible, a tradable obligation regime that extends to only some types of CRA obligations, such as lending or investment obligations, could be an improvement over the current regime.

B. Liquidity

In theory, CRA trading would occur on an active market, with prices of certain types of obligations—loans in a particular community, for example—readily discoverable. Intermediaries could well emerge to facilitate these trades, as they have in the acid rain and carbon emission contexts. But there surely will be frictions, and it is unclear how liquid this market would be. If many banks choose not to trade, the market would be illiquid, which of course would further impede trading, and the potential benefit would be lost. There is no way to know how much trading would occur until one tries to implement the system, but some valuable information could be obtained by simply surveying potential buyers and sellers of CRA obligations regarding how they would expect to respond to a trading regime.

C. Geographic Coverage

The CRA in its current form reflects an ambition that all low- and moderate-income communities be served. A bank's performance under the CRA is evaluated with respect to geographic distribution of the bank's service to CRA-qualified communities throughout its assessment area. As discussed above, this requirement is counterproductive in certain respects. Nonetheless, it does address a concern that communities not be left out.

It is unclear how effectively this concern would be met under a tradable obligation regime. In the extreme, if banks' CRA obligations had no geographic ties, there would be a danger that less attractive CRA-qualified communities across the country would not be served. To the extent that the profit motive drives the market, banks would emerge to serve the low- and moderate-income communities that offer the greatest profit potential (or lowest loss potential), and the supply of such services would expand to less profitable communities (or those where the greatest losses are feared) up to the point at which the nationwide stock of CRA obligations is exhausted. The aggregate quantity of CRA obligations could be increased in order to fill in geographic gaps in coverage. But this would be a blunt policy instrument. Instead, the danger of geographic gaps could be addressed by imposing a geographic constraint within a trading regime. For example, the country could be divided into regional trading markets, and banks that operate within a region could be required to trade only within that region. The imposition of geographic limits would reduce the liquidity of the market, but trading regions could still be large. It is impossible to know in advance the trade-off between geographic distribution of CRA services and the liquidity of the CRA market. This would have to be determined and adjusted with experience.

D. Antitrust

A theme repeated throughout this proposal is that a tradable obligation approach to the CRA would promote concentration of lending markets within CRA-qualified neighborhoods. Concentration would promote internalization of externalities and achievement of economies of scale. But concentration could also lead to antitrust concerns. With CRA examiners periodically present and community groups organized to scrutinize banks' performance, this may not turn out to be a problem, but it is a potential danger of this proposal.

E. A Pilot

Some of the questions raised here and others that surely could be raised might be answered in the abstract. Others, however, can be answered only with experience. A pilot program, perhaps limited to a single region, might be a reasonable step toward determining whether a tradable obligation approach might enhance the delivery of services to low- and moderate-income communities.

V. Conclusion

A tradable obligation approach to the CRA has some promise of responding better to market failures in CRA-qualified communities than does the current command-and-control approach. It also may be a more efficient means of accomplishing the CRA's redistributive goals. The growth of mortgage lending by nonbanks and by banks operating outside the areas in which they have physical facilities also militates in favor of a tradable obligation approach. Nonbank mortgage lenders are not currently covered by the CRA, and extending the CRA in its current form to these institutions may be infeasible. But imposing on them CRA obligations that they can transfer to others would have fewer obstacles. Finally, a tradable obligation approach to CRA may complement the growth of CDFIs over the past decade. Some CDFIs could become transferees of CRA obligations and increase their impact on communities. Others could facilitate transfers among banks and work with transferee banks on a larger scale than they do under the current CRA regime.

Without a doubt, this would be a radical reform. I have raised several issues that would have to be addressed before one could be sanguine about its success. On balance, the approach seems attractive enough to warrant consideration of those issues, as well as others that surely would arise if it were adopted, in order to assess the viability of this approach to the CRA. ■

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The Community Reinvestment Act: Past Successes and Future Opportunities

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More than 30 years ago, before passage of the Community Reinvestment Act (CRA), relatively few banks made meaningful numbers of loans to people with low and moderate incomes. Whether because of racial discrimination or fear of credit weaknesses, many banks "redlined" entire areas of American cities as places where they would not lend.[1] Accordingly, most inner cities were islands of urban blight whose residents had limited access to capital. The prospects were scant for breaking the cycle of urban decay, except through direct government investment.

The overwhelming majority of studies find that the CRA has succeeded in increasing lending in low- and moderate-income neighborhoods. Inner cities have not yet been wholly transformed by the CRA, but they have been demonstrably improved by the act's implementation. Most bankers would now agree that many low- and moderate-income individuals living in neighborhoods that were once redlined have proved they can responsibly use credit to better their lives. Indeed, this basic lesson—that people who have been shut out of the banking system can be sound credit risks—has been proved true all over the world. Muhammad Yunus, who won the Nobel Prize for his work in microcredit lending, more recently demonstrated that such lending can provide access to the productive economy to even the poorest of the poor.

Although the act has been the law for decades, the controversy surrounding it has never completely faded. Its supporters argue it has not fulfilled its potential, particularly in recent years, because regulators have failed to enforce it aggressively. From time to time, bankers criticize the CRA as unnecessary, unfair, and burdensome, a criticism that was more prevalent before the 1994 regulatory revisions, particularly among small banks. Most recently, a handful of critics have argued, incorrectly, that the CRA led to the subprime crisis because it pressured banks to lend to people with insufficient income and against properties that lacked enough value to collateralize the loan. In fact, the subprime crisis resulted from high-rate interest loans—often originated by unregulated mortgage brokers who are not subject to the CRA or bank regulation—and fueled by excessive leverage, the antithesis of CRA lending.

The banking industry has also seen fundamental changes since the CRA became law in 1977. For example, market-based lenders such as money market funds and securities firms held more financial assets than banks in recent years. Most banks in the late 1970s were local businesses and typically did not operate statewide. Today, the banking industry is dominated by very large institutions–some with more than $2 trillion in assets–with extensive interstate branching networks. Moreover, a substantial number of homebuyers had their mortgages originated from nonbank lenders, such as Countrywide Financial (now part of Bank of America).

One consequence of these changes is that certain underlying assumptions that Congress made when it passed the act no longer hold. For example, Congress assumed that banks would continue to be the most important financial enterprises in the economy and were therefore uniquely granted the support of the federal safety net. Banks are no longer unique, as the reach of the federal safety net has been extended to nonbank financial com-

1 *Ironically, even the federal government played a role in shutting out inner-city neighborhoods from traditional sources of credit by encouraging the development of credit maps. See Amy E. Hillier, "Redlining and the Homeowner's Loan Corporation." Journal of Urban History, 29(4) (2003), pp. 394-420.*

panies. In the late 1990s, the Federal Reserve arranged the bailout of a hedge fund, Long Term Capital Management. Most recently, it arranged and participated in the bailout of insurance company American International Group, the nationalization of Fannie Mae and Freddie Mac, and the bailout of investment bank Bear Stearns, and it has granted broker-dealers access to the Federal Reserve's Discount Window. An additional assumption, correct at the time, was that banks had clearly defined service areas, but interstate banking has made a geographically-based service area outdated.

If the CRA is to continue to be effective, it must be modernized by expanding its reach to nonbanks and its service area focus from one that is almost entirely local to one that can be national in appropriate circumstances.

This paper examines the history of the CRA; academic studies of its accomplishments; why the CRA is not to blame for the subprime mortgage crisis; and it offers recommendations to address lingering issues surrounding the CRA, particularly how it might be changed in light of the changed financial services landscape.

The History of the CRA

Beginning in 1935, the Home Owners' Loan Corporation (at the behest of the Federal Home Loan Bank Board) in collaboration with private organizations developed maps that rated areas in and around larger American cities for mortgage lending risk. The riskiest neighborhoods were outlined in red. Private lenders used these maps as guides to determine where they should lend, and as a consequence, lending decisions for homes in supposedly high-risk areas were not based on the income of the individual, but on the neighborhood in which the person lived. Because it was common practice for homes in white neighborhoods to have covenants that prohibited ownership by racial and religious minorities, redlining meant that racial minorities and the poor were concentrated in the most rundown parts of cities, areas that were made worse by the race riots of the 1960s.

Much change was needed to turn blighted areas of American cities around, including an end to racial discrimination and improved government services. It was also clear by the mid-1970s that normal access to traditional credit channels for residents and small businesses in redlined neighborhoods was essential to rebuilding the inner city.

The Housing and Community Development Act of 1977

Congress banned racial discrimination in lending in the Equal Credit Opportunity Act of 1974 and in the Fair Housing Act, which was passed as part of the Civil Rights Act of 1968. Despite these measures, Congress needed to outlaw redlining as well because lenders were engaging in "neighborhood discrimination" by denying mortgages to applicants on the basis of the neighborhood in which the property was located, not on the creditworthiness of an individual borrower.[2] Even a middle-income borrower might be denied a loan for a house in a redlined neighborhood. Senator William Proxmire, a Wisconsin Democrat who was then the chairman of the Senate Banking Committee and who engineered the CRA's passage, remarked that "many creditworthy areas [were] denied loans," a trend he argued "undoubtedly aggravates urban decline."[3]

The CRA was included in the Housing and Community Development Act of 1977 and was signed into law by President Jimmy Carter on October 12, 1977. In his remarks, the president made specific note of the CRA, congratulating Congress on "devising the formulae to channel funds into areas that are most in need" by "add[ing] a restraint on unwarranted redlining of depressed areas."[4] Since its passage, the scope of the CRA has expanded from urban inner cities to include disadvantaged rural communities as well.

But why would banks choose to ignore profitable lending opportunities? One answer is a market failure, in this case information barriers and costs. When the CRA became law, 14,411 commercial banks and 4,388 thrifts were operating, but relatively few had branches in redlined neighborhoods.[5] Because banks

2 *15 U.S.C. §§1691 et seq. and 42 U.S.C §§ 3601 et seq.*

3 *123 Cong. Rec. H8958 (daily ed. Jun. 6, 1977).*

4 *Jimmy Carter, "Remarks on Signing H.R. 6655 Into Law" (Washington, DC: The White House, October 12, 1977).*

5 *FDIC. "Federal Deposit Insurance Corporation, Number of Institutions, Branches and Total Offices, FDIC-Insured Commercial Banks, United States and Other Areas, Balances at Year End, 1934 – 2007" (Washington, DC: FDIC, August 2008), available at www2.fdic.gov/hsob/hsobRpt.asp; and OTS. "2007 Fact Book, A Statistical Profile of the Thrift Industry." (Washington, DC: DOT, June 2008), available at files.ots.treas.gov/481109.pdf.*

were not located there, they lacked awareness of attractive lending opportunities in those neighborhoods. Banks feel safer and find it more convenient to lend in a familiar neighborhood than an unfamiliar one, as investigating a new neighborhood requires spending time and effort.

Likewise, low- and moderate-income borrowers typically lacked sufficient knowledge of finance; thus, unlike more active participants in the financial system, they may not have known how best to approach banks. Lang and Nakamura and Ling and Wachter confirmed that banks face an initial informational barrier to overcome.[6] However, if one bank found successful lending opportunities in an area, others soon followed. Some banks might "free ride" on the efforts of others and cherry-pick the easiest lending opportunities.

Another critical problem was racial discrimination. Munnell and colleagues, reviewing Boston-area HMDA data, concluded that minority loan applicants had a higher loan denial rate, even when controlling for economic, employment, and neighborhood characteristics.[7] Avery *et al* found that lower levels of lending to blacks could not be fully explained by income and wealth.[8]

Of course, banks did not entirely ignore inner cities. The Senate Banking Committee found that some financial institutions were simply taking deposits from inner city residents and lending them elsewhere. Senator Proxmire cited several examples of disinvestment, including the situation in Brooklyn, New York, where only about 11 percent of local deposits were reinvested in the community, and a similar case in Washington, DC, where a bank invested "about 90 percent of the money…outside of the community where the money [was] deposited."[9]

Senator Robert B. Morgan, a Democrat from North Carolina, led the opposition to the CRA. Although Morgan said he supported the "ultimate intent" of the CRA, which was "to assure that the credit needs of the inner city are adequately met," he argued that if it were effective, the CRA would amount to credit allocation, but if it failed, it would only discourage inner-city lending.[10] In response to concerns regarding credit allocation, the lending quotas mandated by early drafts of the act were removed. Thus, the enacted version of the CRA does not state the amount or the manner by which financial institutions should fulfill their community obligations, leaving considerable flexibility for the institutions and their regulators to determine the details of CRA compliance programs. Anticipating critics' charge that the CRA forces institutions to make bad loans, the act explicitly provides that CRA lending should be "consistent with the safe and sound operation of such institution."[11]

The CRA applies only to banks and thrifts.[12] Congress reasoned that these institutions already have a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered."[13] Additional legislation was necessary because "the absence of specific, statutory language… undercut efforts to get a uniform policy of community reinvestment."[14] Senator Proxmire added that, "convenience and needs does not just mean drive-in teller windows and Christmas Club accounts. It means loans."[15] At the time, banks and thrifts were the dominant lenders and were thought to have "the capital, the know-how, and the efficiency to do the job" of making loans to rebuild cities.[16] To encourage compliance with the act, federal financial regulatory agencies were to examine

6 *William Lang and Leonard I. Nakamura, "A Model of Redlining," Journal of Urban Economics, 33 (Spring 1993), pp. 223-234; David C. Ling and Susan M. Wachter, "Information Externalities and Home Mortgage Underwriting," Journal of Urban Economics, 44 (November 1998), pp. 317-332.*

7 *Alicia Munnell et al. "Mortgage Lending in Boston: Interpreting HMDA Data." Working Paper 92-7 (Boston: Federal Reserve Bank of Boston, October 1992).*

8 *Robert B. Avery, Patricia E. Beeson, and Mark S. Sniderman, "Account for Racial Differences in Housing Credit Markets." Working Paper 9310 (Cleveland: Federal Reserve Bank of Cleveland, December 1993).*

9 *123 Cong. Rec. H8958 (daily ed. Jun. 6, 1977).*

10 *Ibid., H8653.*

11 *12 U.S.C. §2901.*

12 *Ibid.*

13 *Ibid.*

14 *123 Cong. Rec. H8932 (daily ed. Jun. 6, 1977).*

15 *123 Cong. Rec. H8958 (daily ed. Jun. 6, 1977).*

16 *Ibid.*

institutions' adequacy in meeting "the convenience and needs" of their local communities, defined as including both deposit and credit services.[17]

Another important reason that banks and thrifts were deemed to have an obligation to lend in their neighborhoods was that the government's grant of a charter confers special privileges, such as protection from competition and access to the federal safety net, including low-cost deposit insurance from the Federal Deposit Insurance Corporation (FDIC) and inexpensive credit from the Federal Reserve Banks and the Federal Home Loan Banks.[18]

Legislative Amendments to the CRA

Since its passage in 1977, Congress has amended the CRA several times. The first revisions took place as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which required regulatory agencies to make public their CRA evaluations and ratings.[19]

Two years later, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991, which expanded the regulators' information disclosure requirements to include publication of both the data and the factual findings used to support the rating assigned to an institution. In making these changes, Congress sought to promote greater uniformity and transparency in CRA examinations and ratings, in response to activists' complaints that it was nearly impossible to determine regulators' assessment criteria or to monitor an institution's CRA performance.[20]

Following the FIRREA amendments to the CRA, regulators adopted a more descriptive four-level ratings scale: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance.[21] Ironically, this new rating scheme in the view of some community activists compressed ratings and made it more difficult to differentiate between mediocre, good, and excellent ratings.[22] However, following the rule change, a larger proportion of institutions received below-average ratings than before, indicating that regulators were becoming more rigorous in their examinations.[23]

Of course, the reason the CRA's supporters and Congress wanted a more rigorous rating process was their belief that banks would want to avoid receiving a poor CRA rating and risk having an application to establish a new branch or to buy a bank rejected on the basis of a low rating. Furthermore, a low rating might make a bank less attractive to potential buyers. As it turned out, the CRA ratings did decline, but application denials linked to the CRA did not significantly increase. Thomas found that regulators denied only 20 more applications by 1996, bringing the total number of denials since the act's passage to 31 of nearly 105,000 applications.[24]

The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 and the Housing and Community Development Act of 1992 (1992 HCDA) contained subtle changes to increase the range of activities eligible for CRA credit. The former stipulated that banks could get CRA credit for participating in lending consortia with minority- or women-owned banks or low-income credit unions, provided that the loans benefited the local community. The 1992 HCDA stated that providing a branch in predominately minority areas, or to minority- or women-owned banks, should be viewed positively during CRA evaluations. Lawmakers reasoned that minority- and women-owned institutions are more likely to provide

17 123 Cong. Rec. H8932 (daily ed. Jun. 6, 1977).

18 Richard D. Marsico, Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act (Durham: Carolina Academic Press, 2005).

19 U.S. General Accounting Office, "Community Reinvestment Act: Challenges Remain to Successfully Implement CRA." Report to Congressional Requesters. GAO/GGD-96-23 (Washington, DC: GAO, November 1995).

20 Marsico, Democratizing Capital.

21 Kenneth H. Thomas, "CRA's 25th Anniversary: The Past, Present and Future." Working Paper No. 346 (Annandale-on-Hudson, NY: Bard College, Levy Economics Institute, June 2002).

22 Kenneth Thomas, Community Reinvestment Performance (Chicago: Probus Publishing, 1993).

23 Ibid.

24 Kenneth Thomas, The CRA Handbook (New York: McGraw Hill, 1998).

credit to low- and moderate-income neighborhoods, and assisting those institutions would indirectly promote CRA-related lending.[25]

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 made more significant changes. Up to this point, it was unclear that a bank had much at stake in CRA assessments. Congress amended the CRA to require that regulators conduct separate CRA performance assessments for each state in which an institution maintains a presence, with the intention of discouraging banks from taking the deposits they raised in one state and using them to ratchet up lending in another.[26] In addition, given that banks needed a Satisfactory rating for regulatory approval of interstate branches, Riegle-Neal augmented community activists' leverage to extract CRA lending commitments. The effect of these changes was that banks planning to branch out across states, which were generally larger institutions, were motivated to achieve high CRA ratings. Today, however, most banks have long since branched out, diminishing the importance of the additional incentive that Riegle-Neal provided.

The Gramm-Leach-Bliley Act of 1999 (GLBA) included several revisions to the CRA legislation. First, it required that a banking firm and all of its subsidiaries receive and maintain CRA ratings of Satisfactory or higher to establish a financial holding company and engage in expanded financial activities. Likewise, national banks must receive and maintain at least a Satisfactory rating to establish and maintain a financial subsidiary, which a bank must do if it wants to conduct securities business. Second, the GLBA mandated that terms be disclosed of CRA-related agreements that were negotiated between financial institutions and community groups. This provision reflected the view of Senator Phil Gramm, a Texas Republican, that community activists "extort" commitments from banks with threats of protests and challenges. The third revision was in response to industry complaints about the burden of compliance. The GLBA limits the frequency with which regulators can conduct CRA examinations at institutions with ratings of Satisfactory or higher. It also prohibits agencies from performing CRA examinations at institutions with less than $250 million in assets or that are affiliated with a holding company with less than $1 billion in assets.[27]

The GLBA significantly reduced the number of CRA examinations, given that many banks are categorized as Small. Apgar and Duda found that less than 30 percent of all residential mortgage loans were subject to CRA review in 2003.[28]

The 1995 Regulatory Reform

Regulators in 1995, at the behest of President Clinton, also substantially changed how the CRA is administered. Prior to 1995, CRA examiners assessed performance on the basis of 12 factors and then rated institutions on a five-point scale, where 1 was the highest possible grade and 5 the lowest. These ratings were opaque and subjective. For instance, the Federal Home Loan Bank, the former thrift regulator, considered a ranking of 3 to be Satisfactory while the three other federal bank regulators required a rating of 2 for a bank's CRA performance to be considered adequate.[29]

Not many institutions received low CRA ratings, and those that did seemed to suffer few consequences. It was extremely rare for a regulator to deny an application for a branch or a merger on the basis of an institution's CRA rating. A study by Thomas found only 11 CRA denials out of more than 50,000 branch and merger applications between 1977 and 1989.[30]

Both regulated financial institutions and CRA supporters complained that enforcement was too subjective and bureaucratic and that the examinations focused too much on process, primarily evaluating institutions on the basis of their plans for low- and moderate-income lending rather than actual lending performance.[31] Statistics on early CRA enforcement actions and ratings are unavailable, given that the regulators did not publish that information

25 *Marsico, Democratizing Capital.*

26 *Ibid.*

27 *Ibid.*

28 *William Apgar and Mark Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." Federal Reserve Bank of New York Economic Policy Review (June 2003).*

29 *Thomas, "CRA's 25th Anniversary."*

30 *Thomas, Community Reinvestment Performance.*

31 *Board of Governors of the Federal Reserve System. "The Performance and Profitability of CRA-Related Lending." Report to Congress. (Washington, DC: Federal Reserve, July 2000).*

prior to the 1989 passage of FIRREA.[32]

In response to these criticisms, President Clinton asked the regulatory agencies in July 1993 to reform how they implemented the CRA to provide more standardized and objective assessments that emphasized lending performance and to make sanctions against noncompliant institutions more effective.[33] The President's goals were to:

- Promote consistency and evenhandedness in CRA enforcement,
- Improve public CRA performance evaluations,
- Implement more effective sanctions, and
- Develop more objective, performance-based CRA assessment standards.[34]

The Office of the Comptroller of the Currency (OCC) headed the interagency review effort, which was the first comprehensive assessment since the act had passed 16 years earlier. In 1994, the agencies held multiple hearings in cities from coast to coast to gauge public reaction to the CRA, its effectiveness and its burden, and to solicit suggestions for its improvement. Individuals and organizations submitted thousands of pages of comments, and the heads of the relevant agencies were personally involved in creating the proposed and final rules. In April 1995, the agencies released the final, revised interagency regulations. The regulations changed the system of assessment from one that was heavily subjective and paper-based, to one that was more objective and de-emphasized form over substance compliance.

The revised regulations also tailored the examination approach such that evaluations took into account the institution's size and business strategy.[35] The following four examination models are still used today. The first model is a basic assessment for small retail institutions, which measures four lending ratios. A second type of examination is applied to large retail businesses, which consists of rigorous tests to evaluate lending, investment, and service. The third model is given to wholesale or limited-purpose community institutions. Those institutions are permitted to select the criterion under which they are to be evaluated: community development (CD) lending, CD investments, and/or CD services. The fourth model is the "strategic plan" examination, available to firms of any size, where an institution determines its own lending, investment, or service performance standards.[36]

Under all models, each institution is evaluated within its Performance Context, which reflects the institution's characteristics, including its products and business model, its peers, its competitors, its market, and the economic and demographic features of its assessment areas.

Retail institutions are evaluated on their performance within their assessment areas, but wholesale institutions can be assessed on the basis of their efforts nationwide.[37]

The impact of the changed regulations was substantial. Paperwork burdens declined, CRA loan commitments by banks substantially increased, and CRA grading by the regulatory agencies became tougher. Although the revised regulations have continued to lessen paperwork burdens, and loan commitments remain strong, grading has become less onerous. As of June 2008, 79.7 percent of examinations resulted in a Satisfactory rating, 16.1 percent in an Outstanding rating, and 4.1 percent in a rating of either Needs to Improve or a Substantial Noncompliance.[38] The share of Outstanding ratings stood at 27 percent prior to the 1995 reforms, but fell to approximately ten percent though 2001. The share of below-Satisfactory ratings continued to hover around two to three percent even after the reforms. The latest CRA ratings data indicate that the ratings' distribution is returning to what it was after the passage of the FIRREA in 1989, when roughly 80 percent of all institutions were rated as Satisfactory and the remaining institutions were divided between Outstanding and below-Satisfactory ratings.[39] A case can be made that the strong CRA ratings reflect an improvement in CRA activities, at least at some banks.

32 GAO, "Community Reinvestment Act."

33 Board of Governors, "Performance and Profitability" and Apgar and Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act.

34 Thomas, "CRA's 25th Anniversary."

35 Board of Governors, "Performance and Profitability."

36 Thomas, "CRA's 25th Anniversary."

37 Board of Governors, "Performance and Profitability."

38 FFIEC. CRA Rating Database. (Washington, DC: FFIEC, August 2008), available at www.ffiec.gov/craratings/default.aspx.

39 Thomas, "CRA's 25th Anniversary."

Empirical Evidence Regarding the Impact of the CRA

What has the CRA accomplished during the 30 years since its passage? Several studies examine this question and point to areas for future improvements. To make sense of these studies, it is necessary to identify the version of the rules the authors are assessing given that the act and its implementation rules have been changed significantly over the years. The following discussion covers the initial approach to implementing the CRA as well as major changes that increased disclosure and stressed performance over process.

With regard to the initial version of the act, most observers find that, despite the vast majority of institutions receiving at least a Satisfactory rating, the act effected only a modest increase in lending, and documenting CRA performance created an excessive paperwork burden on banks. The changes to the act in the early to mid-1990s made the ratings more transparent and increased the incentives for larger banks to achieve at least a Satisfactory rating. Finally, most observers agree that the 1995 interagency revisions to the CRA regulations had the biggest impact on CRA lending and led to increased lending and reduced regulatory burden.

Specifically, the evidence shows that the changes made to the law and regulations in the 1990s coincided with a rise from $1.6 billion in 1990 annual commitments to $103 billion in 1999, and peaking at $812 billion in 1998.[40] CRA lending volume increased greatly between 1993 and 2000.[41] The number of CRA-eligible home purchase loans originated by CRA lenders and their affiliates rose from 462,000 to 1.3 million.[42]

The Joint Center for Housing Studies at Harvard University conducted one of the most comprehensive studies of the CRA's effectiveness. Using enriched HMDA data to evaluate the CRA's performance between 1993 and 2000, researchers found that the CRA-regulated financial institutions operating in their assessment areas outstripped noncovered or out-of-area lenders in originating conventional, conforming, prime mortgages to CRA-eligible borrowers. Their multivariate statistical analysis confirms that CRA lenders originated more home purchase loans to lower-income individuals and in low- and moderate-income communities, and the lenders acquired a greater proportion of the low- and moderate-income loan market than they would have without the influence of the CRA. The researchers found further that the CRA "may have increased the CRA-eligible loan origination share by seven percent, from 30.3 percent to 32.4 percent" during the study period.[43] This seven percent increase translated to 42,000 originations. They also find evidence of more rapid increases in housing prices and higher turnover rates in CRA-eligible neighborhoods, indicating higher levels of demand from the wider availability of funds to borrowers in these areas. Finally, from interviews with CRA lenders, the researchers report that lenders incorporated CRA lending into standard business practices, which they found "profitable, productive of good will, or both."[44]

Other studies find that the CRA has been effective in encouraging financial institutions to lend to redlined neighborhoods. Several analyses conclude that the CRA had a positive influence in encouraging lending to low- and moderate-income borrowers and in low- and moderate-income neighborhoods. Litan and colleagues estimate that the CRA accounted for up to 20 percent of the growth in low- and moderate-income lending among CRA lenders, and that CRA lenders were more likely to originate prime loans to low- and moderate-income borrowers than were non-CRA lenders.[45] Avery and colleagues and Apgar and Duda both conclude that the CRA has expanded lending and service to low- and moderate-income individuals and neighborhoods. Avery

40 *National Community Reinvestment Coalition, "CRA Commitments" (Washington, DC: NCRC, September, 2007).*

41 *Factors other than the CRA reforms per se may also have contributed to this increase, including a strong economy, low interest rates, the development of credit scoring models (which reduced processing costs), and the increased use of securitization and the maturing of the secondary market, which enabled depository institutions to increase their mortgage lending volumes beyond their core deposit base and allowed nondepository mortgage financing companies to expand their lending activities.*

42 *Robert E. Litan et al. "The Community Reinvestment Act after Financial Modernization: A Final Report" (Washington, DC: Department of the Treasury, January, 2001); Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System" (Cambridge, MA: Harvard University, March, 2002).*

43 *Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act," p. 58.*

44 *Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act."*

45 *Litan et al. "The Community Reinvestment Act After Financial Modernization."*

finds this was particularly true for consolidating organizations, and Apgar and Duda find that CRA lenders operating within their assessment areas made a larger share of prime, conventional loans to CRA-eligible borrowers than either CRA lenders operating outside their assessment areas or non-CRA lenders.[46]

In addition, studies find that lending to low- and moderate-income and minority borrowers increased at a faster pace than lending to higher-income borrowers. Avery and colleagues, for example, find that lending to low-income borrowers increased by about 31 percent between 1993 and 1997, while lending to higher-income borrowers increased by only 18 percent over the same period.[47] Likewise, the number of home purchase loans made to residents of low-income neighborhoods increased 43 percent while lending to high-income neighborhoods rose only 17 percent.[48] Moreover, Barr finds that homeownership in low- and moderate-income areas increased by 26 percent between 1990 and 2000, whereas it increased only 14 percent in high-income areas during the same period.[49]

However, the research also indicates that the CRA may not be keeping up with innovations and trends in the financial industry, such as industry consolidation and nondepository lending, and this is eroding the act's effectiveness. Apgar and Duda find that the 25 largest lenders originated 52 percent of all home purchase loans in 2000; each of these lenders made more than 25,000 loans. However, in 1993, only 14 institutions made more than 25,000 loans, making up 23.5 percent of the retail mortgage market.[50] Similarly, Avery and colleagues note a 40 percent drop in the number of commercial banks and savings associations between 1975 and 1997 due to mergers and acquisitions, liquidations, and failures. Concomitant to the consolidation trend, more of the remaining financial institutions are operating outside their assessment areas, lending through affiliated mortgage and finance companies. Mergers and acquisitions extended the geographic reach of many institutions such that by 1998, firms with out-of-state headquarters owned more than 25 percent of banking assets.[51]

Other observations suggest that industry consolidation itself may have had little direct effect on CRA lending by banks and thrifts. For example, Avery and colleagues find no consistent, robust relationship between consolidation and home purchase lending between 1993 and 1997 at the market level. They find instead that the percentage change in lending in areas with high consolidation differed little from that in low-consolidation areas. However, the authors note that institutions increased their lending by only eight percent in their assessment areas, but 69 percent elsewhere, so any regional lending changes attributable to consolidation could have been offset by lending activities at other institutions.[52] Furthermore, CRA-regulated institutions operating within their assessment areas originated only 38 percent of all conventional prime residential mortgages and three percent of subprime loans in 2000.[53]

It does seem clear, however, that industry consolidation was accompanied by nondepository lenders gaining larger shares of mortgage origination in the years prior to the current market turmoil. Given that nondepository lenders are exempt from CRA requirements, their increasing share of mortgage originations may have weakened the act's scope and its ability to encourage stable lending in low- and moderate-income areas. In 1993, thrifts originated nearly 50 percent of mortgages on one- to four-unit properties, and commercial banks originate another 22 percent. Four years later, mortgage companies such as brokers and retail mortgage banks originated 56 percent of these loans. They grew by taking market share from thrifts, which were responsible for only 18 percent of such loans.[54] In addition, the mortgage industry's increasing specialization in delivery channels caused

46 *Robert B. Avery et al., "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act." Federal Reserve Bulletin (February 1999); Apgar and Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act."*

47 *Avery et al., "Trends in Home Purchase Lending."*

48 *Liz Laderman, "Has the CRA Increased Lending for Low-Income Home Purchases?" FRBSF Economic Letter 2004-16 (San Francisco, CA: Federal Reserve Bank of San Francisco, June 25, 2004).*

49 *Michael S. Barr, "Credit Where It Counts: The Community Reinvestment Act and its Critics." New York University Law Review 75 (2005).*

50 *Apgar and Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act."*

51 *Avery et al., "Trends in Home Purchase Lending."*

52 *Ibid.*

53 *Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act."*

54 *Ibid.*

mortgage lending to move out from banks. Commercial banks made one-fourth of all originations in 1997, although their mortgage company affiliates or subsidiaries processed as many as 43 percent of the residential mortgages the commercial banks originated.[55]

Scholars also studied the profitability of CRA lending, as the statute requires CRA lending to be safe and sound. Studies generally concur that CRA loans are profitable, although often less so than standard loans. Meeker and Myers carried out a national survey of banks, savings and loans institutions, and bank holding companies with mortgage subsidiaries. Almost all said CRA lending was profitable, although a significant proportion noted that it was less so than other types of loans. However, the response rate to the survey was only 16 percent and the sample of responses was not randomly selected.[56]

In a more recent survey, the Federal Reserve Board of Governors contacted the largest CRA-covered retail lending institutions. Eighty-two percent of respondents reported that CRA home purchase and refinancing loans were profitable, and 56 percent reported that CRA loans were generally as profitable as other home purchasing and refinancing loans. However, 51 percent of the surveyed institutions stated that CRA loans had a higher delinquency rate relative to all loans, although 69 percent indicated that charge-offs for CRA loans were either no different from, or were lower than, the rate for other loans. These results may be skewed by nonresponse bias, given that only 29 percent, or 143 of the original sample of 500 institutions, responded. Moreover the findings may not apply to smaller institutions, given that the responding banks accounted for 40 to 55 percent of all CRA-loan originations at the time.[57]

Naturally, the CRA is not without its critics. The most often cited is Jeffery Gunther, who argues that the benefits of the act do not outweigh its costs. Gunther attributes the growth in low- and moderate-income lending between 1993 and 1997 to: (1) the removal or loosening of unnecessary regulations, such as interest rate and geographic restrictions; (2) a reduction in information costs stemming from automation and improved communications technologies; and (3) the development of better relationships between real estate developers and neighborhood associations. He finds that low- and moderate-income lending at non-CRA institutions, such as credit unions and independent mortgage companies, grew faster than at CRA-covered institutions. Gunther claims the low- and moderate-income share of the lending portfolios at non-CRA firms increased from 11 percent in 1993 to 14.3 percent in 1997, whereas that of CRA lenders remained at approximately 11.5 percent over the same period. He also adds that non-CRA lenders accounted for slightly less than 40 percent of all one- to four-family home purchase loans originated in low- and moderate-income neighborhoods in 1997. These facts lead Gunther to conclude that because non-CRA lenders tend to be subject to fewer regulatory restrictions than their CRA counterparts, the loosening of regulations must be the major reason for the increase in volume of low- and moderate-income lending.[58]

Gunther also argues that the CRA imposes costs by encouraging institutions to take on additional credit risk. He finds that higher CRA lending levels are positively correlated with a problematic CAMELS rating, defined as a 3 or higher, but negatively correlated with a problematic CRA rating. He also finds a positive correlation between low- and moderate-income lending volume and a problematic CAMELS rating, but he finds no statistical relationship between low- and moderate-income volume and problematic CRA ratings. Finally, Gunther finds a positive relationship between reduced profitability and problematic CAMELS and CRA ratings.[59]

Gunther's evidence, however, is not persuasive. Although it is true that non-CRA lenders increased their share of subprime/CRA lending to 40 percent, they increased their share of all one- to four-family mortgage originations to an even higher 56 percent; they therefore did not increase their community lending by as much as their overall mortgage lending.[60] Gunther also has not differentiated between CRA loans by CRA lenders, which

55 *Ibid.*

56 *Larry Meeker and Forest Myers, "Community Reinvestment Act Lending: Is It Profitable?" Financial Industry Perspectives (December 1996).*

57 *Board of Governors, "Performance and Profitibility."*

58 *Jeffery W. Gunther, "Should CRA Stand for 'Community Redundancy Act'?" Regulation 23(3) (2000), pp. 56-60.*

59 *Ibid.; Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act."*

60 *Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act."*

tend to be on fair and reasonable commercial terms, and predatory loans, which are more likely to be made by companies that fall outside the jurisdiction of the CRA. In 2000, CRA-regulated institutions operating within their assessment areas originated only three percent of subprime loans.[61] Further, Gunther fails to prove that increased CRA lending caused the lower CAMELS ratings. An institution's CAMELS rating can decline for many reasons unrelated to the CRA. For example, CRA lending is a small part of the business of insured depositories. As noted above, the institutions themselves report that charge-off rates for CRA loans are approximately equal to or lower than all other loans, although the delinquency may be higher. Perhaps the biggest weaknesses with Gunther's claims are that his findings are based on small institutions and his data are old. The ratings data are from 1991 through 1996, and therefore do not reflect the impact of the 1995 rule revisions, which emphasize lending performance over process. Further, it is questionable whether results for small institutions can be extrapolated to large ones because small banks have less incentive to establish a robust CRA program.

The CRA and the Subprime Loan Crisis

The most recent charge against the CRA is that it is to blame for the subprime lending crisis. In recent months, a few commentators, such as economist Larry Kudlow and *Wall Street Journal* editorial board member Stephen Moore, have argued that the crisis is an inevitable consequence of the CRA.[62] They charge that the act compels banks to lower their underwriting standards in order to make loans to people who live in low- and moderate-income neighborhoods. Some critics add that the Riegle-Neal Act and the GLBA ratcheted up the pressure on banks to lend to less creditworthy borrowers. They say that banks had little choice but to make "CRA loans," which they assume to be less safe.

So how well do these arguments hold up to the empirical evidence? Not well. Below, we examine the two fundamental arguments: (1) that the CRA caused the dramatic rise in subprime mortgage lending; and (2) that subprime mortgage default, per se, is the root cause of the present mortgage market crisis.

History of Subprime Mortgages

Before we argue the point, we must define what we mean by a subprime mortgage. The term is used inconsistently in the relevant research. Under its 2001 "Interagency Guidance," the bank regulator community uses a definition of a subprime borrower, for example, as someone who has:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last five years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau of proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-services requirements from monthly income.[63]

Lenders usually and more casually classify mortgages as subprime if the borrower has a FICO score of less than 620. However, loans with very high loan-to-value ratios may also be rated below prime.[64] For example, some lenders consider a loan subprime if the borrower makes a down payment of five percent or less, even if their FICO score exceeds 660.

Subprime loans are by no means synonymous with CRA loans. The differences are marked between the characteristics of the borrowers who receive subprime loans and CRA loans. For example, an analysis of the HMDA data by ComplianceTech finds that, in 2006, about 67 percent of subprime loans were made to upper- or

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61 *Ibid*.

62 *David Walker Interview with Larry Kudlow, on Lessons from Subprime, CNBC, April 4, 2008; Steve Moore Interview with Larry Kudlow, on Kudlow & Company, CNBC, March, 26, 2008.*

63 *Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, Expanded Guidance for Subprime Lending Programs (Washington, DC: OCC, FRB, FDIC, OTS, January 2001).*

64 *The credit score cut-off in Fannie Mae and Freddie Mac's lending guidelines is a FICO score of 620. Today, it is probably more common to refer to a loan with a high FICO score and a high loan-to-value ratio as an "Alt-A" loan as distinct from subprime.*

middle-income borrowers; low- and moderate-income borrowers received only about 28 percent.[65] Indeed, low- and moderate-income borrowers received the smallest share of subprime mortgage loans in each year between 2004 and 2007. Some might assume that the majority of subprime loans were offered to minorities. However, since 2004 (when more detailed HMDA data were collected), more than one-half of the subprime loans were issued to upper- and middle-income borrowers in neighborhoods that were neither low nor moderate income.[66]

Subprime mortgages present a wide range of default probability. Fair Isaac ranks an individual with a FICO score of 660 at the 42nd percentile of the borrower population; this person has a 15 percent chance of a delinquency that exceeds 90 days within 24 months. A person with a FICO score of 600 is ranked in the 31st percentile, with a 31 percent chance of having a delinquency that is more than 90 days during the next 24 months.[67] Both these borrowers could be rated subprime.

Perhaps the best current characterization of a subprime borrower is having a FICO score of less than 660, with one or more of the banking agency characteristics outlined above, and with nonstandard terms designed to maximize profitability to the lender, not to advance the goals of the CRA.

Subprime loans hardly existed before the early 1980s because, prior to that time, it was not legal for a bank to charge different interest rates depending on the risk, to make a variable interest rate loan, or to make a loan with balloon payments.[68] Furthermore, as noted above, a combination of redlining and lending discrimination further discouraged loans to low- and moderate-income Americans.

Beginning in the early 1980s, banks were given the ability to price loans on the basis of risk, but it took more than a decade before subprime loans became common. As recently as 1995, only about ten percent of mortgage originations were subprime; by 1997 that number had grown to 14.5 percent.[69] The Asian debt crisis in 1998 caused interest rates to rise and markets to suddenly become illiquid. One result was that holders of subprime mortgages discovered they had underpriced risk when default rates rose to levels higher than expected. The repricing of risk caused the number of subprime originations to decline. However, the business quickly recovered and, by 2002, the volume of subprime mortgages was growing faster than ever. *Inside Mortgage Finance* finds that subprime originations grew 56 percent between 2002 and 2003. [70]

There are important key differences between the subprime loans made after 2002 and those made during the 1990s, when all grades of subprime loans grew at approximately the same rate. According to Chomsisengphet and Pennington-Cross, the growth in subprime loans between 2000 and 2003 was almost entirely in A-rated loans, the highest grade of subprime mortgages. In fact, the originations of lower grade subprime loans continued to decline slightly.[71]

The Influence of the CRA on Subprime Originations

In *Subprime Mortgages*, the late Federal Reserve Governor Edward Gramlich argues that both market and regulatory developments help explain the rapid growth in subprime loans. The emergence of credit scoring, he notes, offered a more inclusive and less costly way to make loans. However, a more crucial factor, he finds, was investors' expanding appetite for Wall Street's subprime securitizations. The share of subprime loans sold into securitizations grew from 28.4 percent in 1995, to 55.1 percent in 1998, to more than 80 percent in 2006.[72]

On the regulatory side, Gramlich believes the CRA played some role in the increase in subprime lending, if nothing more than to legitimize doing business in

65 Maurice Jourdain-Earl, The Demographic Impact of the Subprime Mortgage Meltdown (Washington, DC: ComplianceTech, 2008).

66 Ibid.

67 myFICO, Understanding Your FICO Score (Minneapolis: Fair Isaac Corporation, 2007).

68 In 1980, the Depository Institutions Deregulation and Monetary Control Act provided banks flexibility to set rates and fees for mortgages. In 1982, the Alternative Mortgage Transaction Parity Act allowed banks to make variable rate mortgages and mortgages with balloon payments.

69 Souphala Chomsisengphet and Anthony Pennington-Cross, "The Evolution of the Subprime Mortgage Market," Federal Reserve Bank of St. Louis Review (January/February 2006), pp. 31-56.

70 Inside Mortgage Finance. "The 2004 Mortgage Market Statistical Annual." (Washington, DC: Inside B&C Lending, 2004).

71 Ibid.

72 Inside Mortgage Finance. "The 2004 Mortgage Market Statistical Annual."

formerly redlined neighborhoods.[73] For example, he points to a study by Immergluck and Wiles, which finds that more than one-half of subprime refinances were in predominately African-American census tracts. Gramlich sees this as an indication that some banks were targeting low- and moderate-income neighborhoods in order to demonstrate they were serving the community.

However, over time, distinctions between CRA loans and subprime loans began to emerge. These distinctions are reflected both in regulatory attitudes and in more subjective observations. In the late 1990s and early 2000s, regulators began to draw a material distinction between the modern subprime loan and a true CRA loan. In the early 1990s, many CRA loans were "subprime" in the strictest sense of the term, meaning that borrowers in low- and moderate-income areas tended to have lower FICO scores. By the early 2000s, however, it was becoming clear that regulators were using the term "subprime" differently from "CRA loan," and that CRA lending practices differed from those of non-CRA lenders in low- and moderate-income areas. The CRA lender tends to have a social, or at least a nonpredatory, objective, given that it is regulated and examined by the bank regulatory agencies. In contrast, subprime lending, particularly of the 2005 to 2007 vintage, partially perverted the goal of the CRA in that it became a kind of redlining in reverse. The nonbank, non-CRA lenders—that is, modern subprime lenders—are driven to sell as many high rate loans as they can, with no particular social motivation.

A study by the law firm Traiger and Hinckley finds evidence of this distinction between lenders in the 2006 HMDA data. They conclude that banking companies that made CRA loans in the 15 most populous metropolitan statistical areas (MSAs) were more conservative in their lending practices than lenders not covered by the CRA. They find that 59 percent of these banks were less likely to originate high-cost loans, and when they did, the average interest rate was 51 basis points lower than the rate for prime loans. Interestingly, the banks that made CRA loans in large MSAs were 30 percent more likely to hold the high-cost CRA loans in portfolio than were banks and nonbanks that lent elsewhere. This suggests that the CRA has encouraged banks that lend in populous MSAs to take a thoughtful approach to low- and moderate-income lending, instead of simply moving farther out on the risk curve.[74]

Some analysts also point to the Tax Reform Act of 1986 as playing a role in the rise of subprime lending because taxpayers could deduct interest on home, but not consumer, loans. This incentive is particularly strong when housing prices are rising and interest rates are low, as was the case in the early 2000s. For example, 2003 loan performance data show that more than one-half of subprime loans were for cash-out refinancing. Gramlich discounts the importance of the home interest deduction in encouraging low- and moderate-income individuals to take out subprime loans because few of them itemize their returns, as is required to deduct mortgage interest.[75]

Since 2000, the subprime mortgage market has evolved in such a way as to further discount the CRA as a significant factor in the subprime mortgage market. Gramlich calculated from HMDA data that, "Only one-third of CRA mortgage loans to low- and moderate-income borrowers have rates high enough to be considered subprime."[76] Moreover, the 2006 HMDA data show that middle- and upper-income census tracts were home to more than one-half of subprime loans compared with about 25 percent in low- and moderate-income tracts.[77]

Another indication the subprime crisis was caused by factors other than the CRA is that un- or under-regulated mortgage brokers played an increasing role in originating subprime mortgages. Most of these brokerages are not owned by depository institutions or their affiliates, and are therefore not subject to the CRA. In 2004 and 2005, mortgage brokerage companies reported on more than 60 percent of all loans and applications under HMDA. Two-thirds of the brokers were independent. According to the Federal Reserve, these independent brokers originate 50 percent of all subprime loans.[78] If the CRA were

73 *Edward Gramlich, Subprime Mortgages (Washington, DC: Urban Institute Press, 2007).*

74 *Traiger and Hinckley, LLP, "The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis and Addendum" (New York: Traiger and Hinckley, January 7, 2008).*

75 *Gramlich, Subprime Mortgages.*

76 *Ibid, p. 25.*

77 *Jourdain-Earl, The Demographic Impact.*

78 *Executive Office of the President, Economic Report of the President (Washington, DC: U.S. Government Printing Office, February 2008), Table B-76.*

a driving consideration for depositories, banks and thrifts would want to be the portals through which all low- and moderate-income borrowers enter to ensure they receive full CRA credit for originating all qualifying loans.

As a case in point, Jim Rokakis, Treasurer of Cuyahoga County in Ohio, noted that in 2005, when home mortgage originations peaked in the Cleveland area, unregulated mortgage brokers made the vast majority of those loans. In 2005, he said, the biggest lender, Argent Mortgage, originated 18 percent of home mortgages and that the next largest lender, Century Mortgage, originated approximately five percent of the mortgages. Although both firms, now defunct, were well-known subprime lenders, neither was subject to the CRA. The fourth, fifth, and sixth largest lenders were likewise not subject to the CRA. In fact, the CRA applied to only four of the top ten mortgage originators in the Cleveland area in 2005. Together, the regulated originators were responsible for only 15 percent of originations, amounting to 648 mortgages. By way of comparison, home foreclosures in Cuyahoga County are on a pace to reach 15,000 in 2008. Rokakis concludes, "Did [the banks] make these loans to help their parent institutions' CRA ratings look better? Possibly. Did these 648 loans play a major role in the city's default and foreclosure crisis? Hardly."[79]

In fact, subprime mortgage lending has become a specialized segment of the mortgage business. As Chomsisengphet and Pennington-Cross say, "[T]he market share of the top 25 firms making subprime loans grew from 39.3 percent in 1995 to over 90 percent in 2003."[80] As of July 2007, 34 percent of the top 50 residential mortgage originators, measured in terms of the numbers of loans originated, were neither depository institutions nor owned by one of the 50 largest bank holding companies.[81] What is more, subprime lenders are concentrated in California. If the CRA were an overriding consideration, one would expect to see most large and regional banks competing in the subprime lending space to serve low- and moderate-income borrowers, and it would be unlikely that subprime origination would be dominated by specialists in California. That firms not subject to the CRA have come to play such a prominent role in the subprime business suggests that firms are originating these types of loans to make money and not as a response to regulatory or social imperatives.

In sum, the evidence shows that the emergence of securitization, loan risk pricing, and specialization are what caused the subprime mortgage market to grow. The CRA may have been one contributor to the growth, but it was certainly not a very important one.

The CRA and Subprime Mortgage Defaults

We now turn to the question of whether regulatory pressure to lend to low- and moderate-income borrowers created an environment in which banks and investors assumed too much credit risk, or whether market pressures pulled investors and banks into this situation. Mian and Sufi find that high demand for mortgage-backed securities (MBS) led to the surge in subprime lending.[82] Investors underpriced the risk posed by subprime collateralized mortgage obligations (CMOs), while investment banks and very large commercial banks created new secondary instruments to boost rates of return by greatly increasing leverage and liquidity risk. When the housing bubble burst, massive write-downs of these highly leveraged secondary securities soon followed.

Between 2004 and 2006, interest rates were reasonably low and the yield curve relatively flat; in fact, at the end of 2005 and again in January 2006, the yield curve was inverted. Yield spreads were so low that investors were not being adequately compensated for the risks they were assuming. Investors were aggressively seeking yield, and saw subprime mortgages as the ticket. Many assumed that the default risk of subprime mortgages, although higher than that of prime mortgages, would be relatively low. Given that the economy was stable, investors thought they could take advantage of a flat yield curve to increase their returns by financing long-term securities with cheap, short-term debt.

Investors' appetite for subprime mortgage securitizations was huge, and Wall Street responded by providing

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79 Jim Rokakis, "Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis." Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Washington DC, October 16, 2008.

80 Chomsisengphet and Pennington-Cross, "The Evolution of the Subprime Mortgage Market," p. 40.

81 American Banker. "Leading Residential Originators in the first half of 2007." (New York, NY: American Banker, October 2008), available at www.americanbanker.com/rankings.html?rankingchart=/Mortgages/101207LeadingResidentialOriginators.htm.

82 Atif Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis." Working Paper (Chicago: University of Chicago, Booth School of Business, May 2008).

more of the products, greatly increasing the demand for originations of subprime loans. At the retail level, mortgage brokers were happy to oblige, as they were paid on the volume of loans they originated.

One consequence of the decoupling of the mortgage origination and the mortgage holding process is the emergence of an agency problem, which undoubtedly played an important role in the events leading up to the subprime crisis. When banks make and hold a loan, they have every incentive to ensure the screening and underwriting process is done properly. After all, they stand to lose otherwise. In the originate-to-distribute model that became popular prior to the subprime crisis, the originator suffers no loss if a borrower defaults, as it bears little, if any, of the cost of underwriting mistakes. Instead, its income is typically based on the volume of loans it sells. Likewise, financial institutions that buy these loans have less incentive to scrutinize the loans they sell into securitization as carefully as the ones they keep. Instead, their income grows when they sell more loans into securitization.

Keys and colleagues confirm these agency problems in their analysis of two million home purchase loans made between 2001 and 2006. They find that originators pushed borderline, but subpar, low-documentation loans over the minimum qualifying credit score. As a result, the group of loans just above the cut-off score defaulted 20 percent more often than those just below it. They also find that the information available to mortgage-backed securities holders tends to understate the true risk of borrower default.[83]

Predictably, credit standards declined, especially in 2006. Federal Reserve Chairman Ben Bernanke summed up the analysis in testimony before Congress: "The originate-to-distribute model seems to have contributed to the loosening of underwriting standards in 2005 and 2006. When an originator sells a mortgage and its servicing rights, depending on the terms of the sale, much or all of the risks are passed on to the loan purchaser. Thus, originators who sell loans may have less incentive to undertake careful underwriting than if they kept the loans. Moreover, for some originators, fees tied to loan volume made loan sales a higher priority than loan quality. This misalignment of incentives, together with strong investor demand for securities with high yields, contributed to the weakening of underwriting standards."[84]

That said, the data show that the defaults of subprime mortgages, though quite problematic, are not by themselves high enough to cause a freeze in credit markets or to push the U.S. economy into recession. As of June 2008, the stock of subprime mortgages outstanding was roughly $2 trillion.[85] According to Standard and Poor's, only 20 percent of the worst of the subprime mortgage vintages that were originated after 2000 are more than 90 days delinquent.[86] Therefore, seriously delinquent subprime mortgages make up about 1.25 percent of all home mortgages and, even when including all other nonperforming one- to four-family home mortgages, the overall 90-day delinquency rate is lower than it was in the early 1990s.[87] In addition, many delinquent mortgages do not go into foreclosure. Demyanyk and Van Hemert forecast actual foreclosure rates at less than one-half of the 60-day delinquency rate.[88]

Instead, a new and different kind of securitization, rather than traditional subprime mortgage securitizations, caused the meltdown in the credit markets. In effect, Wall Street created highly leveraged bets predicated on the continued strong performance of traditional subprime mortgage-backed securities. Investment bankers morphed subprime mortgages into complicated credit derivative products, many of which were based on subprime CMOs and other collateralized debt obligations, which they sold to banks and other investors worldwide. Unlike stocks, futures, or commodities, these securities were not subject to margin requirements, and banks and investors paid for these secondary securitizations almost

83 *Benjamin J. Keys, "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans." Working Paper (Athens, Greece: European Finance Association, April 2008).*

84 *Ben S. Bernanke, "Subprime Mortgage Lending and Mitigating Foreclosures." Testimony before the Committee on Financial Services, U.S. House of Representatives, Washington, DC, September 20, 2007.*

85 *Congressional Budget Office, "Federal Housing Financial Regulatory Reform Act of 2008." Cost Estimate (Washington, DC: CBO, June 2008).*

86 *Standard and Poor's, "U.S. RMBS Subprime Securitization Volume Declines amid More-Stringent Guidelines," RMBS Trends (August 31, 2007).*

87 *FDIC. Statistics on Depository Institutions Report. (Washington, DC: FDIC, August 2008), available at www2.fdic.gov/sdi/index.asp.*

88 *Yuliya Demyanyk and Otto Van Hemert, "Understanding the Subprime Mortgage Crisis" (St. Louis, MO: Federal Reserve Bank of St. Louis, August 12, 2008).*

entirely with borrowed short-term money. The resulting leverage raised the potential rate of return, but also magnified the negative impact of any diminution in value of the underlying mortgages. It was these highly leveraged secondary and tertiary financial products that turned a problem into a crisis.

As defaults of underlying mortgages began to rise, the effect cascaded (and magnified) first onto the subprime originators themselves, and then onto the holders of these highly leveraged debt instruments. Many investors, realizing they had underpriced their risks, panicked. When investors pulled back, holders of the secondary and tertiary subprime securitizations were suddenly unable to roll over their debt. Many had no choice but to sell whatever assets they had, including these CMOs, at deeply discounted prices, thereby further reducing asset values. The massive and painful deleveraging we are all experiencing today has its immediate roots in this massive, systemic margin call that started at the end of 2008. Given the magnitude and source of the problem, one must conclude that CRA loans played at best a bit part in this global tragedy.

The declining performance of the most recent vintage of subprime loans is yet another piece of evidence that the CRA is not the cause of the subprime problem. Standard and Poor's shows higher delinquency rates, measured on an absolute basis, for 2006 vintage loans than for earlier vintages.[89] Demyanyk and Hemert find that, after adjusting for factors such as housing price appreciation and borrower credit rating, the average loan-to-value ratio increased while loan quality steadily declined between 2001 and 2006, yet the price spread between prime and subprime mortgages shrank. They attribute the declines in underwriting and in pricing to a "classic boom-bust scenario, in which unsustainable growth leads to the collapse of the market."[90] In other words, the pull of investor demand for mortgage-related securities drove the market, not a push from banks in the supply of mortgages. If banks largely were responding to pressure to make CRA loans, we would have witnessed the latter phenomenon.

One additional piece of evidence is that regulators have not increased the pressure on banks to make more CRA-related loans since 2000. Indeed, regulators were beginning to worry about lax lending practices. For example, OCC Chief Counsel Julie Williams said in a 2005 speech: "Recently introduced flexible financing options and relaxed terms have enabled many Americans to purchase homes they could not otherwise afford. But these nontraditional mortgage products also have raised concerns—about increased risks for borrowers and lenders and how well those risks are understood; about the extent to which banks' lending practices are fueling real estate speculation and unsustainable housing price appreciation; and about the marketing and disclosure practices spawned by the new practices and whether consumers fully understand the products they are selecting."[91] In September 2006, regulators urged banks to show caution, issuing guidance on nontraditional lending products such as "teaser" rate mortgages.[92] The guidance advised banks to evaluate a borrower's ability to repay the debt at the fully indexed rate, and that poorly managed concentrations in these products would invite elevated supervisory attention. They reiterated many of those points in another statement in March 2007.[93]

Thus, it is apparent that the increase in subprime defaults did not result from the CRA inducing banks to reduce underwriting standards or undervalue risk. Rather, investors' desire for higher investment yields and Wall Street's response pulled the non-CRA, unregulated mortgage market in that direction.[94]

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89 Standard and Poor's, "U.S. RMBS Subprime Securitization Volume Declines."

90 Demyanyk and Van Hemert, "Understanding the Subprime Mortgage Crisis," abstract.

91 Julie L. Williams, "Remarks by Julie L. Williams Chief Counsel and First Senior Deputy Comptroller Office of the Comptroller of the Currency," Canisius College School of Business, Buffalo, NY, September 14, 2005.

92 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Administration. Interagency Guidance on Nontraditional Mortgage Product Risks (Washington, DC: OCC, FRB, FDIC, OTS, NCUA, September 2006).

93 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Administration, "Proposed Statement on Subprime Mortgage Lending," Federal Register 72 (45) (March 8, 2007).

94 The current financial turmoil continues to evolve. However, it is becoming clearer that the problem goes beyond subprime mortgages and that the originate-to-distribute model and other capital market ills have infected the prime mortgage market as well. Of course, the CRA has essentially nothing to do with the prime mortgage market. If this were a CRA-induced phenomenon, we would undoubtedly not see the same outcomes throughout the credit spectrum.

The Future: The Need to Extend the CRA

As we have discussed, the financial services business and the manner in which financial products are structured, offered, delivered, and held by institutions and investors have fundamentally changed in the last 30 years. This raises the question of whether the CRA must also take a different approach to ensuring that low- and moderate-income neighborhoods have sufficient access to credit and other financial services.

The Changing Structure of Finance

When Congress was debating the CRA, banks were the dominant financial services companies, and they were certainly the dominant debt holders. However, during the past 30 years, the banking and thrift industries have been losing ground to other financial companies, and today nonbank lenders hold more credit-market debt than do banks and thrifts (see Figure 1).

New technologies, financial innovation, and increased economies of scale have helped to transform the financial services sector. Today, nonbanks, including hedge funds and broker-dealers, are able to amass savings and investments efficiently from all over the country for large borrowers and large securities offerings. Individual investors participate in national capital markets via mutual funds, tax-deferred pension funds, hedge funds, private equity funds, and others—bypassing traditional intermediaries. Whereas in 1990, bank and thrift deposits exceeded mutual fund shares by $2.75 trillion, in 2000 they both held roughly equal amounts.[95]

The banking industry responded to these changes in a variety of ways, including consolidating into very large, multistate companies. Community banks, with clearly defined service areas, have steadily lost market share to the big, money-centered banks. Since 1992, banks with $100 million to $1 billion in assets saw their share of banking system assets cut in half, from 19.4 percent to 9.5 percent (see Figure 2).[96] In 2007, the average institution was 20 times larger than the average institution in 1977.

One significant, but frequently ignored, consequence of the transformation to national financial markets is that local markets and local neighborhoods receive less individualized attention. As savings increasingly flow to large financial institutions and investment funds, investment becomes more focused on very large borrowers (both domestic and foreign). This is because large banks make loans most efficiently when the transactions costs per dollar are small. Large banks tend to serve small borrowers with standardized loans and other products, such as lines of credit, mutual funds, and credit cards. To make money on nonstandard loans—for example, by financing a start-up or a small business—requires knowledge of the borrower and experience with the local market, as well as close monitoring. Large banks cannot do this cost-effectively, although a local banker or a specialized lender with knowledge of, or close proximity to, local borrowers can. Indeed, community and regional banks more actively lend to projects that qualify for CRA credit. In 2001, banks with less than $1 billion in assets held only 16.8 percent of bank and thrift assets, but they extended about 28.2 percent of all CRA loans and more than 47 percent of CRA farm loans.[97] In fact, small business is highly dependent on community and regional banks for financing. In 2007, about 25.2 percent of commercial loans across the banking industry were in amounts less than $1 million. About 63.3 percent of the loans made by small banks were less than that amount.[98]

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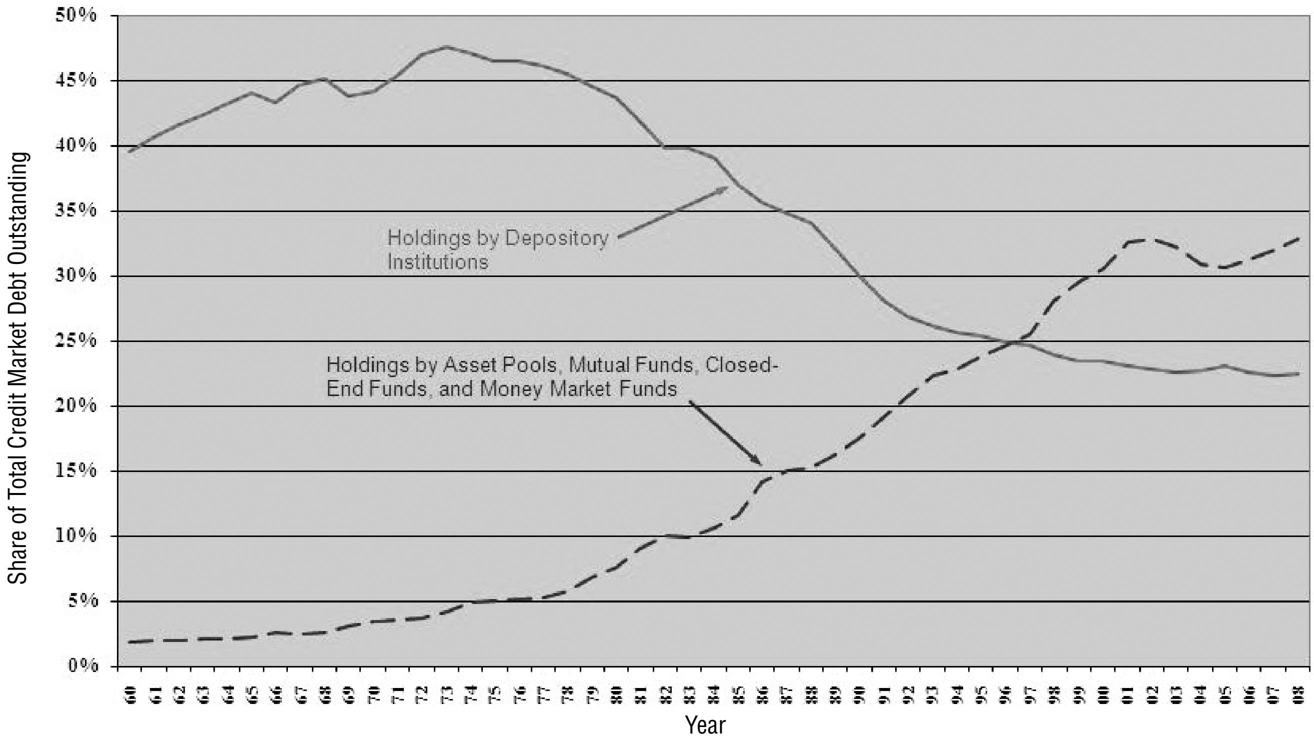
95 *Board of Governors of the Federal Reserve System. Flow of Funds Accounts of the United States. (Washington, DC: FRB, August 2008) available at www.federalreserve.gov/releases/z1/.*

96 *Source: FDIC Call Reports.*

97 *FFIEC.CRA National Aggregate Table 4-3 for All Institutions. (Washington, DC: FFIEC, March, 2007), available at www.ffiec.gov/craadweb/national.aspx.*

98 *FDIC. Quarterly Banking Profile, Fourth Quarter 2007. (Washington, DC: FDIC, December 2007), available at www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.*

Figure 1: Market-based Lenders have Surpassed Depository Institutions as Holders of Credit Market Debt



Source: Federal Reserve Board, Flow of Funds. Credit market debt includes: corporate and foreign bonds, government and agency securities, residential and commercial mortgages, open market paper, other loans and advances, and bank loans not elsewhere classified.

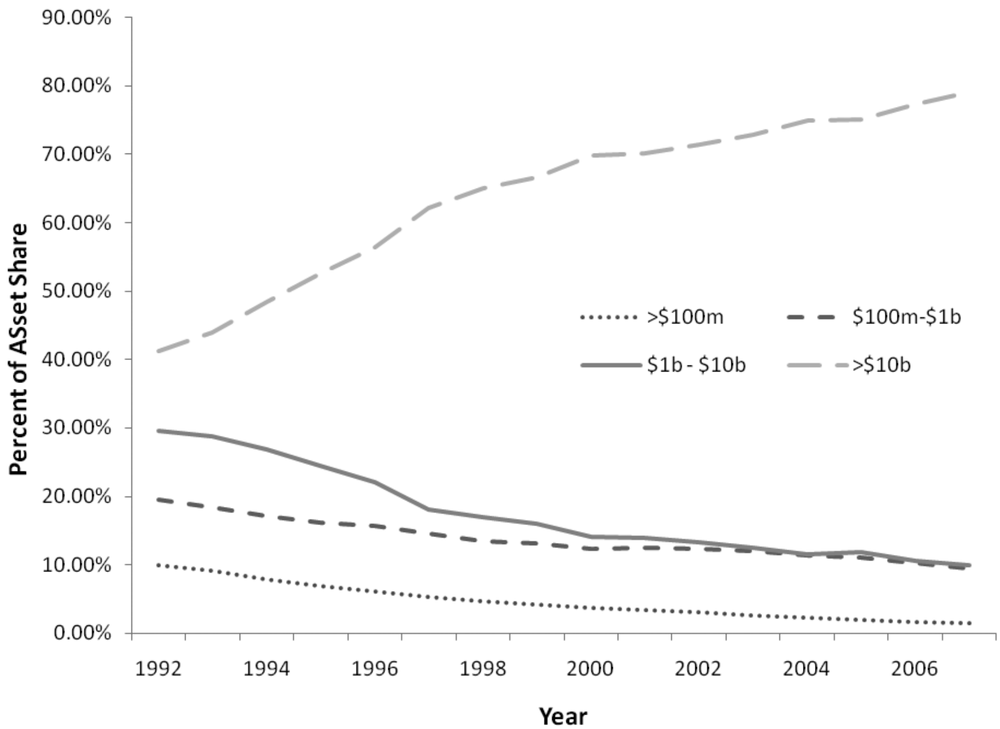
Furthermore, the evolution to global credit markets has made the financial services business more competitive, driven by the rise of nonbank entities, and more dependent on national and international capital markets. One result is that financial products have become more complex and sophisticated, and that low- and moderate-income borrowers must now have greater financial sophistication to understand the risks these products pose. In this sense, financial products have become less sensitive to the needs of low- and moderate-income borrowers. There are no better examples than the pay-option adjustable rate mortgages and low-doc home mortgages that have been cultivated by Wall Street's appetite for securitized products.

Low- and moderate-income homebuyers have seen their access to credit improve, in part as a result of government priorities. However, a potential consequence of the subprime crisis is a partial retreat of credit from low- and moderate-income areas, at least by banks and other regulated entities. This creates an opening for un- and underregulated outlets, such as check cashing centers, payday lenders, unscrupulous home improvement lenders, and sellers of inappropriate insurance and securities products, to prey on low- and moderate-income areas. Unfortunately, although there are many unscrupulous firms willing take the hard-earned savings of low- and moderate-income families, firms that offer residents in these neighborhoods safe and sound ways to save and invest their money are in short supply.

Implications of the Change in Financial Services for the CRA

So what do these fundamental changes mean for the low- and moderate-income neighborhoods and why does it make sense to expand the CRA? First, the obligation to meet the needs of low- and moderate-income neighborhoods is not being applied to nonbank financial services companies, whose share of financial assets now exceed those of banks and thrifts, and whose holdings continue to grow. Absent a CRA mandate that all financial services companies meet the needs of low- and moderate-income neighborhoods in the areas

Figure 2: Bank Asset Share by Size Class



they serve, and an expansion of the CRA mandate to non-credit-related services, these lower-income areas will continue to be underserved in financial services and fall prey to unscrupulous practices. Low- and moderate-income areas need access to other financial services and products–from insurance, savings, money transmittal, and securities services–on fair, nonpredatory terms.[99] This is even more urgent as financial services continue their shift from traditional banks to a more complex set of institutions and products.

Second, banks and thrifts are no longer the only financial service providers that benefit from the federal safety net, as they were in 1977. Not only has the Federal Reserve granted large broker-dealers access to the Discount Window, but it has intervened to save a major hedge fund (Long Term Capital Management) and a major insurance company (AIG) from collapse. The Fed has in essence supported almost all large financial services companies, regardless of charter, during the present financial crisis.

Third, the holding company structure allows banks to reduce their CRA obligations by pushing activities away from the bank and onto holding company affiliates; this has been going on for the past several years and is common in the mortgage and consumer lending areas.

Fourth, in many cases, the area banks serve is no longer self-evident or defined by a geographic community. Today, virtually all of the top 50 banking companies have extensive interstate banking operations. Moreover, new kinds of banks have emerged, such as credit-card banks and Internet banks, that operate nationwide with limited or no local and physical presence. For such firms, anchoring CRA obligations to the low- and moderate-income area surrounding a charter or headquarters does not reflect the reality of their businesses or their impact on low- and moderate-income consumers.

With respect to the credit needs of these lower-income neighborhoods, the subprime crisis indicates that, when it comes to home mortgages at least, the issue may be as much about the need to protect borrowers from fraudulent or predatory lending practices as it is about the flow of capital. However, reigning in the excesses of subprime lending may have a disproportionate impact on low- and moderate-income

99 *Michael Sherraden and Michael S. Barr, "Institutions and Inclusion in Saving Policy." Working Paper BABC 04-15 (Cambridge, MA: Harvard University, Joint Center for Housing Studies, March 2004).*

areas. Credit availability in these areas may contract substantially if lenders and investors believe wrongly that low- and moderate-income borrowers are not good credit risks. In that case, vigorous application of the CRA would be as necessary as it was in 1977 to ensure a continuous flow of investment on fair terms. Indeed, inner cities and economically declining regions require large capital investment in infrastructure, and the demolition or rehabilitation of dilapidated properties, if they are to be attractive environments for private capital investment, including investments in homes.

Adapting to New Realities

The obvious response to the changes in the financial services business would be to apply the CRA to all service providers who benefit from the federal safety net or who are government chartered and regulated. Besides banks and thrifts, this would include broker-dealers, insurance companies, and credit unions, at a minimum. It ideally would also include all other major financial institutions important to a stable economy, such as hedge funds and private equity funds with more than $250 million in assets, consistent with the GLBA's Small Bank size cut-off.

Logic and need point to this solution. As noted above, nonbank providers of services are expanding in the low- and moderate-income marketplace (as well as small businesses and farms)–a market the CRA is meant to serve. Furthermore, nonbank service providers clearly benefit from some form of explicit or implicit government support, through a government charter and regulatory authority or through the periodic need for the government to step in and resolve problems in times of crisis.

The CRA should be modified to reflect the different mix of products and services that many newly covered financial services offer, as well as their often nationwide reach. In the spirit of the CRA, covered institutions would be given maximum flexibility in their CRA-targeted market activities by avoiding the strict quantitative goals for CRA investment. For example, these institutions would be asked to provide their products to CRA-targeted markets, to devise appropriate modifications to their products for these markets, or to support the efforts of other financial services institutions to provide appropriate financial products and services to these markets. When financial firms have widely dispersed products and no defined service area, they would be given the flexibility to provide these products and services to national markets or those within their main services areas. Banks should also have geographic flexibility in defining their service areas.

To be successful, offering products and services in low- and moderate-income areas requires a certain degree of expertise, which some large nonbank financial institutions either have or can acquire. For example, several insurance companies have CRA-like programs that add value in low- and moderate-income geographies. However, for those institutions that do not have this expertise, they should be allowed to partner with community groups, such as the NeighborWorks networks, to serve these areas.

Another approach might be to ask nonbank service providers to customize their products to low- and moderate-income individuals and geographies, or modify their products to support efforts by other financial services institutions that provide useful financial products and services to CRA-targeted markets. For instance, broker-dealers might help communities raise funds for infrastructure development, hedge funds could hold community development-related debt instruments, and private equity funds could invest in community development projects or instruct firms in which they have ownership stakes to fund CRA projects in the communities they serve. Alternatively, broker-dealers and investment funds could offer pro bono financial, accounting, and tax analysis to community organizations and low-income families in targeted neighborhoods. This could be modeled after pro bono programs many law firms offer.

The goal of the CRA is to encourage doing profitable business in low- and moderate-income neighborhoods and with low- and moderate-income borrowers. It is not about losing money, just as it is not about engaging in predatory practices. This means that a revised and expanded CRA must encourage the creative use of financial tools to assist low- and moderate-income individuals or communities. For example, educational, community, and neighborhood revitalization projects should clearly be other ways to fulfill CRA obligations.

Finally, it will be necessary to examine and rate the quality of nonbank financial firms' CRA programs, to clarify regulatory expectations, and to provide an independent evaluation of an institution's efforts to serve its community. Realistically, these examinations also may be necessary to induce reluctant organizations to fulfill their responsibilities to low- and moderate-income communities. Perhaps the best approach would be interagency teams to engage in CRA examinations.

Nonbank financial institutions might also be given the option of providing all or part of their CRA assistance through the Community Development Financial Institutions (CDFI) Fund or in partnership with Community Development Financial Institutions. The federal government established the Fund in 1994 to support the establishment of CDFIs.[100] As of August 1, 2008, some 805 CDFIs have been established in various cities, most of which have been successful.[101] The CDFI movement has been constrained by limitations in the federal budget. Additional funds and assistance from nonbank CRA-covered institutions would add to the success of this effort and would support low- and moderate-income neighborhoods, which is fundamentally the same mission as that advanced by the CRA.

Financial firms should be given the flexibility under a modified CRA to provide these products and services to those markets that are within their main services areas, or nationally where they have widely dispersed products and no defined service area; indeed, this geographic flexibility ought to be provided to banks as well. Similarly, regulators should implement the revised CRA in a manner that preserves the spirit of flexibility.

To ensure comparable treatment of banks and nonbanks, all financial institutions must be subject to examination. The results of the examinations should be transparent to the public so they can readily discern the basis for the ratings. To provide a meaningful incentive for institutions to take the ratings seriously, Congress might consider capping the percentage of executive salary and bonus that is tax deductible if a firm fails to maintain at least a Satisfactory CRA rating.

Conclusion

The financial intermediation process, the structure of the banking system, and the methods for delivering financial services have changed in fundamental ways since 1977, and they have changed in ways no one could have predicted when the CRA was enacted. The facts on the ground in low- and moderate-income neighborhoods have changed as well. Explicit redlining is by and large a thing of the past. Innovations in technology and financial markets have lowered the cost of mortgages and consumer financing to the point that many more creditworthy borrowers are able to access credit.

Yet, the heart of the problem that the CRA was intended to solve remains: the need for the financial services sector to deliver enough support to low- and moderate-income neighborhoods. Neighborhoods require sound infrastructure, healthy retail businesses, and a core of well-maintained homes to retain value and to attract investment. There are still information deficiencies in these areas, resulting in a more subtle, and perhaps unintended but still hurtful, form of redlining, which in turn causes some banks to underinvest and contributes to racial discrimination in lending. Critics who argue that the subprime crisis proves the CRA is a misguided and unwarranted government intervention in the financial services sector are wrong, not only because the facts show that Wall Street excesses, not the CRA, caused the subprime crisis, but also because there are identified market failures that require government action to address.

The CRA will need to be modernized in three areas to bring it into the twenty-first century:

First, because nonbank financial institutions now hold more financial assets than banks and thrifts, the current CRA is tapping a declining share of the financial services sector. We therefore recommend expanding the CRA to nonbank financial institutions.

Second, some nonbank service providers cannot deliver financial services directly to low- and moderate-income residents because they do not have the means to make retail loans or provide other relevant retail products. However, they can channel funds through banks and thrifts and CDFIs, which do have experts in community development and the ability to deliver loans at the retail level. Alternatively, nonbanks can play an important role in coordinating community development initiatives by providing direct and indirect financial support to community development projects, and offering free advisory and support services.

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100 12 U.S.C. §4701 et seq.

101 Department of the Treasury, "Certified Community Development Financial Institutions: Alphabetical by Organization" (Washington, DC: DOT, August 2008), available at www.cdfifund.gov/docs/certification/cdfi/CDFIbyOrgName.pdf; and Community Development Financial Institutions Fund, Three Year Trend Analysis of Community Investment Impact System Institutional Level Report Data (Washington, DC: CDFI Fund, December 2007).

Third, providing alternative and innovative ways to fulfill CRA obligations, without establishing quotas, aligns with the spirit of the CRA and is an approach that has been successful to date. It emphasizes flexibility and innovation, not credit allocation.

With these changes, the CRA could become an even more powerful engine for revitalizing low- and moderate-income neighborhoods, coming to the fore just when the government's ability to use tax revenues to pay for infrastructure improvement and to invest in urban development is greatly diminished.

The CRA is not a panacea. Moving it into the twenty-first century requires the same kind of care and creativity that fostered the act in 1977, and provided for its reform in the 1990s. However, the CRA has proved it can help meet low- and moderate-income individuals and communities' material needs. Indeed, after the crisis caused by the subprime turmoil rolls through these neighborhoods, their problems are likely to be even more acute. Accordingly, we urge that the CRA be expanded as we have outlined here, and that considerable legislative and regulatory effort be turned to this purpose. ■

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A More Modern CRA for Consumers

Ellen Seidman
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When the Community Reinvestment Act (CRA) was enacted in 1977, low-income American communities, especially in cities, were suffering from disinvestment and a lack of credit availability. The CRA requires banks and thrifts operating in and near those communities to lend in them, consistent with safe and sound operations. Since 1977, the financial services system and financial needs of low- and moderate-income consumers have changed dramatically. At least until recently, when credit has tightened, we have become concerned not only about access to credit, but also about the quality of credit. Moreover, consumers have greater need for quality, affordable transactional, saving, investment and insurance products. The combination of the CRA's flexible affirmative mandate and the public availability of CRA examinations has been extremely powerful. This article asserts that while the CRA itself needs updating, its basic elements can and should be extended to a broader array of consumer financial products and providers.

Thirty Years of the CRA

In 1977, concerned about the denial of credit to lower-income communities, both minority and white, Congress enacted the Community Reinvestment Act. Under the CRA, "regulated financial institutions have [a] continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered." The statute also requires that federal bank regulators both "assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income (LMI) neighborhoods, consistent with safe and sound operation of such an institution" and that they "take such record into account in its evaluation of an application for a deposit facility by such institution."[1] Bank regulators award institutions one of four ratings, from Outstanding to Substantial Noncompliance, and they make the examination reports (called Public Evaluations) public.

In the 30 years since its enactment, the CRA has substantially changed how banks and thrifts view and serve low- and moderate-income communities and consumers. These communities have seen billions, perhaps trillions, of dollars of credit and investment flow to them as a result of the act, other collateral laws such as the Home Mortgage Disclosure Act (HMDA),[2] various antidiscrimination statutes, and Fannie Mae and Freddie Mac obligations.[3] Although those subject to the CRA once complained bitterly about it, that time has largely passed.

In the same 30 years, the U.S. financial system has also seen major changes. Even prior to the 2008 financial crisis, the number of banks and thrifts had declined

1 12 USC 2901.

2 12 USC 2801. HMDA was enacted in 1975 and requires virtually all institutions making residential mortgage loans to maintain records on applications, denials, income, race, gender, location, use, and since 2004 for certain loans, the price of individual loan transactions, and to report this information to the federal banking regulatory agencies or the Department of Housing and Urban Development. The Federal Financial Institutions Examination Council makes the information for individual institutions and geographies available to the public in paper and electronic form, and individual institutions are required to have their information available to the public at their offices.

3 According to the Joint Center for Housing Studies, "CRA has expanded access to mortgage credit; CRA-regulated lenders originate more home purchase loans to lower-income people and communities than they would if CRA did not exist." See "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System" (Cambridge, MA: Harvard University, March 2002), available at www.jchs.harvard.edu/research/crareport.html). Eugene A. Ludwig, Comptroller of the Currency, said in remarks at the U.S. Treasury on July 15, 1997: "Since CRA became law in 1977, we have witnessed more than $215 billion of loan commitments for low and moderate income lending. . . . Since 1993 . . . home mortgage loans to low and moderate income census tracts have risen by 22 percent, more than twice as fast as the rate of growth in all home mortgage loans. In the past four years, banks have invested four times as much in community development projects as they did in the whole previous thirty years." See full remarks at www.occ.treas.gov/ftp/release/97-65.txt). Likewise, Senator Levin, quoting Chairman Alan Greenspan, 145 Cong. Rec. S4775-76 (1999), said "CRA has 'very significantly increased the amount of credit in communities' and the changes have been 'quite profound.' In 1997 alone, almost 2,000 banks and thrifts reported $64 billion in CRA loans, including 525,000 small business loans worth $34 billion; 213,000 small farm loans worth $11 billion; and 25,000 community development loans totaling $19 billion."

precipitously. Those that remain are, in general, far larger and geographically disbursed, a trend that shows signs of accelerating, not slowing down. Moreover, both nonbank financial institutions (such as check cashers) and the capital markets now have far greater impact on the financial and economic lives of low- and moderate-income consumers and communities than they did in 1977.

The Need for Greater Access in a New World of Financial Services

From a consumer perspective, the current market troubles have demonstrated that although access to credit is critical, so too is the need for credit that is high quality and fairly priced. In an economy that is moving away from cash and toward greater global connectivity, consumers need well designed and fairly priced transactional services, including remittance services. The nearly nonexistent national savings rate coupled with the many families who have no or limited assets, also underscore the need for savings and investment opportunities that are easy to access and use.[4]

From a community perspective, both branch closures and the consolidation of the banking industry have reduced access to bank services and decision makers and to the talents and leadership of local bankers in meeting community economic development needs. At the same time, community-based organizations, including community development corporations, Community Development Financial Institutions, loan funds, counseling agencies, advocates, and others, have expanded to serve these communities directly and to leverage the efforts of banks and thrifts operating under the CRA.

The bulk of discussion about the CRA is focused on community investment and on home mortgage lending. This is not surprising given that measurement of activity in these two areas is relatively straightforward (HMDA makes measuring residential lending particularly easy), and regulators and outside forces have kept up a steady stream of questions about "how much are you doing, where, and for whom?" Intermittently, critics have taken on the Service Test, which attempts to measure how well banks serve customers other than through loans, arguing that it is misguided or simply ineffective in either measuring or encouraging banks and thrifts to provide quality financial services in lower-income communities.[5]

This article, in contrast, asks whether the framework of the CRA—a relatively broad affirmative mandate to serve—can be the basis for substantially improving the financial services offered to consumers of all income levels, in all communities, but with a special focus on the needs of low- and moderate-income consumers. It considers the question with respect to both the banks and thrifts already covered by the CRA and the many other types of organizations that also provide financial services to consumers.

The Changing Face of Consumer Financial Services

Since the CRA was enacted, consumer financial services, particularly for those of modest incomes, have changed dramatically. Consumers have moved from an economy in which cash and, to a lesser extent, checks were the major way of transacting business, paying bills, and getting paid to one in which only one-fifth of retail transactions are made in cash, and check use is declining in favor of credit and debit cards and ACH transactions.[6]

To purchase a large item in 1977, consumers sought a term loan from their bank, and for smaller transactions, they used independent consumer finance companies and retailers. Today, a bank term loan (other than for a car, boat, or house) is rare, the independent finance companies have largely been acquired by banks, and credit cards are ubiquitous. In 2004, approximately

4 *For information on low savings rates, see Department of Commerce, Bureau of Economic Analysis, "Personal Savings Rate (online chart, 2008), available at http://www.bea.gov/briefrm/saving.htm. The savings rate has been below one percent since 2005, although for the second quarter of 2008, it was more than two percent. This was likely due to the federal stimulus checks that families received, largely in May, when the rate shot up to 4.9 percent. Personal savings then declined to 2.5 percent in June. For information on poverty, see Signe-Mary McKernan and Caroline Radcliffe, "Enabling Families to Weather Emergencies and Develop: The Role of Assets." (Washington, DC: Urban Institute, 2008), available at http://www.urban.org/publications/411734.html.*

5 *See, e.g., Kelly Cochran, Michael Stegman, and Robert Faris, "Creating a Scorecard for the CRA Service Test: Strengthening Banking Services Under the Community Reinvestment Act" (Washington, DC: Brookings Institution, 2003), available at http://www.brookings.edu/papers/2003/01childrenfamilies_stegman.aspx.*

6 *On retail transactions see Ronald Mann, Charging Ahead: The Growth and Regulation of Payment Card Markets (New York: Cambridge University Press, 2006) p. 10, data as of 2003). On rise of debit cards, see Federal Reserve, 2007 Federal Reserve Payments Study (Washington, DC: U.S. Federal Reserve, December 2007), available at http://www.federalreserve.gov/newsevents/press/other/20071210a.htm.*

75 percent of American households held a credit card, and in 2008, nearly $1 trillion in credit card debt was outstanding.[7] But the advent of credit scoring combined with the demise of usury laws has made credit more expensive than in the past, in both interest and fees. During this current crisis, all types of credit have become scarce, particularly for those of modest means or with less-than-pristine credit records. These changes mean that pricing and terms are as big a concern as access to credit.

Similar changes have occurred in the mortgage market. Until the current mortgage crisis, mortgage originations and funding had shifted from banks and thrifts to origination through broker and correspondent channels, often for sale to independent mortgage companies, with funding by the capital markets. Although the large independent mortgage banks have ceased to exist, and mortgage credit in general has dried up, it is unlikely that originations will fully move back to retail banking. The sheer scale of the housing market, even if we assume a return to pre-2000 origination levels, suggests brokers will continue to play a role, but that all those who are part of the mortgage origination chain, including brokers, will be required to take some responsibility for the performance of the loan.

Other areas of financial services have also seen major changes. The number of Americans who were born abroad climbed from approximately 14 million in 1980 (6.2 percent of the population) to 33.5 million in 2003 (11.7 percent of the population), creating demand for a new financial service: remittances.[8] The stock market has also seen a surge of new players. Whereas in 1977 few Americans invested in financial instruments beyond a savings account, as of 2004, one in five American families owned stocks and 15 percent owned mutual funds. Nearly one-half had retirement accounts.[9] These products are generally provided by entities other than banks and thrifts, including broker-dealers and insurance companies.

The Growing Ranks of the "Unbanked"

These broad changes in consumer financial services have uniquely affected lower-income Americans. The combination of a shrinking cash economy, the consolidation of the bank and thrift industries (frequently accompanied by fewer branches in minority and lower-income communities), and the large number of new immigrants have generated additional needs and introduced new players to the system. Consumers need ways to turn paychecks into cash, send money to native countries, and borrow money—ranging from small sums for an emergency to home mortgages based on unconventional income sources or streams. Nonbank financial service providers have become ubiquitous in lower-income communities, including check cashers, whose services frequently include remittances, bill pay, and small dollar credit; other small-dollar lenders such as payday lenders, pawn shops, and auto title lenders; and retailers who offer general purpose, reloadable, prepaid cards in addition to their own gift cards. Author Howard Karger estimates that the United States has more check-cashing and payday lending outlets than McDonald's, Burger King, Target, Sears, JC Penney, and Wal-Mart stores combined.[10]

The alternative sector is frequently characterized as high-priced and predatory, but it also provides products and services that meet the financial services needs of a significant swath of the population that banks, thrifts, and credit unions are not serving fully.[11] Although the Federal Reserve's Survey of Consumer Finance estimates that as of 2004, about ten percent of families lacked a checking account, other surveys suggest that the number of individuals without a checking or savings account reaches nearly 30 percent among lower-income populations.[12] As Michael Barr noted in his recent study of lower-income consumers in Detroit:

7 *For data on credit cards, see Brian K. Bucks, Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," Federal Reserve Bulletin (March 2006), p. A31. For data on outstanding debt, see "Federal Reserve Statistical Release G.19" (Washington, DC: Federal Reserve, July 8, 2008).*

8 *U.S. Census Bureau, "Table 1. Nativity of the Population and Place of Birth of the Native Population: 1850 to 1990" (Washington, DC: Census, March 9, 1999), available at www.census.gov/population/www/documentation/twps0029/tab01.html; U.S. Census Bureau, The Foreign-born Population in the United States: 2003 (Washington, DC: Census, August 2004).*

9 *Bucks, "Recent Changes in U.S. Family Finances" p. A13.*

10 *Howard Karger, Shortchanged: Life and Debt in the Fringe Economy (San Francisco: Berrett Kohler Publishers, 2005), p. 6.*

11 *Karger, Shortchanged.*

12 *Bucks, "Recent Changes in U.S. Family Finances," p. A15. For the other surveys, see, e.g., Ellen Seidman et al., "A Financial Services Survey of Low- and Moderate-Income Households," (Chicago, IL: Center for Financial Services Innovation, 2004), available at www.cfsinnovation.com/research-paper-detail.php?article_id=293; Barr, "Financial Services, Saving and Borrowing."*

> Though associated with high fees both banked and unbanked sample members often describe AFS [alternative financial services] transactions as convenient. At the same time, bank accounts are usually not well structured to serve LMI households. Bank fees are quite high, and over half of banked LMI households reported paying minimum balance or overdraft or insufficient fund fees in the previous year. The financial services mismatch between the needs of LMI households and the products and services offered to them largely constrains LMI households to choose among high fee, ill-structured products offered by banking and AFS institutions.[13]

The Center for Financial Services Innovation recently completed a national study of un- and underbanked consumers, a group that includes approximately 40 million households, or about 36 percent of American households.[14] This group has a median household income of $26,390. Nearly one-half (47 percent) work full-time, and 63 percent own their homes. The group is 60 percent white, 19 percent Hispanic, and 16 percent non-Hispanic black. The survey found that nearly one-half of the group did not have a checking or savings account, that is, they were "unbanked," although about one-half of that number had had an account at some point in the past. The most frequent reason for not having a bank account was not having enough money to make one useful. The Detroit study reached similar conclusions, but also noted that three-fourths of the unbanked said they would like to open a bank account in the next year, and one-third had recently looked into getting a bank account.[15]

A New Paradigm for Responsibility in Consumer Financial Services

Both the changing consumer financial services landscape in general and the particular problems that lower-income consumers face as they attempt to transact business (borrow, save, invest, and insure their possessions) strongly suggest that it is time for a new paradigm for consumer financial services. To address the substantial and continuing changes in the industry, the country needs a proposal just as bold and just as flexible as the CRA was 30 years ago. I suggest the following:

> Any financial institution that provides an essential consumer product must make that product available in a fair and transparent manner to low- and moderate-income consumers in all communities in all broad geographies in which the entity does more than an incidental amount of business in the product.[16]

Fairness and Transparency

Fairness and transparency are central principles in the financial services sector. But these principles often apply differently to low- and moderate-income consumers. The reasons for these different applications include a smaller margin for error and lack of capital on which to base a recovery when something goes wrong; generally lower education levels among participants; less access to quality and timely financial advice; and, particularly in the last 15 years, a younger population often with limited experience with the American financial system.

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13 Barr, "Financial Services, Saving and Borrowing" p. 3.

14 Center for Financial Services Innovation, "The CFSI Underbanked Consumer Study, Underbanked Consumer Overview andMarket Segments." Fact Sheet. (Chicago, IL: CFSI, June 8, 2008), available at www.cfsinnovation.com/research-paper-detail.php?article_id=330366. The 40 million includes both unbanked (no checking or savings account) and underbanked (having an account, but having made one or more nonbank financial transactions in the prior 30 days).

15 See Barr, "Financial Services, Saving and Borrowing" pp. 13-14.

16 The paradigm would not explicitly cover financial institutions that do not provide products to consumers directly or through agents, such as investment banks and Fannie Mae and Freddie Mac. However, the responsibilities institutions have in directly serving consumers should carry through to their investment activities. See Letter from Edward B. Kramer, Deputy Superintendent of Banks, State of New York Banking Department, "Due Diligence Recommendations Concerning the Eligibility of Loan Purchases and Investments for Consideration Under the Community Reinvestment Act," July 26, 2001, available at http://www.banking.state.ny.us/lt010726.htm. In addition, these institutions might well be covered by some version of the CRA Investment Test.

In this context, fair then means that an entity providing essential consumer financial services to the general public, directly or through agents, must abide by the following principles:

- Essential financial services must meet the needs and desires of low- and moderate-income consumers, with sufficient market research to accurately assess those needs;
- Essential financial services must be offered at equitable prices and terms, on the basis of cost and an accurate assessment of risk;
- Analysis of potential profitability over time, need for capital, and other investment criteria must be done on a basis that is no less favorable for service to low- and moderate-income consumers than it is for wealthier consumers.

For example, if a bank offers overdraft protection based on a line of credit or a tie to a savings account to customers who open checking accounts in branches in suburban neighborhoods, it would also be required to investigate whether consumers in lower income communities would prefer this type of protection to a fee-based overdraft program. It would then analyze the potential profitability of such programs in both types of communities on an equal basis (e.g., if profitability is analyzed on a product rather than customer basis in one place, the same type of analysis should be used in the other), and offer (or decline to offer) the product in both places at prices that accurately reflect cost and risk on a similarly individualized basis.

Transparency has two essential dimensions, one for consumers and one for the public:

- Firms must provide actual and potential customers with quality service and accurate information about the terms of products, delivered in a timely and understandable fashion, including realistic information about risks;
- Firms must provide the public (or if information is proprietary, a government intermediary) with information on how the firm provides essential consumer financial services; and that information must be available in a manner and with sufficient quality, quantity, and timeliness to allow persons outside the firm to accurately assess the extent to which a firm meets its obligations, both during the current period and over time.

Taken together, these two concepts would require better and more accurate disclosure to consumers about product terms and risks—the one-page mortgage disclosure document suggested by Alex Pollock of the American Enterprise Institute is an example[17]—and the extension of HMDA reporting to other products such as credit cards and small consumer loans.

This paradigm thus focuses on the effective development, marketing, and distribution of well-designed and understandable consumer products and services, and it imposes a requirement of equity across communities and consumers of all types. It concentrates the attention of business, the public, and government on what is important to consumers, and uses the market forces generated by consumers with the knowledge and resources to demand high-quality financial services to extend the reach of those products and services to the rest of the market.

Products and Services Subject to the New Responsibility Paradigm

The extent of coverage of products under this new paradigm is an important consideration. It is critical not to pull back on current coverage of the CRA. At the same time, it is also clear that not all products, services, or financial institutions should be covered by CRA-style regulation. To take an extreme example, it is neither necessary nor an appropriate use of scarce enforcement resources to ensure that hedge fund investment opportunities be available to low- and moderate-income consumers. However, coverage should not be excessively limited, or too tied to current economic conditions and financial structures and opportunities.

A useful way to think about products and services that should be covered by the CRA is to focus on those financial products and services that are essential to full and active participation in the American middle class. These include products and services to meet transactional, credit, saving and investment, and insurance needs. Products and services should be considered "essential"

17 *See* Alex Pollock, "The Basic Facts About Your Mortgage Loan," (Washington, DC: American Enterprise Institute, 2007), available at http://www.aei.org/docLib/20070913_20070515_PollockPrototype.pdf.

only if the public broadly uses them. Although the items included will likely change over time, by defining them in terms of functionality rather than specific products, we reduce the need for additions or subtractions.

Transactions

With respect to transactions, the ongoing, revolutionary changes occurring with prepaid cards and the likelihood of major breakthroughs in using mobile phones for financial services call for a functional approach.[18] Essential functionalities are converting sources of revenue (particularly paychecks and benefits of all sorts) into useable means of payment; and a means of making timely and secure payments and transfers to savings or investment.

Credit

For credit, "essential" may be defined in terms of likely future credit needs. This, of course, was the area of initial concern under the CRA, and it continues to be critical in providing the leverage for major wealth-building investments such as a home or higher education and to smooth income fluctuations. Thus, essential credit products include short-term credit, whether secured or unsecured, for small amounts; auto credit; mortgage credit, and credit for postsecondary education.

Savings and Investments

Saving and investment were not part of the initial CRA focus, in part because the CRA at the time sought to address the problem that financial institutions in lower-income communities did not reinvest low-income individuals' savings in their communities. Today, the problem is not so much reinvestment of savings as spurring savings in the first place. It is clear, given the current debt-led economic troubles and low national personal savings rate, that Americans need to save more money.

In 1977, individual access to investment opportunities was limited, but there was less need for such opportunities because defined-benefit retirement plans, in which the employer took responsibility for investment decisions and outcomes, were much more common. This has since changed. The new paradigm should therefore cover: (a) non purpose-limited, short-term savings opportunities; (b) longer-term, low-risk saving and investment opportunities (e.g., insured accounts, CDs, and Treasury obligations including savings bonds); and (c) investment opportunities such as retirement accounts and tax-advantaged Section 529 education savings plans.

Insurance

Insurance is also an essential product. In most states, drivers must be insured, and mortgage creditors demand homeowner's insurance. Both types of insurance are important to protecting these assets. It is therefore critical to include automobile and homeowner's insurance in the new responsibility and accountability regime. Medical insurance, including long-term care coverage, is also highly desirable; a significant share of bankruptcies is caused by uninsured medical expenses. However, this is an issue that goes far beyond the financial services sector and requires a much broader solution.

How These Principles Relate to Current CRA Enforcement and Interpretation

To bring the CRA more fully in line with both the modern financial services system and the principles and scope proposed, some changes are needed. The most important are the following:

- The CRA should cover service to low- and moderate-income consumers in providing an essential product everywhere a bank or thrift does a significant amount of business in any of the essential products. If a firm operates nationally, it should be evaluated on how well it serves low- and moderate-income consumers nationwide with the type of product it is offering nationally. Thus, CRA coverage with respect to mortgage loans should depend on where the firm makes such loans, not where it has deposit-taking branches, as is currently the case.
- Effective public disclosure should be added that covers additional essential products, including the essential transaction and savings products used by low- and moderate-income consumers. Thus, HMDA should be extended to other essential consumer products.

18 *For example, the advent and spread of reloadable prepaid cards, which can in some instances function as a bank account, would have been unforeseen five years ago; the spread of mobile banking has the same potential for dramatic change in the consumer financial services market. For a comprehensive discussion of these and other technologies in the context of lower-income consumers in developing countries, see Consultative Group to Assist the Poor (CGAP), "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance" (Washington, DC: CGAP, 2008), available at www.cgap.org/p/site/c/template.rc/1.9.2583.*

- Any for-profit subsidiary or holding company affiliate that provides any of the essential products should be evaluated in the same manner and at the same time as the largest bank or thrift in the holding company group. This would overcome the current situation in which lower quality products offered by a bank or thrift holding company through a subsidiary escape evaluation because they are offered outside of the bank or thrift.
- Consumer protection and fair lending responsibilities must be more firmly embedded in CRA evaluations. This would extend the 2005 regulatory revisions that mandate, when evaluating lending activities, that evaluators assess compliance with the fair lending and consumer protection laws and regulations to cover transactional, saving, and investment offerings.[19] The quality of products, especially credit products, must be considered in addition to the penetration of such products into all communities.
- Incentives should be established that are external to the CRA, potentially including reduced insurance premiums for outstanding performance; as the current troubles in the market remind us, treating consumers well is good for business over the long term. To stimulate better performance and limit grade inflation, the number of Outstanding ratings should be limited, perhaps to a slowly increasing percentage above current levels.

Extending the Paradigm to Other Essential Functions

Some commentators assert that the CRA, with its requirement that banks and thrifts fully serve all communities in their assessment areas, is to blame for the current financial crisis.[20] There are many reasons to doubt such claims, including timing (CRA was passed and the regulations strengthened long before serious problems arose), the generally higher quality of mortgages made by depository institutions in their assessment areas, and the fact that the worst excesses have occurred as CRA enforcement diminished in the past eight years.[21] However, the most convincing reason not to lay the blame on the CRA is the high proportion of high-priced loans that were made by entities not subject to the CRA.[22] The problem, of course, was that these other institutions were also exempt from the level of consumer protection to which banks and thrifts were subject, and they discovered that lending with fewer limitations to individuals in lower-income communities was highly profitable.[23]

This problem of unequal regulation and enforcement raises a need for some caution with respect to extending the CRA beyond banks and thrifts, particularly for credit products. Although the Federal Reserve and Congress have reduced the regulatory disparity in mortgage lending, enforcement disparities will continue and other types of credit are still under highly variable regulatory schemes.[24] For example, payday lending is

19 See 12 CFR 345.28(c) (FDIC); 12 CFR 228.28(c) (Federal Reserve); 12 CFR 25.28(c) (OCC); 12 CFR 563e.28(c) (OTS).

20 See, e.g., comments of Larry Kudlow at http://www.cnbc.com/id/15840232?video=702180420&play=1. More recent accusations are collected (and rebutted) at Media Matters, September 30, 2008, available at http://mediamatters.org/items/200809300012.

21 See Randall Kroszner, "The Community Reinvestment Act and the Recent Mortgage Crisis" (Washington, DC: Federal Reserve Board, December 3, 2008), available at http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm. For evidence of high-quality mortgages, see See Traiger and Hinckley LLP, "The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis" (New York, NY:Traiger and Hinckley, LLP, January 7, 2008) available at www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf; and Traiger and Hinckley LLP, "Addendum to: The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis," (January 14, 2008) available at http://www.traigerlaw.com/publications/addendum_to_traiger_hinckley_llp_cra_foreclosure_study_1-14-08.pdf. For the diminishing enforcement during the past eight years, see Ellen Seidman, "It's Still not CRA," (Washington, DC: New America Foundation: September 22, 2008), available at www.newamerica.net/blog/asset-building/2008/its-still-not-cra-7222; Michelle Singletary, "Blame Game Gets Nasty When it Targets the Poor," Washington Post, October 12, 2008, p. F1.

22 Robert Avery, Kenneth Brevoort, and Glenn Canner, "The 2006 HMDA Data," Federal Reserve Bulletin (December 2007), p. A89.

23 See Edward Gramlich, "Booms and Busts, The Case of Subprime Mortgages" (Jackson Hole, WY: Federal Reserve Board, August 31, 2007), available at www.kc.frb.org/publicat/sympos/2007/pdf/2007.09.04.gramlich.pdf.

24 For efforts by the Federal Reserve, see 73 Fed. Reg. 44522 (July 30, 2008). For congressional efforts, see Public Law 110-289 (July 30, 2008).

entirely prohibited in several states (e.g., New York, North Carolina, and Maryland), subject to relatively tight usury caps in others (Ohio and Arkansas), allowed with other types of regulatory protections in others (Illinois), and allowed without significant limitation in still others (California). As we think about extending the CRA, it will be important to coordinate its service requirement with an acceptable minimum standard of consumer protection.[25]

One way to extend the CRA to other types of financial institutions is to replicate the statute, assigning responsibility for examination and enforcement to regulators (to the extent the firms involved are subject to regulatory supervision), or to surrogates such as the U.S. Department of Housing and Urban Development. For credit unions, which are regulated similarly to banks and thrifts (and also the beneficiaries of federal insurance), such extension would seem appropriate, perhaps modifying the credit unions' statutory service obligation to take into account enhanced responsibilities under a new regime. However, for other types of financial services, operating under different types of (or no) supervisory regimes, alternative solutions are likely required. These solutions should take maximum advantage of existing regulatory systems and responsibilities with the aim of achieving equity in result, rather than complete consistency in regulatory methodology.

Enhanced Public Reporting

A first step should be to ensure that any requirement for public reporting and dissemination of information about credit extends beyond residential lending to include all creditors who extend similar types of credit.[26] As HMDA has demonstrated, the obligation to report can be effectively extended to institutions outside federal regulatory jurisdiction when uniform reporting requirements are in effect, when government-supplied software is available, and when a single entity (in the case of HMDA, the Federal Reserve) is responsible for cleaning data, making it public, and doing the initial analysis. Although the Department of Housing and Urban Development is the initial recipient of mortgage data under HMDA, information about other types of credit could be provided initially to state regulators or directly to the Federal Reserve.

Similarly, public reporting on noncredit services should be tailored to the type of service and should include all those providing such services as a significant part of their business. For example, to ensure banks, thrifts, or credit unions are meeting service obligations, the primary focus might be the incomes of checking and savings account holders. For insurance companies, the information might relate to the characteristics of holders of defined types of policies. Because this information would be industry-specific, it should be gathered and disseminated by industry-specific regulators where such exist, under standards developed in coordination with bank regulators. As with credit information, other types of financial services providers could provide information directly to the Federal Reserve.

Increased Regulatory Reach and Enforcement

Public dissemination of information serves to inform the public and expand the likelihood that those providers who are offering quality products will have a competitive advantage with consumers. However, to ensure that providers are meeting their obligations to serve fairly consumers who may not be able or inclined to take advantage of such data, public dissemination of data must be accompanied by a regulatory regime that evaluates compliance and imposes consequences, both directly on the company and indirectly by increasing public awareness of how an institution is behaving. This aspect is the most difficult part. We cannot expect other regulatory regimes to adopt wholesale the bank regulatory model, and it is unlikely that would even be desirable.

Instead, the principles of the responsibility paradigm should be added to various regulatory regimes in a manner that is consistent with the scope and intent of the particular regime, and that is consistent with and builds on existing and improved consumer-oriented obligations and protections. For state-regulated entities, the appropriate mechanism is likely national legislation establishing principles, a regulatory floor, and a back-up regulatory regime should states not adopt the regulatory minimum.[27]

25 *For a suggestion for how to accomplish this, see Elizabeth Warren, "Unsafe at Any Rate," Democracy (Summer 2007), available at www.democracyjournal.org/article.php?ID=6528. Warren proposes a Financial Product Safety Commission modeled on the Consumer Product Safety Commission.*

26 *This suggestion is already getting some traction. See "Democrats Eyeing HMDA-Like Rules for Nonmortgages," American Banker, July 18, 2008.*

27 *This is similar to the scheme adopted for regulation of mortgage brokers in the Housing and Economic Recovery Act of 2008. See Title V, Pub. Law 110-289 (July 30, 2008).*

Integrating the paradigm's principles consistently into disparate regulatory regimes will require consultation and collaboration at both the state and federal levels. Moreover, for financial services not currently subject to any federal supervision and limited state regulation, it is appropriate to consider a combination of enhanced state regulatory authority (and funding), increased responsibility and funding for the Federal Trade Commission, and/or new statutory responsibilities at the state and federal levels, with private rights of action to enforce them.

Considering Broad-Based Product Specifications

Consumer protections have, in general, focused on limiting product terms, including price, marketing, and advertising. Recently, some have proposed an alternative: requirements that products meeting certain criteria be offered first, or that products be limited to those that meet standard terms, with competition permitted only on, for example, price. With respect to mortgages, for example, several behavioral economists have suggested that all home buyers be first offered a 30-year fixed-rate mortgage, and that lenders provide clear disclosure if borrowers turn down the "default" mortgage; lack of reasonable disclosure would be a defense to bankruptcy or foreclosure if an alternative loan turns bad.[28] Ronald Mann has suggested that credit card contract terms be standardized, limiting competition to a small set of clearly identified and relatively easy-to-comprehend terms, such as the interest rate and level of various fees.[29]

In the realm of transaction accounts and on a more limited basis, Michael Barr has suggested a model "starter" account accessible only by debit card, with no overdrafts permitted and with no minimum balance requirement.[30] And states require preapproval of consumer insurance products, although as the post-Katrina experience in New Orleans has demonstrated, this does not eliminate controversy surrounding underwriting, pricing, or the effectiveness of coverage.[31]

It is worth exploring whether developing a limited number of preferred or default products for the population in general, or developing a more limited subset targeted by a new CRA obligation, could systematically improve the outcomes for consumers of a broadly applied obligation to serve. Such a product set, if accompanied by a safe harbor protection for providers, might also reduce the uncertainty in a requirement for "fair and equitable" treatment of consumers.

Prioritizing and Sequencing

Even considered in the context of existing regulatory regimes, adopting in full a new responsibility paradigm is a major undertaking. It is, however, possible to stage adoption. One possibility is to begin with the products most likely to create major problems for consumers, and the entities that sell those products. The current situation in the credit markets suggests that credit products should be first on the agenda, followed perhaps by investment products. A second scheme would be to stage implementation based on the lack of availability or accountability for essential products. In this scheme, an initial focus could be on transaction products, where federally regulated depositories are not effectively serving all Americans and alternative providers are subject to little scrutiny and public accountability. A third alternative would be to begin where existing statutory and regulatory schemes are most developed and where implementation of the agenda's principles would require relatively modest changes. This suggests that, beyond banks and thrifts, credit unions should be first, followed by insurance companies and their agents, and then securities brokers.

Each alternative has benefits and drawbacks. For example, moving first on credit products might generate the most benefit for consumers, but it would require development and enforcement of more powerful regulatory and

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28 Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "A One-Size-Fits-All Solution," New York Times, December 26, 2007, available at http://www.nytimes.com/2007/12/26/opinion/26barr.html?scp=1&sq=michael percent20barr percent20mortgage&st=cse. See also Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Financial Services Regulation" (Washington, DC: New America Foundation, October 2008), available at http://www.newamerica.net/files/naf_behavioral_v5.pdf.

29 Ronald Mann, "'Contracting' for Credit," 104 Mich LR 899 (2006) at 927-28.

30 Michael Barr, et al, "Behaviorally Informed Financial Services Regulation," op cit note 27 at 30-31. This account is similar to the Opportunity NYC account that New York City has arranged at a small number of banks and credit unions to hold the proceeds of its conditional cash transfer program. See http://home2.nyc.gov/html/ceo/downloads/pdf/report_opportunity_nyc.pdf.

31 See Daniel Schwarcz, "Towards a New Approach for Resolving Consumer Insurance Disputes." Working paper (Ann Arbor, MI: Social Science Research Network 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1183482.

enforcement regimes for entities not currently subject to federal supervision. On the other hand, starting by expanding CRA-like obligations to credit unions but ignoring payday lenders, finance companies and independent mortgage bankers would have the virtue of relative simplicity but would exacerbate the competitive inequality in the current regulatory system. But the alternatives also suggest ways to improve, in measured increments, the essential financial products and services consumers need, and the manner in which those services are delivered.

Conclusion

Thirty years ago, numerous American cities were dying for lack of credit. By enacting the CRA, the federal government challenged the banking industry to help those communities and their residents achieve a better life. Together with related statutes such as HMDA and antidiscrimination and consumer protection laws, the CRA has had a substantial, positive impact in bringing credit and other financial services to low- and moderate-income consumers and communities.

The 30 years since the CRA's adoption have seen massive changes in the number, complexity, and types of financial products consumers use, how they are marketed and accessed, and who provides them. Simultaneously, the increase in homeownership, workforce restructuring, and the decline in employer-provided retirement and health benefits require consumers to take much greater responsibility for their financial health and stability. Many Americans are not doing well in meeting this new responsibility. The mortgage and credit markets are in turmoil with extraordinarily high and rising levels of foreclosures, the personal savings rate is extremely low, bankruptcies are at record levels, and debt burdens are overwhelming many families. The new responsibility paradigm presented here challenges the entire financial services industry—as the CRA did 30 years ago—to help American consumers do better. ■

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CRA Lending During the Subprime Meltdown

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The current scale of mortgage delinquencies and foreclosures, particularly in the subprime market, has sparked a renewed debate over the Community Reinvestment Act (CRA) and the regulations governing home mortgage lending. On one side, detractors argue that the CRA helped to precipitate the current crisis by encouraging lending in low- and moderate-income neighborhoods.[1] Economist Thomas DiLorenzo, for instance, wrote that the current housing crisis is "the direct result of thirty years of government policy that has forced banks to make bad loans to uncreditworthy borrowers."[2] Robert Litan of the Brookings Institution similarly suggested that the 1990s enhancement of the CRA may have contributed to the current crisis. "If the CRA had not been so aggressively pushed," Litan said, "it is conceivable things would not be quite as bad. People have to be honest about that."[3]

On the other side, advocates of the CRA point to a number of reasons why the regulation should not be blamed for the current subprime crisis. Ellen Seidman, formerly the director of the Office of Thrift Supervision, points out that the surge in subprime lending occurred long after the enactment of the CRA, and that in 1999 regulators specifically issued guidance to banks imposing restraints on the riskiest forms of subprime lending.[4] In addition, researchers at the Federal Reserve Board of Governors have reported that the majority of subprime loans were made by independent mortgage lending companies, which are not covered by the CRA and receive less regulatory scrutiny overall.[5] In addition to being excluded from CRA obligations, independent mortgage companies are not regularly evaluated for "safety and soundness" (a key component of the regulatory oversight of banks) nor for their compliance with consumer protections such as the Truth in Lending Act and the Equal Credit Opportunity Act.[6] This has created what the late Federal Reserve Board Governor Ned Gramlich aptly termed, a "giant hole in the supervisory safety net."[7]

What has been missing in this debate has been an empirical examination of the performance of loans made by institutions regulated under the CRA, versus those made by independent mortgage banks. The ability to conduct this research has been limited by the lack of a dataset that links information on loan origination with information on loan performance. In this study, we use a unique dataset that joins lender and origination

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* *This article is based on a longer working paper that is part of a Federal Reserve Bank of San Francisco's Working Paper Series, available at http://www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf.*

1 *Walker, David. Interview with Larry Kudlow. Lessons from Subprime. CNBC, April 4, 2008, and Steve Moore. Interview with Larry Kudlow. Kudlow & Company. CNBC, March 26, 2008.*

2 *DiLorenzo, Thomas J. "The Government-Created Subprime Mortgage Meltdown." September 2007, available at http://www.lewrockwell.com/dilorenzo/dilorenzo125.html.*

3 *Weisman, Jonathan (2008). "Economic Slump Underlines Concerns About McCain Advisers." Washington Post, April 2, 2008, A01.*

4 *Seidman, Ellen. "It's Still Not CRA," September 2008, available at http://www.newamerica.net/blog/asset-building/2008/its-still-not-cra-7222.*

5 *Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (2007). "The 2006 HMDA Data." Federal Reserve Bulletin 94: A73–A109. See also: Kroszner, Randall S. (2008). "The Community Reinvestment Act and the Recent Mortgage Crisis." Speech given at the Confronting Concentrated Poverty Policy Forum, Board of Governors of the Federal Reserve System, Washington, DC, December 3, 2008.*

6 *The federal laws that govern home mortgage lending, including the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Truth in Lending Act, apply to both depository institutions and nonbank independent mortgage companies. However, the enforcement of these laws and the regulations that implement them differ greatly between banks and nonbanks. Banks are subject to ongoing supervision and examination by their primary federal supervisor. In contrast, the Federal Trade Commission is the primary enforcer of these laws for nonbanks and only conducts targeted investigations based on consumer complaints.*

7 *Gramlich, Edward M. (2007). "Booms and Busts: The Case of Subprime Mortgages." Paper presented in Jackson Hole, Wyoming, August 31, 2007, available at http://www.urban.org/UploadedPDF/411542_Gramlich_final.pdf.*

information from the Home Mortgage Disclosure Act (HMDA) reports with data on loan performance from Lender Processing Services, Inc. Applied Analytics (LPS).[8] We thus have access to information on borrower characteristics (including race, income, and credit score), loan characteristics (including its loan-to-value ratio, whether it was a fixed or adjustable-rate mortgage, and the existence of a prepayment penalty), institutional characteristics (whether the lending institution was regulated under the CRA and the loan source), and loan performance (delinquency and foreclosure).

In this article, we use these data to examine several interrelated questions:

- What is the neighborhood income distribution of loans made by independent mortgage companies versus those made by institutions regulated under the CRA?
- After controlling for borrower credit risk, is there a difference in the foreclosure rates for loans made by independent mortgage companies versus those made by institutions regulated under the CRA?
- How do other factors, such as loan terms and loan source, influence the likelihood of foreclosure?
- How do the factors that influence foreclosure differ in low- and moderate-income neighborhoods compared with the factors in middle- and upper-income neighborhoods?

The article is organized into four sections. In the first section, we provide background information on the CRA and review the existing literature on the relationship between the CRA and mortgage lending in low- and moderate-income communities. In the second section, we describe our data and methodology. The third section presents the results of our models. We conclude with the policy implications of this study and present suggestions for further research.

The Community Reinvestment Act

In 1977, concerned about the denial of credit to lower-income communities—both minority and white—Congress enacted the Community Reinvestment Act. The CRA encourages federally insured banks and thrifts to meet the credit needs of the communities they serve, including low- and moderate-income areas, consistent with safe-and-sound banking practices. Regulators consider a bank's CRA record in determining whether to approve that institution's application for mergers with, or acquisitions of, other depository institutions. A key component of the CRA is the Lending Test (which accounts for 50 percent of a Large Bank's CRA rating), which evaluates the bank's home mortgage, small-business, small-farm, and community-development lending activity. In assigning the rating for mortgage lending, examiners consider the number and amount of loans to low- and moderate-income borrowers and areas and whether or not they demonstrate "innovative or flexible lending practices."[9]

The CRA has generated significant changes in how banks and thrifts view and serve low- and moderate-income communities and consumers. Researchers who have studied the impact of the CRA find, on balance, that the regulations have reduced information costs and fostered competition among banks serving low-income areas, thereby generating larger volumes of lending from diverse sources and adding liquidity to the market.[10] In a detailed review, William Apgar and Mark Duda of the Joint Center for Housing Studies at Harvard University

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8 *Formerly known as McDash Analytics.*

9 *As part of their CRA exam, large banks are also evaluated on their investments and services. Under the Investment Test, which accounts for 25 percent of the bank's CRA grade, the agency evaluates the amount of the bank's investments, its innovation, and its responsiveness to community needs. Under the Service Test, which makes up the remaining 25 percent of the bank's evaluation, the agency analyzes "the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services." Different rules apply for Small and Intermediate Small institutions. For more complete details on the CRA regulations, visit http://www.ffiec.gov/cra/default.htm for text of the regulations and Interagency Q&A.*

10 *Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (1996). "Credit Risk, Credit Scoring, and the Performance of Home Mortgages." Federal Reserve Bulletin 82: 621–48. See also: Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (1999). "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act." Federal Reserve Bulletin 85: 81–102; Michael S. Barr (2005). "Credit Where It Counts: The Community Reinvestment Act and Its Critics." New York University Law Review 80(2): 513–652; Belsky, Eric, Michael Schill, and Anthony Yezer (2001). The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending (Cambridge, MA: Harvard University Joint Center for Housing Studies); Evanoff, Douglas D., and Lewis M. Siegal (1996). "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending." Economic Perspectives 20(6): 19–46; and Litan, Robert E., et al. (2001). The Community Reinvestment Act After Financial Modernization: A Final Report (Washington, DC: U.S. Treasury Department).*

concluded that the CRA has had a positive impact on low- and moderate-income communities. In particular, the study notes that "CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if the CRA did not exist."[11]

Since the passage of the CRA, however, the landscape of financial institutions serving low- and moderate-income communities has changed considerably. Most notably, innovations in credit scoring, coupled with the expansion of the secondary market, have led to an explosion of subprime lending, especially in the last few years. According to one source, the subprime market accounted for fully 20 percent of all mortgage originations in 2005, with a value of over $600 billion.[12] Many of these loans were not made by regulated financial institutions; indeed, more than half of subprime loans were made by independent mortgage companies, and another 30 percent were made by affiliates of banks or thrifts, which also are not subject to routine examination or supervision.[13]

Given the large role played by independent mortgage companies and brokers in originating subprime loans, there has been growing interest in extending the reach of the CRA to encompass these changes in the financial landscape. Yet to date, there has been little research that has empirically assessed individual loan performance at CRA-regulated institutions versus loan performance at independent mortgage companies, particularly within low- and moderate-income areas. Instead, most of the existing literature has focused on determining the share of subprime lending in low-income communities and among different racial groups.[14] These studies, however, cannot assess whether loans made by institutions regulated by the CRA have performed better than those made by independent mortgage companies. Answering this question has been difficult given the lack of a single dataset that captures details on loan origination as well as details on loan performance.

A few recent studies attempt to match data from different sources to shed light on pieces of this puzzle. Researchers at Case Western's Center on Urban Poverty and Community Development used a probabilistic matching technique to link mortgage records from the HMDA data with locally recorded mortgage documents and foreclosure filings.[15] They found that the risk of foreclosure for higher-priced loans, as reported in the HMDA data, was 8.16 times higher than for loans that were not higher priced. They also found that loans originated by financial institutions without a local branch had foreclosure rates of 19.08 percent compared to only 2.43 percent for loans originated by local banks.

Another recent study released by the Center for Community Capital at the University of North Carolina uses a propensity score matching technique to compare the performance of loans made through a LMI-targeted community lending program (the Community Advantage Program [CAP] developed by Self-Help, a Community Development Financial Institution) to a sample of subprime loans in the McDash database.[16] They found that for borrowers with similar income and risk profiles, the estimated default risk was much lower for borrowers with a prime loan made through the community lending program than with a subprime loan. In addition, they found that broker-origination, adjustable-rate mortgages and prepayment penalties all increased the likelihood of default.

Both of these studies provide important insights into the relationship between subprime lending and foreclosure risk, and conclude that lending to low- and moderate-income communities is viable when those

11 *Apgar, William, and Mark Duda (2003). "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." Federal Reserve Bank of New York Economic Policy Review (June): 176.*

12 *Inside Mortgage Finance (2007). Mortgage Market Statistical Annual (Bethesda, MD: Inside Mortgage Finance Publications).*

13 *Avery, Brevoort, and Canner (2007). "The 2006 HMDA Data." See also: Kroszner (2008). "The Community Reinvestment Act."*

14 *See, for example: Avery, Robert B., Glenn B. Canner, and Robert E. Cook (2005). "New Information Reported Under HMDA and Its Application in Fair Lending Enforcement." Federal Reserve Bulletin (Summer 2005): 344–94; Gruenstein Bocian, Debbie, Keith Ernst, and Wei Li (2008). "Race, Ethnicity, and Bubprime Home Loan Pricing." Journal of Economics and Business 60: 110–24; and Calem, Paul S. Jonathan E. Hershaff, and Susan M. Wachter (2004). "Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities." Housing Policy Debate 15(3): 603–22.*

15 *Coulton, Claudia, Tsui Chan, Michael Schramm, and Kristen Mikelbank (2008). "Pathways to Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland and Cuyahoga County." Center on Urban Poverty and Community Development, Case Western University, Cleveland, Ohio.*

16 *Ding, Lei, Roberto G. Quercia, Janneke Ratcliffe, and Wei Li (2008). "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models." Center for Community Capital, University of North Carolina, Chapel Hill.*

loans are made responsibly. However, both studies are limited in certain important ways. Coulton and her colleagues do not examine the regulatory oversight of the banks that made the loans, and are only able to control for a limited number of borrower and loan characteristics. Ding and his colleagues are constrained by having access only to a relatively narrow subset of loans securitized by the CAP program. Because the sample of CAP mortgages may not be representative of a national sample of mortgage borrowers, and especially since being part of the CAP demonstration may influence the lender's behavior and the quality of the loans they sell to Self-Help, the study's findings may not be applicable to lending in low- and moderate-income areas more generally.

In this study, we attempt to build on these research contributions by: (a) examining the performance of a sample of all loans (prime and subprime, and not limited to a specific demonstration program) made in California during the height of the housing boom; and (b) controlling for a wider range of variables, examining not only borrower characteristics, but assessing the influence of loan and lender variables on the probability of foreclosure as well.

Methodology

The quantitative analysis we use relies on a unique dataset that joins loan-level data submitted by financial institutions under the Home Mortgage Disclosure Act (HMDA) of 1975[17] and a proprietary data set on loan performance collected by Lender Processing Services, Inc. Applied Analytics (LPS). Using a geographic crosswalk file that provided corresponding zip codes to census tracts (weighted by the number of housing units), data were matched using a probabilistic matching method that accounted for the date of origination, the amount of the loan, the lien status, the type of loan, and the loan purpose. To check the robustness of the matching procedure, we compared the sample statistics from the matched sample with the same sample statistics from the unmatched sample and found them to be similar. The LPS database provides loan information collected from approximately 15 mortgage servicers, including nine of the top ten, and covers roughly 60 percent of the mortgage market. Because the LPS includes both prime and subprime loans, the sample of loans tends to perform better than the sample in other databases such as Loan Performance First American's subprime database. However, we believe that for this paper it is important to consider both prime and subprime loans in evaluating the performance of loans made by institutions regulated under the CRA, since presumably the original intent of the CRA was to extend "responsible" credit to low- and moderate-income communities.

For this paper, we limit our analysis to a sample of conventional, first-lien, owner-occupied loans originated in metropolitan areas in California between January 2004 and December 2006. This time period represents the height of the subprime lending boom in California. We also limit our analysis in this instance to home purchase loans, although other studies have noted that much of the demand for mortgages during this period was driven by refinance loans and this will certainly be an area for further study. This leaves us with 239,101 matched observations for our analysis.

Borrower and Housing Market Characteristics

For borrower characteristics, we include information from the HMDA data on borrower race and/or ethnicity. Most of the existing research on subprime lending has shown that race has an independent effect on the likelihood of obtaining a higher-priced loan.[18] HMDA reporting requirements allow borrowers to report both an ethnicity designation (either "Hispanic or Latino" or "Not Hispanic or Latino") and up to five racial designations (including "white" and "African American" or "black"). We code and refer to borrowers who were

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17 Enacted by Congress in 1975, the Home Mortgage Disclosure Act (HMDA) requires banks, savings and loan associations, and other financial institutions to publicly report detailed data on their mortgage lending activity. A depository institution (bank, savings and loan, thrift, and credit union) must report HMDA data if it has a home office or branch in a metropolitan statistical area (MSA) and has assets above a threshold level that is adjusted upward every year by the rate of inflation. For the year 2006, the asset level for exemption was $35 million. A nondepository institution must report HMDA data if it has more than $10 million in assets and it originated 100 or more home purchase loans (including refinances of home purchase loans) during the previous calendar year. Beginning in 2004, lenders were required to report pricing information related to the annual percentage rate of "higher-priced" loans, defined as a first-lien loan with a spread equal to or greater than three percentage points over the yield on a U.S. Treasury security of comparable maturity.

18 Avery, Canner, and Cook (2005). "New Information Reported Under HMDA."

identified as "Hispanic or Latino" and "white" as Latino, borrowers who were identified as "African American or black" as black, and borrowers who were identified as "Asian" as Asian. We code borrowers and refer to them as "white" if they are "Not Hispanic or Latino" and only identified as "white" in the race field.

We use two other borrower-level variables in the analyses that follow. From the HMDA data, we include the borrower income, scaled in $1,000 increments. From the LPS data, we include the FICO credit score of the borrower at origination.[19] Because FICO scores are generally grouped into "risk categories" rather than treated as a continuous variable, we distinguish between "low" (FICO < 640), "middle" (640 >= FICO < 720) and "high" (FICO >= 720) credit scores.[20] We assume that lower credit scores would lead to a higher probability of delinquency and, subsequently, foreclosure.

At the neighborhood level, we include the FFIEC income designation for each census tract, the same measure that is used in evaluating a bank's CRA performance. Low-income census tracts are those that have a median family income less than 50 percent of the area median income; moderate-income census tracts are those that have a median family income at least 50 percent and less than 80 percent of the area median income; middle-income census tracts are those that have a median family income at least 80 percent and less than 120 percent of the area median income; and upper-income are those with a median family income above 120 percent of the area median income. In addition to tract income, we also include variables from the 2000 Census that attempt to capture the local housing stock, including the percent of owner-occupied units and the median year houses in the census tract were built.[21] We also include the tract's capitalization rate, defined as a ratio of the tract's annualized median rent divided by the median house value. A larger value for this measure is consistent with lower expected price appreciation or more uncertain future house prices.[22] We would expect this variable to be positively associated with the relative likelihood of foreclosure.

In addition to neighborhood-level variables, we also include a variable on the performance of the local housing market. Economic research conducted at the Federal Reserve Bank of San Francisco and the Federal Reserve Bank of Boston has shown that house price dynamics are an important predictor of foreclosure.[23] Because current house values may be endogenously related to foreclosure rates, we include an OFHEO variable that captures house price changes in the MSA/metropolitan division in the two years prior to the loan origination.[24] We assume that loans originated during a time of significant house price appreciation will be more likely to be in foreclosure, since it is areas that saw prices rising rapidly relative to fundamentals that have seen the most dramatic realignment of prices.

Loan Characteristics

In the models that follow, we also include various loan characteristics that may affect the probability of foreclosure. From HMDA, we include whether or not the loan was a "higher-priced" loan. Researchers have shown a strong correlation between higher-priced loans and delinquency and foreclosure.[25] Since higher-priced loans are presumably originated to respond to the cost of lending to a higher risk borrower (such as those with

19 *Although there are several credit scoring methods, most lenders use the FICO method from Fair Isaac Corporation.*

20 *In running the models with FICO treated as a continuous variable, foreclosure risk increased monotonically with FICO score declines, and did not significantly affect the other variables in the model.*

21 *In some models we tested, we also controlled for neighborhood-level variables such as the race distribution and educational level of the census tract, but these proved not to be significant in many of the model specifications, and tended to be highly correlated with the FFIEC neighborhood income categories. In addition, we were concerned about including too many 2000 census variables that may not reflect the demographic changes that occurred in neighborhoods in California between 2000 and 2006, years of rapid housing construction and price appreciation.*

22 *Calem, Hershaff, and Wachter (2004). "Neighborhood Patterns of Subprime Lending."*

23 *Doms, Mark, Frederick Furlong, and John Krainer (2007). "Subprime Mortgage Delinquency Rates." Working Paper 2007-33, Federal Reserve Bank of San Francisco. See also: Gerardi, Kristopher, Adam Hale Shapiro, and Paul S. Willen (2007). "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures." Working Paper 07-15, Federal Reserve Bank of Boston.*

24 *We use OFHEO instead of Case Shiller because Case Shiller is available only for Los Angeles and San Francisco and we wanted to capture changes in house-price appreciation across a greater number of communities, particularly those in California's Central Valley.*

25 *Pennington-Cross, Anthony (2003). "Performance of Prime and Nonprime Mortgages." Journal of Real Estate Finance and Economics 27(3): 279–301. See also: Gerardi, Shapiro, and Willen (2007). "Subprime Outcomes;" and Immergluck, Dan (2008). "From the Subprime to the Exotic: Excessive Mortgage Market Risk and Foreclosures." Journal of the American Planning Association 74(1): 59–76.*

impaired credit scores), it is not surprising that this relationship exists. However, the current crisis has also shed light on the fact that many loans originated during the height of the subprime lending boom included additional features that can also influence default risk, such as adjustable mortgage rates, prepayment penalties, and the level of documentation associated with the loan.[26] For this reason, we include a wide range of variables in the LPS data on the terms of the loan, including the loan-to-value ratio, whether or not the loan has a fixed interest rate, whether or not it included a prepayment penalty at origination, and whether or not it was a fully documented loan. We also include data on the value of the monthly payment, scaled at $500 increments. While standard guidelines for underwriting suggest that monthly costs should not exceed 30 percent of a household's income, recent field research suggests that many loans were underwritten at a much higher percent.

Lender Characteristics

To determine whether or not a loan was originated by a CRA-regulated institution, we attach data on lender characteristics from the HMDA Lender File, following the insights of Apgar, Bendimerad, and Essene (2007)[27] on how to use HMDA data to understand mortgage market channels and the role of the CRA. We focus on two variables: whether or not the lender is regulated under the CRA, and whether or not the loan was originated within the lender's CRA-defined assessment area, generally defined as a community where the bank or thrift maintains a branch location.[28]

As was described above, CRA regulations apply only to the lending activity of deposit-taking organizations and their subsidiaries (and, in some instances, their affiliates). Independent mortgage companies not only fall outside the regulatory reach of the CRA but also a broader set of federal regulations and guidance designed to protect the "safety and soundness" of the lender.[29] In contrast to CRA-regulated institutions, independent mortgage companies are subject to state licensing and monitoring requirements and do not undergo routine examination.

We further distinguish between loans made by a CRA-regulated lender outside its assessment area and those made by a CRA-regulated lender within its assessment area. Mortgages made by banks and thrifts in their assessment areas are subject to the most detailed CRA review, including on-site reviews and file checks. The assessment-area distinction also correlates with differences in the way mortgages are marketed and sold.[30] For example, loans made to borrowers living inside the assessment area are likely to come through the institution's retail channel. In contrast, loans made to borrowers living outside the organization's CRA-defined assessment area are more likely to be originated by loan correspondents or mortgage brokers. We assume that if a lending entity subject to the CRA has a branch office in a metropolitan statistical area (MSA), then that MSA is part of the entity's assessment area. Loans made in MSAs where the lending entity does not have a branch office are assumed to be originated outside the entity's assessment area.[31]

Building on recent research suggesting the importance of mortgage brokers during the subprime lending boom,[32] we also include a loan-source variable that captures the entity responsible for the loan origination, even if the loan eventually was financed by a CRA-regulated lender or independent mortgage company. We control for whether the loan was made by a retail institution, a correspondent bank, or a wholesale lender. Wholesale lenders are third-party originators, generally mortgage brokers, that market and process the mortgage application. One important methodological note is that our models that include the loan-source variable are run on a smaller sample of loans. In these models, we

26 *Crews Cutts, Amy, and Robert Van Order (2005). "On the Economics of Subprime Lending." Journal of Real Estate Finance and Economics 30(2): 167–97. See also: Immergluck (2008). "From the Subprime to the Exotic."*

27 *Apgar, William, Amal Bendimerad, and Ren Essene (2007). Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data (Cambridge, MA: Harvard University, Joint Center for Housing Studies).*

28 *We exclude loans originated by credit unions from this analysis; credit unions are not examined under the CRA and comprise a relatively small proportion of the home-purchase mortgage market.*

29 *Apgar, Bendimerad, and Essene (2007). Mortgage Market Channels and Fair Lending.*

30 *Ibid.*

31 *Our methodology is consistent with that of Apgar, Bendimerad, and Essene (2007), who assume that if a lending entity subject to the CRA has a branch office in a particular county, then that county is part of the entity's assessment area.*

32 *Ernst, Keith, D. Bocia, and Wei Li (2008). Steered Wrong: Brokers, Borrowers, and Subprime Loans (Durham, NC: Center for Responsible Lending).*

exclude loans where loan source is equal to "servicing right" due to endogeneity concerns.[33] Some financial institutions specialize in servicing "scratch and dent" mortgages, which, by their nature, would be more likely to foreclose.[34] Indeed, in early models we found loans obtained through a servicing right were significantly more likely to be in foreclosure than loans originated by any other loan source.

Findings

In Table 1 (at the end of this article), we present simple descriptive statistics that show the distribution of loan originations made by CRA-regulated institutions (CRA lenders) versus independent mortgage companies (IMCs), stratified by neighborhood income level. The table demonstrates the important role that IMCs have played in low- and moderate-income communities in California during the subprime boom. While CRA lenders originated more loans in low- and moderate-income tracts than did IMCs, IMCs originated a much greater share of higher-priced loans in these communities. Indeed, more than half of the loans originated by IMCs in low-income communities were higher priced (52.4 percent), compared with 29 percent of loans made by CRA lenders; in moderate-income communities, 46.1 percent of loans originated by IMC lenders were higher priced, compared with 27.3 percent for CRA lenders. In addition, 12 percent of the loans made by IMCs in low-income census tracts and 10.3 percent of loans in moderate-income census tracts are in foreclosure, compared with 7.2 percent of loans made by CRA lenders in low-income census tracts and 5.6 percent in moderate-income census tracts.

It is also worth noting the relatively small share of loans that were originated in low- and moderate-income communities; only 16 percent of loans made by CRA lenders were located in low- and moderate-income census tracts. IMCs made a slightly greater share of their total loans (20.5 percent) in low- and moderate-income communities. The relatively limited share of lending in low- and moderate-income communities may be due in part to the high cost of housing in California, yet it also suggests that on the whole, lending in low- and moderate-income communities remained a relatively small share of the lending market for regulated financial institutions, despite the incentive of the CRA.

These descriptive statistics, however, do not control for the wide range of borrower and loan characteristics that may influence the likelihood of foreclosure. For example, might the higher rates of foreclosure among IMC-originated loans be due to different risk profiles of the borrowers themselves? In the following tables, we present a series of binomial logistic regression models that predict the likelihood of a loan being in foreclosure, controlling for various borrower and loan characteristics. In all the models, we cluster the standard errors by census tract because standard errors are likely not independent across time within tracts. We also examined the correlation among the independent variables in each of the models and found that although many of the factors we include are interrelated, the models perform well and the coefficients and standard errors do not change erratically across different model specifications. We present the findings as odds ratios to assist in interpreting the coefficients.

In Table 2, we present the full model, including all variables with the exception of loan source. Several findings stand out. First, metropolitan house-price changes do have a significant effect on the likelihood of foreclosure. Rapid house-price appreciation in the two years preceding origination significantly increases the likelihood of foreclosure (odds ratio 1.26). This is consistent with previous research that has linked foreclosures and delinquencies to local housing market conditions, particularly in California, where house prices rose quickly in relation to fundamentals and where subsequent corrections have been quite dramatic.[35] A higher percent of owner-occupied housing in a tract and more recent construction both also seem to increase the likelihood of foreclosure, but only slightly. The tract's capitalization rate is not significant.

Second, and not surprisingly, FICO scores matter. A borrower with a FICO score of less than 640 is 4.1 times

33 "Servicing right" as the loan source means that only the servicing rights were purchased, not the whole loan. The lender was likely not involved in the credit decision or in determining the credit criteria. In some cases, the loan itself may not be salable or may be damaged ("scratch & dent"). Damaged loans are usually impaired in some way, such as missing collateral or an imperfect note/lien.

34 Pennington-Cross, Anthony and Giang Ho (2006). "Loan Servicer Heterogeneity and the Termination of Subprime Mortgages." Working Paper 2006-024A, Federal Reserve Bank of St. Louis.

35 Doms, Furlong, and Krainer (2007). "Subprime Mortgage Delinquency Rates."

more likely to be in foreclosure than a borrower with a FICO score of more than 720; for borrowers with a FICO score between 640 and 720, the odds ratio is 2.68. We also find that race has an independent effect on foreclosure even after controlling for borrower income and credit score. In particular, African American borrowers were 1.8 times as likely as white borrowers to be in foreclosure, whereas Latino and Asian borrowers were, respectively, 1.4 and 1.3 times more likely to be in foreclosure as white borrowers.[36] The income of the neighborhood also seems to have some effect on the foreclosure rate. Loans located in low-income tracts were 1.8 times more likely to be in foreclosure than those in upper-income tracts, with the risk declining monotonically as the income of the neighborhood increases.

Yet the model shows that even with controls for borrower characteristics included, the terms of the loan matter. Consistent with previous research, we find that higher-priced loans are significantly more likely (odds ratio 3.2) to be in foreclosure than those not designated as higher priced in the HMDA data. But we also find that other loan features—such as the presence of a prepayment penalty at origination, a fixed rate interest loan, a high loan-to-value ratio, a large monthly payment in relation to income, and the loan's level of documentation—all have a significant effect on the likelihood of foreclosure, even after controlling for whether the loan was a higher-priced loan or not. A fixed interest rate significantly and strongly reduces the likelihood of foreclosure (odds ratio 0.35), as does the presence of full documentation (odds ratio 0.61). An increase of ten percentage points in the loan-to-value ratio—for example, from 80 to 90 percent loan-to-value—increases the likelihood of foreclosure by a factor of 3.0.

What is interesting, however, is that even after controlling for this wide range of borrower, neighborhood, and loan characteristics, loans made by lenders regulated under the CRA were significantly less likely to go into foreclosure than those made by IMCs (odds ratio 0.703). This provides compelling evidence that the performance of loans made by CRA-regulated institutions has been significantly stronger than those made by IMCs.

Even more striking is what we find when we present the same model with the CRA lender status broken down by loans made within the CRA lenders' assessment area and loans made outside the CRA lenders' assessment area (with the omitted category being loans originated by IMCs). Presented in the second column of the table, we find that loans made by CRA lenders in their assessment areas were half as likely to be in foreclosure as loans made by IMCs (odds ratio 0.53). For loans made by a CRA lender outside its assessment area, the odds ratio is 0.87. In other words, loans made by CRA lenders within their assessment areas, which receive the greatest regulatory scrutiny under the CRA, are significantly less likely to be in foreclosure than those made by independent mortgage companies that do not receive the same regulatory oversight.

In Table 3, we add information about the source of the loan. As discussed earlier, we omit observations where the loan source is indicated as "servicing right." [37] The model demonstrates the importance of the originating mortgage-market channel in the performance of the loan. While the findings for other variables remained similar to those in models presented above, we find significant differences in the loan performance among loans originated at the retail branch, by a correspondent lender, or by a wholesale lender/mortgage broker. In particular, loans originated by a wholesale lender were twice as likely to be in foreclosure as those originated by a retail branch. This is a significant finding, and it supports other research that has shown that there were significant differences between broker and lender pricing on home loans, primarily on mortgages originated for borrowers with weaker credit histories.[38] Interestingly, the inclusion of loan source also weakens the effect of the CRA variables. While loans made by CRA lenders within their assessment area are still less likely to go into foreclosure than those made by IMCs (an odds ratio of 0.743), the coefficient for CRA loans made outside the assessment area is no longer significant. This suggests that the origination channel is a critical factor in determining the likelihood of foreclosure, even for CRA-regulated institutions.

36 *In some additional preliminary analysis, we interacted the race variables with income and found some variation among the coefficients. For example, while African American borrowers at all income levels were more likely to be in foreclosure, for Asian borrowers, as income went up, the risk of foreclosure decreased compared to white borrowers. The story for Latino borrowers was more mixed and warrants further research. However, these interaction terms did not meaningfully alter the other coefficients, and we do not include the interaction terms here.*

37 *This decreases our sample size from 239,101 to 195,698.*

38 *Ernst, Bocia, and Li (2008). Steered Wrong.*

The Performance of CRA Lending in Low- and Moderate-Income Census Tracts

While the models above control for the income category of the neighborhood, they do not explore the relative performance of loans from CRA-regulated institutions within low- and moderate-income census tracts. In other words, on average, the loan performance of CRA lenders may be better than that of IMCs, but does this hold true within low- and moderate-income census tracts, the areas that are intended to benefit the most from the presence of the CRA? In Tables 4–7, we replicate our analysis above by looking specifically at what happens when we stratify the models by neighborhood income level. For each neighborhood classification (low, moderate, middle, and upper), we present two models: the first including borrower and loan characteristics, and the second adding the loan source. Some interesting differences emerge, both in comparison to the full model and among the models for the different neighborhood income categories.

Regarding the restriction of the sample to low-income neighborhoods, it is interesting to see that the effect of being a CRA lender loses much of its strength as well as its statistical significance. With no loan-source control, the point estimate indicates that CRA loans made outside the assessment area were only slightly less likely to be in foreclosure than loans made by IMCs (an odds ratio of 0.95). However, loans made by a CRA lender within its assessment area remain quite a bit less likely (odds ratio of 0.73) to be in foreclosure than loans made by IMCs in the same neighborhoods, and the effect remains statistically significant. In moderate-income communities, loans made by CRA lenders, both outside and within their assessment areas, are significantly less likely to be in foreclosure. In moderate-income communities, loans made by CRA-regulated institutions within their assessment areas were 1.7 times less likely (an odds ratio of 0.58) to be in foreclosure than those made by IMCs.

Yet, when we include the loan-source variable, the statistical significance of the effect of CRA lending in low- and moderate-income neighborhoods disappears. It is possible that, in these neighborhoods, the explanatory variables other than the CRA-related variables fully capture the practical application of the prudent lending requirements of the CRA and other regulations. If this were the case, then regulations, working through those factors, would be significant underlying determinants of loan performance without the coefficients on the CRA-related variables themselves showing up as statistically significant. That said, the estimation results do demonstrate the importance of the terms of the loan and the origination source in predicting foreclosure, in particular, whether or not the loan was originated by a wholesale lender. Indeed, in low-income neighborhoods, wholesale loans were 2.8 times as likely to be in foreclosure as are those originated by the retail arm of the financial institution; in moderate-income neighborhoods, wholesale loans were two times as likely to be in foreclosure. Given that these regressions control for a wide range of both borrower and loan characteristics, it suggests that more attention be paid to the origination channel in ensuring responsible lending moving forward.

In the following tables, we present the same analysis for middle- and upper-income census tracts. Here the results are more in line with the full sample. Loans made by CRA lenders within their assessment area are significantly less likely to be in foreclosure than those made by IMCs, even after controlling for the loan source. Although at first glance this may be counterintuitive—why would the CRA have an effect in middle- and upper-income areas?—we believe that this finding reflects much broader differences in market practices between regulated depository institutions and IMCs. Specifically, while the CRA may have provided regulated financial institutions with some incentive to lend in low- and moderate-income communities, the CRA is really only a small part of a much broader regulatory structure. This regulatory structure, as well as the very different business models of regulated financial institutions compared with IMCs, has significant implications for loan performance, only some aspects of which we have controlled for in our regressions.

Although not our focus here, an interesting difference that emerges across neighborhood income classifications is the role of the loan-to-value ratio as well as the variable on previous house-price appreciation. In middle- and upper-income neighborhoods, these seem to carry more weight than in low- and moderate-income neighborhoods, suggesting that in higher income areas, investment and economic decisions may be more important in predicting the likelihood that a borrower enters foreclosure. In contrast, in low- and moderate-income neighborhoods, fixed rate and monthly payment seem to have relatively more importance in predicting the likelihood of foreclosure, indicating that in these communities it may be more of an issue of short-term affordability.

While these findings are very preliminary and deserve further exploration, they do suggest that there may be important differences among communities regarding the factors that influence the sustainability of a loan.

Conclusions and Policy Implications

This article presents the first empirical examination of the loan performance of institutions regulated under the CRA relative to that of IMCs using a large sample of loans originated in California during the subprime lending boom. Importantly, by matching data on mortgage originations from the HMDA with data on loan performance from LPS, we are able to control for a wide range of factors that can influence the likelihood of foreclosure, including borrower and neighborhood characteristics, loan characteristics, lender characteristics, and the mortgage origination channel.

Before turning to our conclusions and the policy implications of our research, we would like to emphasize that these findings are preliminary, and additional research is needed to understand more fully the relationship between borrowers, lending institutions, loan characteristics, and loan performance. We see several important gaps in the literature that still need to be addressed. First, it is unclear whether or not our findings for California are applicable to other housing and mortgage markets. The size and diversity of California lend it weight as a valid case study for the performance of CRA lending more generally. However, the high cost of housing in California may influence the nature of the findings, and it would be valuable to replicate this analysis in other markets. Second, we focused our analysis on loans made in low- and moderate-income census tracts, given the CRA's original "spatial" emphasis on the link between a bank's retail deposit-gathering activities in a neighborhood and its obligation to meet local credit needs. A yet-unanswered question is the performance of CRA lending for low- and moderate- income borrowers. In addition, we focus solely on mortgage lending activities and do not examine the impact that the CRA investment or service components may have had on the current crisis.[39] Third, the continued importance of race as a variable deserves further exploration. In all of the models, African Americans were significantly more likely to be in foreclosure than whites. While some of this is likely due to differences in assets and wealth (which we cannot control for), additional research that can tease out the underlying reasons for this disparity may have important implications for fair-lending regulations. Fourth, we focus this analysis on lending for home purchases, yet an examination of refinance loans may yield different results. Finally, it may be valuable to specify this model as a two-step process, where the choice of lender is modeled separately from loan outcomes, particularly if the decision to borrow from an IMC versus a CRA-regulated institution is correlated with unobservable characteristics that affect the likelihood of foreclosure.

Despite these caveats, we believe that this research should help to quell if not fully lay to rest the arguments that the CRA caused the current subprime lending boom by requiring banks to lend irresponsibly in low- and moderate-income areas. First, the data show that overall, lending to low- and moderate-income communities comprised only a small share of total lending by CRA lenders, even during the height of subprime lending in California. Second, we find loans originated by lenders regulated under the CRA in general were significantly less likely to be in foreclosure than those originated by IMCs. This held true even after controlling for a wide variety of borrower and loan characteristics, including credit score, income, and whether or not the loan was higher priced. More important, we find that whether or not a loan was originated by a CRA lender within its assessment area is an even more important predictor of foreclosure. In general, loans made by CRA lenders within their assessment areas were half as likely to go into foreclosure as those made by IMCs (Table 2). While certainly not conclusive, this suggests that the CRA, and particularly its emphasis on loans made within a lender's assessment area, helped to ensure responsible lending, even during a period of overall declines in underwriting standards.[40]

The exception to this general finding is the significance of the CRA variables in the models that focused

39 *For example, regulated financial institutions may have increased their exposure to mortgage-backed securities to satisfy their requirements for the CRA Investment Test. However, analysis conducted by the Federal Reserve Board suggests that banks purchased only a very small percentage of higher-priced loans (Kroszner 2008),1.*

40 *For an analysis of the quality of loans between 2001 and 2006 see Demyanyk Yuliya, and Otto van Hemert (2008). "Understanding the Subprime Mortgage Crisis." Working Paper, Federal Reserve Bank of St. Louis, February 4, 2008.*

on loans made in low- and moderate-income neighborhoods. In these regressions, when loan source was not included as an explanatory variable, loans from CRA-regulated institutions within their assessment areas performed significantly better than loans from IMCs. But, when we included loan source, the significance of the CRA variables disappeared. Even so, loans from CRA-regulated institutions certainly performed no worse than loans from IMCs. Moreover, as mentioned earlier, the practical application of the prudent lending requirements of the CRA (as well as other regulations) may have been captured in the other explanatory variables in the model without the coefficients on the CRA-related variables themselves showing up as statistically significant. For example, 28 percent of loans made by CRA lenders in low-income areas within their assessment area were fixed-rate loans; in comparison, 18.2 percent of loans made by IMCs in low-income areas were fixed-rate. And only 12 percent of loans made by CRA lenders in low-income areas within their assessment areas were higher priced, compared with 29 percent in low-income areas outside their assessment areas and with 52.4 percent of loans made by IMCs in low-income areas.

Yet the finding that the origination source of the loan—retail, correspondent, or wholesale originated—is an important predictor of foreclosure, particularly in low- and moderate-income neighborhoods, should not be ignored. This builds on evidence from other research that suggests that mortgage brokers are disproportionately associated with the origination of higher-priced loans, particularly outside depository institutions' CRA assessment areas[41] and that mortgage brokers may be extracting materially higher payments from borrowers with lower credit scores and/or less knowledge of mortgage products.[42]

The study also emphasizes the importance of responsible underwriting in predicting the sustainability of a loan. Loan characteristics matter: a higher-priced loan, the presence of a prepayment penalty at origination, a high loan-to-value ratio, and a large monthly payment in relation to income all significantly increase the likelihood of foreclosure, while a fixed interest rate and full documentation both decrease the likelihood of foreclosure. For example, in low- and moderate-income communities, higher-priced loans were 2.3 and 2.1 times, respectively, more likely to be in foreclosure than those that were not higher priced, even after controlling for other variables including loan source.

In that sense, our paper supports the need to reevaluate the regulatory landscape to ensure that low- and moderate-income communities have adequate access to "responsible" credit. Many of the loans analyzed in this paper were made outside the direct purview of supervision under the CRA, either because the loan was made outside a CRA lender's assessment area or because it was made by an IMC. Proposals to "modernize" the CRA, either by expanding the scope of the CRA assessment area and/or by extending regulatory oversight to IMCs and other nonbank lenders, certainly deserve further consideration.[43] In addition, the study's findings also lend weight to efforts to rethink the regulations and incentives that influence the practice of mortgage brokers.[44]

In conclusion, we believe that one of the more interesting findings of our research is the evidence that some aspect of "local" presence seems to matter in predicting the sustainability of a loan: once a lender is removed from the community (outside their assessment area) or from the origination decision (wholesale loan), the likelihood of foreclosure increases significantly. For low- and moderate-income borrowers and communities, a return to localized lending may be even more important. Research on lending behavior has suggested that "social relationships and networks affect who gets capital and at what cost."[45] Particularly in communities that have traditionally been denied credit, and where intergenera-

41 *Kenneth P. Brevoort, and Glenn B. Canner (2006). "Higher-Priced Home Lending and the 2005 HMDA Data." Federal Reserve Bulletin (September 8): A123–A166.*

42 *Ernst, Bocia, and Li (2008). Steered Wrong.*

43 *Apgar and Duda (2003). "The Twenty-Fifth Anniversary of the Community Reinvestment Act."*

44 *Ernst, Bocia, and Li (2008). Steered Wrong.*

45 *Uzzi, Brian (1999). "Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing." American Sociological Review 64(4): 481–505. See also: Holmes, Jessica, Jonathan Isham, Ryan Petersen, and Paul Sommers (2007). "Does Relationship Lending Still Matter in the Consumer Banking Sector? Evidence from the Automobile Loan Market." Social Science Quarterly 88(2): 585–97.*

tional wealth and knowledge transfers integral to the home-ownership experience may be missing, social networks and local presence may be a vital component of responsible lending (see Moulton 2008 for an excellent overview of how these localized social networks may influence mortgage outcomes, for example, by filling information gaps for both lenders and borrowers).[46] Indeed, the relatively strong performance of loans originated as part of statewide affordable lending programs,[47] Self-Help's Community Action Program,[48] and loans originated as part of Individual Development Account programs[49] all suggest that lending to low- and moderate-income communities can be sustainable. Going forward, increasing the scale of these types of targeted lending activities—all of which are encouraged under the CRA—is likely to do a better job of meeting the credit needs of all communities and promoting sustainable homeownership than flooding the market with poorly underwritten, higher-priced loans. ■

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See Tables 1 – 7 on the following pages

46 *Moulton, Stephanie (2008). "Marketing and Education Strategies of Originating Mortgage Lenders: Borrower Effects and Policy Implications." Paper presented at the Association for Public Policy Analysis and Management 30th Annual Research Conference, Los Angeles, November 6, 2008.*

47 *Ibid.*

48 *Ding, Quercia, Ratcliffe, and Li (2008). "Risky Borrowers or Risky Mortgages."*

49 *CFED (2008). "IDA Program Survey on Homeownership and Foreclosure," available at http://www.cfed.org/focus.m?parentid=31&siteid=374&id=2663.*

Table 1: Distribution of Lending Activity: CRA Lenders vs. Independent Mortgage Companies

	CRA Lenders	Independent Mortgage Companies
Total Loans		
Low-Income Neighborhood	3,843	1,487
Moderate-Income Neighborhood	24,795	10,609
Middle-Income Neighborhood	67,766	24,606
Upper-Income Neighborhood	83,563	22,432
All Neighborhoods	179,967	59,134
Total High-Priced Loans		
Low-Income Neighborhood	1,116	779
Moderate-Income Neighborhood	6,765	4,892
Middle-Income Neighborhood	10,573	8,068
Upper-Income Neighborhood	5,307	4,338
All Neighborhoods	23,761	18,077
Total Foreclosures		
Low-Income Neighborhood	275	177
Moderate-Income Neighborhood	1,379	1,092
Middle-Income Neighborhood	2,517	1,945
Upper-Income Neighborhood	1,613	1,211
All Neighborhoods	5,784	4,425

Table 2: Model Predicting the Likelihood of Loan Foreclosure

	CRA		CRA with Assessment Area	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Neighborhood Income Level (omitted: Upper-Income)				
Low-Income	1.79 ***	0.149	1.73 ***	0.142
Moderate-Income	1.32 ***	0.067	1.28 ***	0.064
Middle-Income	1.21 ***	0.045	1.18 ***	0.044
Percent Owner-Occupied	1.00 ***	$8.69x10^{-4}$	1.00 ***	$8.68x10^{-4}$
Median Year Housing Built	1.01 ***	0.001	1.01 ***	0.001
Capitalization Rate	0.85	0.515	0.75	0.451
House Price Appreciation (2 years prior to origination)	1.26 ***	0.019	1.22 ***	0.019
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.78 ***	0.084	1.79 ***	0.084
Latino	1.36 ***	0.044	1.36 ***	0.044
Asian	1.29 ***	0.052	1.29 ***	0.052
Borrower Income	1.00 **	$7.17x10^{-5}$	1.00 **	$7.26x10^{-5}$
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.09 ***	0.166	4.07 ***	0.165
Mid-level FICO - 640-720	2.68 ***	0.087	2.65 ***	0.086
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.23 ***	0.004	3.05 ***	0.104
Fixed Interest Rate (yes=1)	0.35 ***	0.017	0.35 ***	0.017
Prepayment Penalty (yes=1)	1.30 ***	0.036	1.31 ***	0.036
Full Documentation (yes=1)	0.61 ***	0.021	0.63 ***	0.022
Monthly Payment	1.06 ***	0.110	1.05 ***	0.004
Loan-to-Value Ratio	3.00 ***	0.080	3.02 ***	0.081
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)	0.70 ***	0.018		
CRA in Assessment Area			0.53 ***	0.017
CRA outside Assessment Area			0.87 ***	0.024
Observations	236,536			

*(**)(***) Statistically significant at 10(5)(1) level.

Table 3: Model Predicting the Likelihood of Loan Foreclosure, includes Loan Source

	CRA with Assessment Area	
	Odds Ratio	**Standard Error**
NEIGHBORHOOD VARIABLES		
Neighborhood Income Level (omitted: Upper-Income)		
Low-Income	2.11 ***	0.232
Moderate-Income	1.35 ***	0.096
Middle-Income	1.24 ***	0.063
Percent Owner-Occupied	1.00 ***	0.001
Median Year Housing Built	1.01 ***	0.002
Capitalization Rate	0.85	0.680
House Price Appreciation (2 years prior to origination)	1.20 ***	0.026
BORROWER VARIABLES		
Borrower Race (omitted: Non-Hispanic White)		
African American	1.77 ***	0.127
Latino	1.38 ***	0.066
Asian	1.24 ***	0.067
Borrower Income	1.00 **	8.91×10^{-5}
Borrower FICO Score (omitted: High - Above 720)		
Low FICO - Below 640	4.58 ***	0.266
Mid-level FICO - 640-720	2.73 ***	0.124
LOAN VARIABLES		
Higher-Priced Loan (yes=1)	2.47 ***	0.119
Fixed Interest Rate (yes=1)	0.39 ***	0.025
Prepayment Penalty (yes=1)	1.55 ***	0.072
Full Documentation (yes=1)	0.63 ***	0.027
Monthly Payment	1.05 ***	0.005
Loan-to-Value Ratio	2.53 ***	0.078
LENDER VARIABLES		
CRA (omitted: Independent Mortgage Company)	0.70 ***	0.018
CRA in Assessment Area	0.743***	0.043
CRA outside Assessment Area	0.995	0.057
Loan Source (omitted: retail branch)		
Correspondent Loan	1.45 ***	0.092
Wholesale Loan	2.03 ***	0.099
Observations	195,698	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 4: Model Predicting the Likelihood of Loan Foreclosure in Low-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.005	1.01	0.008
Median Year Housing Built	1.00	0.006	1.00	0.008
Capitalization Rate	0.64	0.742	0.35	0.685
House Price Appreciation (2 years prior to origination)	1.16 *	0.092	1.17	0.125
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.75 **	0.393	1.96 *	0.728
Latino	0.95	0.121	1.09	0.291
Asian	1.25	0.280	1.43	0.396
Borrower Income	1.00	4.43×10^{-4}	1.00	6.97×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.10 ***	0.783	4.00 ***	1.130
Mid-level FICO - 640-720	2.41 ***	0.434	2.48 ***	0.632
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.12 ***	0.559	2.31 ***	0.591
Fixed Interest Rate (yes=1)	0.29 ***	0.081	0.27 ***	0.104
Prepayment Penalty (yes=1)	1.28 *	0.180	1.42	0.361
Full Documentation (yes=1)	0.71 **	0.114	0.84	0.150
Monthly Payment	1.10 ***	0.031	1.15 ***	0.037
Loan-to-Value Ratio	2.35 ***	0.220	1.81 ***	0.262
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.73 **	0.115	0.89	0.264
CRA outside Assessment Area	0.95	0.121	0.86	0.244
Loan Source (omitted: retail branch)				
Correspondent Loan			1.58	0.536
Wholesale Loan			2.79 ***	0.702
Observations	5,271		3,981	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 5: Model Predicting the Likelihood of Loan Foreclosure in Moderate-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.00 **	0.002	1.00 **	0.002
Median Year Housing Built	1.00	0.002	1.00	0.003
Capitalization Rate	1.21	1.160	0.58	0.806
House Price Appreciation (2 years prior to origination)	1.10 ***	0.033	1.10 **	0.048
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	2.13 ***	0.202	1.88 ***	0.269
Latino	1.32 ***	0.089	1.17	0.117
Asian	1.27 ***	0.115	1.15	0.145
Borrower Income	1.00	1.37×10^{-4}	1.00	1.14×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	3.69 ***	0.310	3.72 ***	0.475
Mid-level FICO - 640-720	2.29 ***	0.162	2.38 ***	0.242
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	2.64 ***	0.181	2.07 ***	0.207
Fixed Interest Rate (yes=1)	0.30 ***	0.032	0.37 ***	0.053
Prepayment Penalty (yes=1)	1.14 ***	0.057	1.55 ***	0.148
Full Documentation (yes=1)	0.73 ***	0.505	0.73 ***	0.062
Monthly Payment	1.09 ***	0.011	1.10 ***	0.015
Loan-to-Value Ratio	2.49 ***	0.106	2.04 ***	0.125
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.58 ***	0.04	0.96	0.119
CRA outside Assessment Area	0.84 ***	0.048	1.17	0.143
Loan Source (omitted: retail branch)				
Correspondent Loan			1.62 ***	0.221
Wholesale Loan			1.96 ***	0.212
Observations	34,933		26,248	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 6: Model Predicting the Likelihood of Loan Foreclosure in Middle-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.001	1.01 ***	0.002
Median Year Housing Built	1.01 ***	0.002	1.00	0.002
Capitalization Rate	0.69	0.636	2.27	2.920
House Price Appreciation (2 years prior to origination)	1.27 ***	0.030	1.23 ***	0.041
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.53 ***	0.113	1.52 ***	0.176
Latino	1.33 ***	0.063	1.31 ***	0.091
Asian	1.17 ***	0.073	1.09	0.093
Borrower Income	1.00 ***	$1.14x10^{-4}$	1.00 ***	$1.42x10^{-4}$
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.22 ***	0.261	5.13 ***	0.454
Mid-level FICO - 640-720	2.68 ***	0.130	2.82 ***	0.201
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	2.93 ***	0.142	2.34 ***	0.172
Fixed Interest Rate (yes=1)	0.34 ***	0.025	0.35 ***	0.035
Prepayment Penalty (yes=1)	1.30 ***	0.055	1.51 ***	0.111
Full Documentation (yes=1)	0.61 ***	0.034	0.59 ***	0.040
Monthly Payment	1.06 ***	0.008	1.06 ***	0.010
Loan-to-Value Ratio	3.10 ***	0.159	2.67 ***	0.127
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.56 ***	0.028	0.80 ***	0.072
CRA outside Assessment Area	0.92 ***	0.038	1.06	0.091
Loan Source (omitted: retail branch)				
Correspondent Loan			1.39 ***	0.129
Wholesale Loan			1.97 ***	0.147
Observations	91,400		73,603	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 7: Model Predicting the Likelihood of Loan Foreclosure in Upper-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.002	1.00 ***	0.002
Median Year Housing Built	1.01 ***	0.002	1.01 ***	0.003
Capitalization Rate	2.79	4.720	3.93	8.280
House Price Appreciation (2 years prior to origination)	1.27 ***	0.039	1.26 ***	0.051
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.67 ***	0.148	1.69 ***	0.218
Latino	1.47 ***	0.088	1.65 ***	0.141
Asian	1.38 ***	0.096	1.33 ***	0.117
Borrower Income	1.00 ***	1.09×10^{-4}	1.00 ***	1.68×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	3.99 ***	0.301	4.64 ***	0.498
Mid-level FICO - 640-720	2.83 ***	0.162	2.83 ***	0.213
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.44 ***	0.225	2.96 ***	0.248
Fixed Interest Rate (yes=1)	0.41 ***	0.032	0.45 ***	0.045
Prepayment Penalty (yes=1)	1.40 ***	0.074	1.50 ***	0.119
Full Documentation (yes=1)	0.57 ***	0.036	0.59 ***	0.048
Monthly Payment	1.04 ***	0.006	1.05 ***	0.007
Loan-to-Value Ratio	3.52 ***	0.127	2.89 ***	0.152
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.49 ***	0.028	0.64 ***	0.067
CRA outside Assessment Area	0.84 ***	0.046	0.93	0.096
Loan Source (omitted: retail branch)				
Correspondent Loan			1.37 ***	0.164
Wholesale Loan			2.12 ***	0.180
Observations	104,932		91,866	

*(**)(***) Statistically significant at 10(5)(1) level.

Expanding the CRA to All Financial Institutions

Liz Cohen and Rosalia Agresti

The Community Reinvestment Act (CRA) was enacted in response to the fact that minority and low-income communities were not being fairly and adequately served by banks which have been beneficiaries of the U.S. government's safety net since the Great Depression. The federal government, by expanding its safety net in 2008 to include investment banks, broker-dealers, and other financial institutions, took the steps necessary to stabilize the global financial markets. The central premise of this article is that in return for access to the Federal Reserve's Discount Window, investment banks, broker-dealers,[1] and other financial institutions should be required to comply with an updated CRA. Fair access for all Americans to the full range of financial services is essential to restore our faith in the U.S. financial system and the health of our economy.

When the CRA was enacted in 1977 the fundamental principle of the legislation was that banks should provide loans and services to the communities from which they obtain deposits. Despite great progress, large segments of the United States population continue to be underserved by the financial services industry and do not have access to the full range of products and services. This is illustrated by the subprime mortgage crisis, which has affected people of every ethnicity and income level, but has been particularly damaging in low-income and minority communities.

According to an analysis of loans reported under the Home Mortgage Disclosure Act, African Americans were 2.3 times more likely and Hispanics were twice as likely as whites to get high-cost loans after adjusting for loan amounts and the income of the borrowers. High-cost, subprime mortgages are often characterized as loans made to people with low credit scores, and therefore blemished credit, or little experience with debt. Scant attention has been paid to the concentration of these loans in neighborhoods that are largely African American, Hispanic, or both. This pattern of disparate lending holds true even when comparing white middle-class or upper-income neighborhoods with similar minority communities.[2]

A recent article in *The New York Times* highlighted this phenomenon in an analysis of two neighboring communities in the Detroit metropolitan area:

> One, located in the working-class suburb of Plymouth, is 97 percent white with a median income of $51,000 in 2000. To the east, a census tract in Detroit just inside Eight Mile Road has a very similar median income, $49,000, but the population there is 97 percent black.
>
> Last year, about 70 percent of the loans made in the Detroit neighborhood carried a high interest rate — defined as three percentage points more than the yield on a comparable Treasury note — while in Plymouth just 17 percent did.

It is hard to prove why there is such a disparity between economically similar neighborhoods, but as the article suggests, a good place to start is the "history of banks' avoiding minority neighborhoods, the practice known as 'redlining.'"[3]

The Changing Financial Services Business

In 1977, financial services in the United States were delivered very differently. There were geographic limitations on where banks and thrifts could operate. Consistent with the Glass-Stegall Act, there were restrictions on the kinds of business that commercial banks could

1 *Broker-dealers trade securities for their own account and for their customers.*

2 *Braunstein, Saundra F., Director, Division of Consumer and Community Affairs, Testimony before the Committee on Financial Services, U.S. House of Representatives, " The Community Reinvestment Act", February 13, 2008.*

3 *Vikas Bajaj and Ford Fessenden, "What's Behind the Race Gap?" The New York Times, November 4, 2007.*

conduct versus investment banks, broker-dealers, and thrifts. Commercial banks took deposits to make personal and commercial loans. Thrifts took deposits and primarily lent people money to purchase homes. Broker-dealers accepted people's money to buy stocks and bonds. Investment banks accepted investors' money to raise debt and equity for businesses. Financial services were a bricks-and-mortar operation where individuals and businesses visited their local bank to deposit a paycheck, establish a savings account, or get a loan. Individuals also went to their local brokerage to invest and to the local office of the investment bank to raise debt and equity to buy or expand their business. The secondary market was relatively undeveloped. It existed primarily in the mortgage market where Ginnie Mae bought Federal Housing Administration (FHA) and Veterans Administration (VA) insured mortgages, packaged them into pools and sold them to mortgage bond investors. Fannie Mae and Freddie Mac were agencies of the federal government that did the same with conventional first mortgages.

Over the last 30 years, we have seen the expansion, privatization, and subsequent renationalization of Fannie and Freddie and unprecedented consolidation in the financial services industry. The local bank has become a branch of a larger, national bank, and the local banker hardly exists anymore. The distinctions that existed in the types of products and services that the various types of financial institutions can offer have disappeared. The Glass-Steagall Act has been virtually repealed, allowing for the creation of the financial supermarket where one institution can make loans, underwrite debt and equity, and sell stocks and bonds. Technological advances such as direct deposit for payroll and Internet banking have made bricks and mortar less important to large segments of more sophisticated customers. According to a 2004 *Michigan Law Review* article by Michael Barr, banks and thrifts' share of financial assets has declined dramatically since the end of World War II from 60 percent to about 25 percent.[4]

Other developments include the advent of 401(k) accounts, which has allowed more individual investors to be responsible for managing their own retirement accounts. And home loans have become increasingly complex financial instruments that are bought and sold in highly developed secondary markets, severing the connection between lender and borrower.

Access to the Federal Safety Net

During the Great Depression, the federal government responded to the crisis of confidence experienced by depositors with a series of measures including providing insurance for individual accounts with deposits up to $100,000 (now $250,000) and the creation of the Discount Window to provide liquidity to commercial banks. To ensure that federally insured deposits were lent in a prudent manner, commercial banks fell under the regulatory oversight of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the Federal Reserve. Today, what has brought many financial institutions to the brink of disaster, was a combination of poor quality loans and insufficient equity capital. The capital markets' increased liquidity and a voracious appetite for return allowed financial institutions to operate with highly leveraged capital structures. When the capital markets broke down, these institutions were forced to hold assets on their balance sheets. They became vulnerable to failure because they did not have the equity to support the assets they were forced to hold.

Bear Stearns, for example, represents a modern day equivalent of a run on a bank. The run was fueled by rumors in the markets that there was a liquidity crisis at Bear Stearns. The rescue of Bear Stearns was the first instance of the Federal Reserve providing access to the Discount Window to a non-commercial bank. JPMorgan Chase's subsequent acquisition of Bear Sterns (facilitated by a federal guaranty), IndyMac's failure and takeover by the FDIC, and Bank of America's acquisition of Merrill Lynch were precipitated by the market's loss of confidence.

In another example, Countrywide was a standalone mortgage bank, which was thinly capitalized and had assets of questionable quality. When faced with mounting losses and limited access to liquidity from the capital markets, Countrywide ran out of cash and was unable to operate independently as a going concern. This led to its sale to Bank of America. To stave off a similar fate, American Express, Goldman Sachs, Morgan

4 *Barr, Michael S. (2004). "Credit Where it Counts: The Community Reinvestment Act and Its Critics" Paper 411, University of Michigan Law Review*

Stanley and GMAC (among others) have all pursued bank holding company status to gain access to the Discount Window and the liquidity safety net it provides.

This phenomenon, where financial institutions of all stripes are looking for government backing, is not uniquely American. At the October, 2008 G8 Conference, European policy makers decided to guaranty the performance of their banks and convinced U.S. policy makers to do the same. These extraordinary actions by the Federal Reserve and by central banks around the world were necessary to prevent the collapse of the global financial system. In other words, the current global financial crisis has precipitated a dramatic expansion of government-backed safety nets.

The Opportunities Created by Extending the CRA to New Financial Institutions

Including investment banks and broker-dealers in the CRA should not be seen as a burden. Rather, these institutions could comply with the act in ways that continue to focus on their core competencies, while simultaneously increasing access to financial expertise and capital for low-income, minority, and underserved communities. This would certainly be in keeping with the amendments made to the CRA in 2005 that expanded its scope to disaster areas and underserved rural areas. In the Detroit neighborhood mentioned earlier, the financial supermarkets could provide multiple choices for people looking for home loans. Investment banks could create funds for and provide direct investment in businesses owned by low-income individuals and minorities or businesses located in low-income and minority communities. Broker-dealers could sell shares in these funds or the actual debt and equity securities issued. Investment banks and broker-dealers could provide training and technical assistance for individuals, entrepreneurs and small businesses. They could locate facilities in underserved areas, or provide sponsorship for charter schools for underserved populations. Causes such as rebuilding New Orleans after Hurricane Katrina and greater homeownership for low- and moderate-income people would be greatly aided by the participation of the investment banking community. The possibilities for new financial products offered to low-income individuals are only limited by the investment banks and broker-dealers' creativity, ingenuity, and entrepreneurial spirit.

It is important to note that most of the loans made by depository institutions examined under the CRA have not been higher-priced loans, and studies show that the CRA has increased the volume of responsible lending to low- and moderate-income households.[5] It is also significant that 50 percent of subprime loans were made by mortgage service companies not subject to comprehensive federal supervision including the CRA and another 30 percent were made by affiliates of banks or thrifts which are not subject to routine supervision or examinations.[6] For those who believe that in exchange for the safety net comes the responsibility to provide fair product and service access consistent with safety and soundness, then compliance with a proven mechanism like the CRA should prevent some of the abuses that we have witnessed in the subprime crisis from reoccurring.

The genius of the CRA is the flexibility it gives banks in how they can comply. In addition, there are meaningful penalties for noncompliance, such as the inability to complete mergers and acquisitions among financial institutions with less than Satisfactory ratings, and that banks' CRA examinations are made public. Given the consolidation in the financial services industry, the penalties for noncompliance with the CRA should be revised. One possibility is charging non-compliant institutions penalty rates on loans from the Discount Window. Another is charging significant fines as a penalty for non-compliant institutions.

Research has shown that the CRA has been successful in its original goal of providing fair access to financial services by expanding access to credit for low-income, moderate-income, and minority households at a reasonable cost. It has offered a better alternative than any other similar legislation or government subsidy, and compares favorably with alternative forms of regulation.[7] In the recent financial crisis, financial institutions covered by the CRA have increased the volume

5 *Yellen, Janet L. president and CEO, Federal Reserve Bank of San Francisco Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, March 31, 2008. See also, Traiger & Hinckley LLP, The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis, Indications that the CRA Deterred Irresponsible Lending in the 15 Most Populous U.S. Metropolitan Areas, January 7, 2008.*

6 *Barr , Michael S., testimony before the U.S. House of Representatives Committee on Financial Services, "The Community Reinvestment Act: Thirty Years of Accomplishments, But Challenges Remain," February 13, 2008.*

7 *Barr, "Credit Where It Counts."*

of responsible lending to low- and moderate-income households. Three decades after enactment of the CRA, it remains flexible with respect to compliance. The break down of the capital markets has caused regulated and non-regulated financial institutions to pursue bank holding company status in search of the safety and the liquidity provided by the Discount Window. The decision to expand the Federal Reserve's safety net to include investment banks, broker-dealers, and other financial institutions has preserved the American financial system. With financial institutions like Morgan Stanley and Goldman Sachs pursuing bank holding company status comes the opportunity to make good on the commitment to provide Americans equal access to the full range of financial services that the CRA originally promised. These institutions that use their creativity and intellectual capital to develop the newest, most innovative products for a select few would now, through compliance with the CRA, also be required to develop products and services for the low-income, minority, and underserved markets. Extending the CRA to the same institutions that benefit from the safety net would result in the fair access for all Americans to the full range of financial services that is essential to restoring our faith in the U.S. financial system and the health of our economy. ■

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What Lessons Does the CRA Offer the Insurance Industry?

Bridget Gainer
Aon Corporation

In light of the $150 billion bailout of AIG, there has been a renewed call for increased federal involvement in the insurance industry, including a proposal to extend something similar to the Community Reinvestment Act (CRA) to insurance providers. Although that seems fair at first glance, simply applying the banking model to insurance is problematic for several reasons: (1) it contradicts the core business model of insurance; (2) it would not address the existing deficiencies in serving the low- to moderate-income market; and (3) the current fractured regulatory structure has no capacity to administer, uniformly and cogently, a national program such as a new CRA-like requirement. A greater opportunity exists in leveraging what insurance does best: mitigating risk to encourage investment and innovation and smooth unpredictable losses.

Why the CRA for Banking Does Not Work for Insurance

Historically, the CRA was a response to a specific deficiency in the practices of some banks—extracting value from a geographic area without an equitable exchange of goods (credit) or services. This rationale for the CRA in banking does not necessarily apply to insurance because the core business model of insurance returns value in the form of claims to the communities from which it collects premiums. And the adequate return of claims dollars, the "loss ratio" statistics of companies and types of policies, are closely monitored to ensure that policies are fair and that the vast majority of premiums are paid back out in claims. Thus, the existing practice of the business ensures an exchange of value that is equitable for the consumer. In other words, there is no insurance equivalent to redlining.

If the goal, however, is to increase low- and moderate-income (LMI) household financial stability, tremendous benefits can be gained by leveraging the vast engine of the insurance industry. The three main assets that contribute to the stability of LMI households are wages, homeownership, and retirement savings. There are clearly deficiencies in the way the market and government provide insurance for these assets; however, those weaknesses cannot be rectified by CRA-like regulation because there is no single set of providers, such as banks, to regulate. Insurance is provided by employers, lenders, various agencies of the state and federal government, and other financial services providers. The solution needs to use both the market and public policy to address these various providers. The best way to develop these new products is to create incentives and changes in tax and other policies, rather than to set quota requirements for numbers of policies defined by geography.

What Will Work for Insurance?

For individuals, especially those in LMI households, events such as foreclosure, job loss, and pension failure can be catastrophic. These events are exacerbated because neither the industry nor the government has achieved success in offsetting risk on a household basis (as purchased by individuals), comparable to the success achieved at the group or large commercial level, (as purchased by large employers, corporations, or unions). In proposing solutions, it is important to consider that the insurable assets of LMI households (household income, homeownership, and retirement savings) are addressed by a government insurance program or tax subsidy (or both). The government alone cannot provide an adequate level of protection for consumers. Thus, the market, encouraged by public policy, has an opportunity to create the optimal balance between protection and investment.

The Role of Insurance in Addressing the Needs of the LMI Household

The most significant asset of LMI households—current and future wages—is exceedingly vulnerable to the vicissitudes of physical ability, industry health, and macroeconomic stability. The private market insurance response to those issues—life, unemployment, and long- and short-term disability—are unable, in their current forms, to adequately replace household income for the LMI population. The government solution, unemployment insurance, is structurally flawed. Less than 45 percent of the U.S. workforce is qualified to receive unemployment benefits in the event of job loss because they work too few hours (part time or seasonal). In addition, the benefits max out at an average of $260 per week, below the poverty line for a family of three. Nongovernment unemployment insurance is not widely available with one of the few examples being insurance connected to payday loans.

Smoothing Household Income

When asked about life insurance, LMI respondents to a recent Federal Reserve survey referred to life insurance positively as "forced savings" that allowed them to save for a targeted time after the loss of a wage earner more effectively than in a traditional savings account.[1] Although life insurance is a highly efficient income-smoothing tool, there are very low take-up rates among LMI households for the whole or term life products that meet this need. Several reasons explain this situation. First, the distribution channel for life insurance—agents—is not cost-effective under the current licensing and regulatory structure. There is clearly a way to offer a streamlined license for agents selling targeted, proscribed policies, similar to how many auto policies are sold. This would be most effective on a national basis because state lines create no difference in the need of buyers for specific life products. Second, the tax benefits of life insurance are less relevant for lower-income households, but this too could be rectified, possibly by attaching a life-insurance purchase to the Earned Income Tax Credit refund process. Finally, there is the issue of Long & Short Term Disability. As the hard economic times or shrinking retirement accounts have kept many older employees working past 65, they are now realizing that a widely used income-protection tool—disability insurance—is rarely available to workers over 65. As with difficult-to-place auto or worker's compensation, market supply could be increased by the implementation of a FAIR plan, an assigned risk pool, or other pooling mechanism to control for adverse selection. This is an issue that should be highlighted by policymakers to draw attention to the need for increased market supply.

If we know that securing the wage stream is vital to household stability, we can either lower the barriers to entering the market via regulatory streamlining or reduce the ultimate cost of the product by creating incentives to purchase, especially through the tax code. While there would be an increased cost to providing this incentive, it goes a long way toward keeping LMI households economically secure. It is also an opportunity to extend protections and benefits throughout the economy, since government already provides a hefty subsidy to middle- and high-income households through mortgage interest deductions and 401(k)/pension/healthcare pretax contributions. Properly conceived, more targeted insurance products could do much to "smooth" household income.

Housing – PMI for Borrowers

Home-ownership rates currently stand at historically high levels for all segments of the U.S. population, including LMI households. Record high foreclosure levels and more than two million seriously delinquent mortgages have prompted greater scrutiny of the lending process. Several risk factors have become apparent; the most important among them is agency risk that results when mortgage underwriters can securitize their way out of bearing the long-term risk. The "insurance" product with the greatest take-up rate among less financially secure borrowers is Primary Mortgage Insurance (PMI), which only protects the lender. The higher yield of these loans coupled with PMI is meant to mitigate the cost of default for the lender, but while the full cost of the interest and PMI is born by the borrower, the borrower receives none of the protection. There is also mortgage life insurance, which is activated only upon the death of the mortgage holder.

The current foreclosure crisis has made apparent the high—and in many cases avoidable—costs when a mortgage moves from delinquency to foreclosure. Many homeowners are not sure of their options and find it difficult to navigate the banking system to advocate for themselves. As a result, many homeowners have simply walked away from their mortgages. Creating a PMI for borrowers could provide short- or longer-term payments in cases of job loss or other economic

1 Robin Neuberger, "Insurance and Asset Building," Chicago Federal Reserve Board, 2008.

difficulty to bridge temporary loss of income. It also has the benefit of bringing a third payor with a longer investment horizon and a separate underwriting methodology to the mortgage. In addition, embedding insurance into the credit decision and mandating its purchase by high-risk borrowers will give borrowers and all parties protection in the case of financial disaster. This effectively increases the take-up rate, or the percentage of people purchasing mortgage insurance, although it is a version that broadens the life/economic events that qualify for payout beyond that of traditional mortgage insurance. Since we are unlikely to revert back to the presecuritized environment, submitting a greater swath of mortgage lending to an additional underwriting protocol— PMI for borrowers—would create additional protection against default and predatory lending. Doing this might lead to slower increases in homeownership at the lowest income levels, since even $50 to 100 a month in increased payments will make home purchase more expensive relative to renting. However, the increased cost of borrowing should accurately reflect risk and the social cost of foreclosure.

Retirement

Retirement gets the least attention when discussing financial services for LMI households. Insufficient savings rates, difficulty managing both investment risk and longevity risk (how long you will live postretirement), and tax policy that accrues benefits disproportionately to high wage earners have all led to a scenario where 43 percent of households will not have enough income in retirement to maintain their preretirement standards of living.[2] This is exacerbated by the fact that only nine percent of all workers saved the maximum allowed, $15,500 in a 401(k), and nearly 20 percent had a loan outstanding against their retirement account. Knowing that Social Security alone cannot provide adequate retirement income indefinitely and that individuals rarely save enough or invest prudently, the alternative is both to mandate and incentivize current workers to more realistically participate in their own retirement. The good news is that the insurance industry already has the products and structure to meet these needs.

Perhaps the most important retirement product is the fixed annuity. A fixed annuity is purchased before or at retirement for a lump sum and then pays out a fixed monthly payment. The payment of a fixed annuity does not fluctuate based on investment return; it is fixed in amount and duration. Annuities can be purchased throughout a career, with payments delayed until a predetermined age. Teresa Ghilarducci, the noted pension economist and academic, has proposed further encouraging retirement savings by mandating a five percent annual savings rate for all workers who purchase slices of annuities—future monthly payments—throughout their working lives. At retirement, this annuity payment would be a supplement to Social Security, bringing the majority of workers above a 70 percent replacement rate of their preretirement income.[3]

Retirement planning and savings need to focus much more forcefully on stable investment vehicles such as fixed annuities. As the past months have shown us, we are gambling with the growing segment of future retirees who will rely solely on a 401(k) to deliver retirement security. What retirees and our economy need is a vehicle, coupled with targeted savings rates, that delivers stable retirement income, not just retirement wealth contingent on the performance of the stock market. This vehicle, fixed annuities, while a proven, flexible, and efficient means for delivering retirement security, suffers from confusing pricing and the fear of the unlikely event of dying too soon and losing the value of the annuity. Many other countries, the UK and Chile most notably, integrate annuities into their public pension systems and create a way to stabilize retirement income.

The dramatic shift from fixed, annuitized defined benefit plans to variable 401(k) plans in recent years has added urgency to the debate. Short of another bailout or a Retirement Stimulus Plan for 401(k) holders, increased retirement stability will be possible only with a rethinking of the retirement tax and policy structure. Plan sponsors have been freezing or terminating defined benefit plans at a steady pace for more than twenty years, having determined that the combination of changing demographics and long-term investment risk was too uncertain and volatile for a corporation's balance sheet to bear. So while the 401(k)-only solution has clearly been found

2 *The Center for Retirement Research at Boston College, various publications, 2008, available at http://crr.bc.edu/index.php.*

3 *Teresa Ghilarducci, When I'm Sixty-Four: The Plot against Pensions and the Plan to Save Them (Princeton: Princeton University Press, 2008), 124–25; 62–63; 54–56.. Pension Rights Center, available at http://www.pensionrights.org/policy.html.*

lacking and defined benefit plans are covering a shrinking minority, the federal government continues to spend roughly $115 billion annually to subsidize this system. Based on marginal tax rates and levels of savings, those benefits accrue largely to middle- and high-income earners, who may save regardless, and ignore the LMI population that cannot. Since the government is truly the insurer of last resort here, the public policy around annuities and strong incentives for retirement savings in the United States needs a strong push on the policy front to become part of the retirement security toolbox.

Obstacles to Success

An additional obstacle to the insurance industry's ability to create new products for LMI consumers is the industry's confusingly decentralized regulatory structure. Insurance companies and brokers who wish to do business nationally must operate under 56 separate state and territory reporting agencies with thousands of regulators and staff, but with little to no common sense consistency. There is certainly a need for more uniformity, which would not only be easier to follow, but also would be easy to regulate. This is true for large-scale policy efforts like the ones outlined in this article, but also it would protect consumers by insisting on better price transparency and consistent requirements to disclose the fees and commissions paid to intermediaries.

The heavy administrative burden in response to the lack of uniform regulation acts as a tax on innovation. The cost and regulatory burden to launch a product—and have it approved by the 56 different agencies—is staggering and dampens new product development, especially in riskier, lower-margin areas that might best address the needs of LMI households. Exacerbating the situation, the position of State Insurance Commissioner is a political appointment or elected office that does not require any insurance expertise or knowledge of the law or the industry—in fact, the requirements are less stringent than what is required to obtain a basic insurance license! The leadership of the National Association of Insurance Commissioners, while thoughtful, changes annually, making progress on long-term issues difficult. Since little institutional insurance expertise, operational or policy, exists at the federal level, it is impossible to contemplate how a national policy or a regulatory regime, the CRA or otherwise, would be implemented.

Conclusion and Next Steps

Addressing systemic financial risk and strengthening consumer protection are tasks that have been avoided for two generations, a task not made any easier within a system that failed to consider the "100 year storm event."[4] Widespread underwriting failures, lack of consideration for systemic risk in the insurance industry, and a convoluted and opaque regulatory structure generated a tremendous tax on our economy. The path forward will need to correct for those failures without stifling the benefits of innovation and new market development.

In a recent speech regarding the CRA, Federal Reserve Chairman Ben Bernanke asserted that one of the goals of the CRA was to lower the "first mover risk" of entering new territories.[5] Similarly, to address household financial stability, tax policy and regulation should be engaged to reduce the risk of entering these new markets and leverage the development capacity and risk-management expertise of the insurance industry to meet the gaps in the current structure.

The following actions are suggested to start this process:

1. Start a conversation on how the insurance industry can play a role in promoting the economic health of LMI individuals and communities.

2. Create a national regulatory structure. As recently proposed by the "Group of 30," headed by Paul Volcker, "for those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established."[6] One model is the Optional Federal Charter, a structure that would allow insurance companies and brokers the option of being federally regulated with one national standard, or remain state-regulated, which is the current system. Large national and global firms, whose complexity and reach create opportunity for systemic risk, would

4 *Alan Greenspan, Testimony before the House Oversight and Investigations Committee, October 23, 2008.*

5 *Chairman Ben Bernanke, Board of Governors of the Federal Reserve System, "The CRA at 30 Years," Speech given at the Community Affairs Research Conference, Washington, DC, March 30, 2007.*

6 *Group of 30, "Financial Reform: A Framework for Financial Stability," January 15, 2009, 59.*

likely be regulated by a sophisticated federal regulator housed within the Treasury or other financial oversight body. Small companies, mutuals, and brokers may choose to remain state-regulated, continuing their close access to local regulators. Regardless of form, no serious discussion of addressing systemic risk or encouraging innovation can go far without modernizing the regulatory structure and the engagement of the federal government.

3. There needs to be a rigorous examination of what best serves consumers as either the primary insurer (the first firewall against job loss, illness, or foreclosure) or the re-insurer (the second line of defense for mortgage, wage, health, and retirement insurance). Currently, the government is the primary insurer for those who will depend solely on Social Security, Medicare, or Unemployment Insurance. The public sector has also become the insurer of last resort for the mortgages held by government-sponsored enterprises (GSEs). We must determine if the existing structure meets the needs of an aging population in a globalized economy and, if not, whether the policies and incentives discussed here are the appropriate hybrid.

4. In a time of financial crisis, we have to be confident that every tax dollar deferred for retirement savings, health care, or mortgage interest is creating value for the economy that would not have been created by private markets or individuals alone. If tax dollars are deferred for retirement savings or housing purchases that would have otherwise occurred in the private market, we are not effectively using those funds as an incentive for "first mover" innovation or to support less financially stable populations that may require future public support. The existing asset-based tax policy needs to be thoroughly examined for fairness, effectiveness, and a demanding return on capital.

5. Federal policy should encourage innovation and expertise and be housed in a new institution, something like a federal center of insurance expertise. The events of late 2008 exposed the fact that not only did no one regulator have a full picture of the financial health of large international insurers, but there was also little insurance expertise at the federal level to adequately address the relevant issues. In addition to gathering information, the center could act as an incubator to accelerate new product development with the carrot of a single, national review and approval of new products, avoiding 56 separate state requirements. The center could also administer a national insurance license for insurance brokers and agents. Both of these functions could lower costs for consumers without compromising oversight. Finally, this institution could also enforce CRA-like regulation.

Now is the time to creatively and rigorously assess what combination of the public sector and industry most effectively and efficiently will meet the financial needs of both LMI households, which have a tremendous need for cost-effective ways to manage income, debt, and retirement risk, and an aging population with stagnant wages, depleted assets, and little savings but staggering debts. Although that does not look like a CRA, it does create ample opportunity to leverage the capacity within the insurance industry to offset risk and employ its expertise to find the most efficient and effective methods, whether public or private. ■

Bridget Gainer has had a varied career in the public, private, and nonprofit sectors and has been engaged in the issues of financial services for low-income consumers for many years. Currently, Bridget is the director of Government Affairs at Aon Corporation, the world's largest insurance broker, where she oversees policy issues in insurance, retirement security, and healthcare. In this role, Bridget directs Aon's political and legislative strategy in Washington and with local governments throughout the country. Previously, Ms. Gainer worked for the Mayor of Chicago where she managed Chicago's Lakefront Park system and its extensive public-private partnerships. Ms. Gainer began her career as a community organizer in New York City and continued that work in Chicago. A native of Chicago, Ms. Gainer is very involved in the civic life of the city with a focus on increasing access to financial services and improving job quality for low-income workers. She is on the boards of St. Gregory's High School and The Center for Economic Progress and Women Employed.

CRA 2.0: Communities 2.0

Mark Pinsky
Opportunity Finance Network

Congress predicated the Community Reinvestment Act (CRA) on one principle and two key facts when it passed the act in 1977. The principle is core and remains true. The facts point to what can and should change to make the CRA more effective in what has become a different kind of marketplace.

The principle is that banks had an affirmative responsibility to serve everyone in their markets equally well without regard to place, race, gender, or ethnicity. This principle serves the fundamental precept of our nation—freedom of opportunity and justice for all—and fulfills the purposes of a robust financial services sector.

The first fact is that banks, at the time the CRA became law, had clearly delineated geographic markets—or footprints. The second fact is that the primary business of banks at that time was to provide a prudent savings option for a vast majority of Americans. Various estimates suggest that almost 70 percent of the long-term savings of Americans were in banks in 1977, when Congress passed the CRA. The CRA defined "markets" as those places where banks took deposits.

In theory and in practice, the CRA has supported community development well. In fact, it has largely defined community development. For better or worse, it is significantly more difficult to lend and invest in markets that are not included in CRA footprints. In practice, underserved submarkets (most often minority and low-income but defined primarily by CRA-shaped geography) comprise the "community" and the provision of financial services is the means to its "development." The CRA has supported countless community development organizations, strategies, and initiatives. It has proved to be a remarkably effective law because it has connected opportunity markets to opportunity capital and financial services.

Since its passage, almost everything having to do with the CRA has changed. Competition, technology, product and service innovation, demographics, and consumer patterns and behavior have transformed banking. At a minimum, two changes are key: the vast majority of banking is defined around complex consumer demographics rather than geography, and deposit-taking is now a relatively small, but still significant, line of business from the perspective of a bank's financial performance and shareholder concerns. Banking no longer centers around place and savings.

Banking today centers around consumer demographics, delivery channels, and product innovations. The rise of online banking services is an indication of the transformation, suggesting that technological tools rather than revolving doors are, or soon will be, the primary way that consumers enter banks.

The financial market crisis that started in 2007 will reverberate through banking, financial services, and community development for the next decade. The transformation in form and structure of the financial services industry, the need to reinvent products ranging from securities to ratings, and the apparent redefinition of financial markets regulation will shape for a generation or more our nation's commitment and capacity to make opportunity finance available to everyone.

The focus of the past few decades on emerging demographic markets, efficient ways of serving those markets, and new products that meet their needs will anchor financial services regardless of the framework. This focus will ensure a role for the CRA in whatever new form it might take. Bankers talk openly and often about the critical importance of Latino markets, for example, and follow up anxiously with concern about whether they are doing enough to capture market share.

As a result, the CRA no longer should be viewed as a policy for the fringe markets. The fringe markets of the 1970s and 1980s are rapidly becoming the broadcloth of the U.S. and global economy and will continue for decades to come. The CRA—in a new form, CRA 2.0—can be a bank's portal to opportunity markets, the emerging growth markets of coming decades, Communities 2.0.

This transformation to CRA 2.0 requires at least four things to happen.

1. Policymakers need to reaffirm the fundamental principle of the CRA as central to broad economic prosperity in the United States and other nations. This is, first, a matter of economic policy, and second, antipoverty or community development policy. The principle of the CRA is more important than ever. Banks, as well as all financial institutions that rely on taxpayer support, explicitly and implicitly, still have an affirmative responsibility to serve everyone in their markets equally well without regard to place, race, gender, ethnicity, and other discriminatory factors, some of which we have learned about only because of the CRA.

The CRA will be stronger when the transaction, or the exchange, is more transparent and accountable; that is, when everyone understands what all sides are giving and what they are getting. This requirement opens a set of questions that policymakers, economists, and political theorists will need to focus on.

- How do you quantify the value of multifaceted government support for financial institutions? What, for example, is the value of deposit insurance relative to the value of Treasury's liquidity for JPMorgan Chase in its acquisition of Bear Stearns?
- What factors currently define the CRA as antipoverty and/or community development policy? What would characterize it instead as economic growth policy? Are there existing models that the CRA can use that would accentuate its economic role?
- What, in this scenario, would differentiate the CRA from more familiar economic growth strategies, such as investments in education or infrastructure? Is there a danger that the CRA would lose its ability to focus on low-income and low-wealth persons and places? What would prevent mission creep?

The $700 billion bailout program (TARP) that Congress created raises the stakes—and raises new questions. The role of government capital in stabilizing and sustaining the financial services industry, much more than just banks, carries with it a clear and irrefutable obligation that participating institutions meet the implicit standard of the CRA—serving all markets equally well and without discrimination. However, the complexity of the intervention and the diversity of the institutions exacerbate the challenge of how to implement solutions.

- Are the policy expectations of distressed institutions such as AIG different from those of a healthy one? If part of the cause of distress is irresponsible practices, would mandating responsible practices (beyond basic safety and soundness) be a reasonable path to institutional health?
- With so much of the financial services sector ailing or failing, would the imposition of CRA-type responsibilities help or hinder systemic recovery? Would the CRA take the blame if distressed institutions fail? (After CRA opponents falsely blamed the CRA for the financial market mess in the first place, is there any cause to doubt that they would scapegoat the CRA?)
- Is the disorder in the financial marketplace a unique opportunity to introduce a new systemic requirement that all players share responsibility for responsible financial services, opportunity finance, and community reinvestment? For policymakers, the question is: Will there ever be a better time?

Policy should also recognize that much, but not all, of CRA 2.0 activity will be either below-market rate (as determined by conventional risk-assessment models) or philanthropic. This touches on a set of questions that are already in play: Is the CRA already diluted by the increasing focus on profitable CRA opportunities? Is there an optimal balance of below-market and market-rate CRA portfolios? What are the parameters for acceptable cross-subsidy strategies by CRA-covered financial institutions, particularly when their financing often involves multiple subsidy streams (such as tax credits)?

2. The CRA's (or its successor law's) definition of markets needs to reflect financial markets as they exist today rather than as they were in 1977. The CRA still should apply to geographic markets, but deposit-taking is an obsolete marker for markets. By current estimates, less than 20 percent of Americans' long-term savings now are deposited in banks. A more appropriate and useful definition of financial institution markets, for the sake of the CRA and otherwise, is everywhere each financial institution offers and/or provides products and services and everyone it serves. If a bank offers a credit card to a low-income person, for example, its CRA responsibility (to provide comparable service for all its products and services) should, in principle, extend not only to that person but to the geographic market where that person lives.

Implementing this policy may not be as easy as it seems. Policymakers would need to find a reasonably simple but clear way of defining markets. The challenge is that consumer markets are often volatile and fast-changing. The response may be that financial institutions are well prepared to respond to these challenges. The financial services industry knows where to find customers, regardless of their income or wealth, and how to market and sell to them. And, increasingly, it knows what products and services customers need. A small but significant portion of the industry, as the current credit crisis has proved, took advantage of that knowledge to prey on consumers.

The capacity of the financial services industry to identify markets demographically is extraordinary, and it can be used to create opportunities for low-income and low-wealth individuals. If the market research capacity of, say, Ameriquest or Countrywide were turned to good purpose, for example, financial institutions could compete in "opportunity markets," where nonconforming assets present potential for both incremental and disruptive market gains.

Just as Web 2.0 reflects a current idea of community, CRA 2.0 should do the same. Banks have choices about the markets they will serve, but the markets they choose to serve will define the community reinvestment markets for which they are responsible. As a practical matter, just as the CRA in its current form exempts the smallest banks, CRA 2.0 needs a reasonable minimum standard. Rather than using asset size, however, CRA 2.0 should apply a materiality test. If a financial institution's share of a market is material (that is, at least five percent of the market), it should be subject to whatever the appropriate expectations might be under CRA 2.0. Credit card banks, for instance, target products to particular market demographics, as they should. If Capital One held a dominant market share for revolving credit-card products in Southeast Washington, DC, for example, it might carry a commensurate responsibility to provide revolving credit across the demographic and economic spectrum.

In short, financial institutions could choose their markets, and their markets in turn would define their CRA 2.0 service areas. This is primarily a problem for market research.

- Can policymakers define markets in ways that are consonant with the ways market players think and act?
- Are there existing tools in the well-developed business of market research that enable ready answers to materiality questions? To market share in consumer markets that change?
- Will this approach work if the test is applied on a periodic basis only—for example, only when a financial institution is acting on its CRA requirements or strategy? New Markets Tax Credits, for example, accept a one-time test at the moment an investment is made. Would such a test work here?

3. Under CRA 2.0, financial institutions should use diverse delivery channels to fulfill their responsibilities to their redefined communities. In 1977, banks had few viable delivery channels and relied primarily on successful community development corporations (CDCs) and other nonprofits defined by local geographies. CDCs remain central in some markets, but over the past 30 years sophisticated capital, product, and service delivery channels have emerged. How well do we understand these channels? What challenges might financial institutions face as they become comfortable with entities that operate with different purposes? How can CRA-covered financial institutions learn to use the best-available channels rather than just the most familiar?

A significant number of well-known and well-respected delivery channels exist that have the capacity to deliver billions of dollars—possibly tens of billions of dollars—of opportunity financing annually. After years of working with the CRA and other levers, many banks have preferred partners in their existing markets. Most nonbank financial institutions, however, have few, if any, partners to draw on.

These delivery channels incorporate local, regional, and national market-based financial collaborations involving banks, Community Development Financial Institutions (CDFIs), government, and diverse financial counseling agencies. In some cases, these systems are mature, sophisticated, and ahead of the curve. Some are led by banks and some by CDFIs. All (of the effective and scalable ones) are grounded in markets defined by economic activity but not by government policy. Today this delivery system is good but not great—but it is not far from providing a capacity commensurate with market demand and need.

To that end, CRA 2.0 should recognize and encourage financial institution engagements through both geographically and economically delimited market channels. Geographic market channels are familiar. Economic market channels (which might also be geographic) include a number of intermediary strategies.

- Investing in, lending to, and offering products through CDFIs, including but not limited to participating in syndicated or related asset sales.
- Participating in syndicated or related asset sales through other financial institutions with differing capacities within particular markets; for example, an East Coast bank or investment manager that offers products or services (credit cards or investment accounts) in, say, Rapid City, South Dakota, might participate in CRA 2.0 activities through a Rapid City–based financial institution.
- Participating in municipal or state government financing channels that meet CRA 2.0 standards.
- Financing CRA 2.0 innovation, research and development, and infrastructure in addition to, not instead of, intermediary financing.

Lawmakers ought to focus primarily on how best to fit these delivery channels to financial institutions under the CRA.

- What are the challenges of aligning the capacities of the delivery channels to the demands of CRA 2.0? To what extent is that investment simply building balance-sheet strength and capacity (in the manner of the CDFI Fund in the Department of the Treasury) versus supporting research and development? Is there sufficient support for innovation to enable the delivery channel players to keep pace with demand for appropriate, safe, and sound delivery channels?
- How can key players on both sides (financial institutions and delivery channels) learn to work together without a shotgun policy?

Last, CRA 2.0 investors face a significant challenge in finding and using delivery channels. Opportunity Finance Network, my organization, has developed a ratings system for investors in CDFIs with the goal of reducing funding and transaction costs. Still in its early stages, the CDFI Assessment and Ratings System (CARS) provides investors with normative ratings of CDFI financial risk and performance and impact risk and performance.[1] Ratings reports are detailed quantitative and narrative assessments. The question remains whether CARS can or should be adapted to serve other delivery channels or whether other ratings systems might emerge to meet market demand. A ratings system infrastructure to give CRA 2.0 investors transparency and consistency seems both desirable and inevitable.

4. Congress should create a new investment class to facilitate CRA 2.0 financing by stipulating either: (1) a new group of products (such as CRA 2.0 mutual funds) with explicit and appropriate fiduciary standards that include opportunity finance; or (2) that managers of existing products (such as pension funds) would not violate their fiduciary requirements by investing in CRA 2.0 opportunities (some at market rates and some below-market rates) that might carry a different level of risk than other assets they manage. In fact, Congress might make it clear that financial managers who are not investing in CRA 2.0 are not fulfilling their fiduciary responsibilities, since the principle of CRA 2.0 is that every person should have access to the resources for economic opportunities.

This idea circles back to the first one—that the CRA should be a core component of economic growth rather than just a policy for an outlier of economic policy. This may be the most important idea among the four, but it is also the most challenging.

- How long would it take to introduce a new fundamental principle into a well-established financial system—money and investment management? What resistance would policymakers face?
- What impact would we see from a new fiduciary requirement that allows or requires even a slight exception to standards of financial return or yield? What laws, policies, and practices would be involved?

1 *For more information, see http://opportunityfinance.net/financing/finance_sub4.aspx?id=56.*

Conclusion

Market innovations will always outpace statutory and regulatory solutions. The CRA as it is currently applied is obsolete because of its form, but not because of its purpose or intent. The policy fix is relatively simple, even though the implementation of the changes I suggest would take years to complete. A forward-looking version of the CRA would continue to serve low-income and low-wealth individuals and communities if the regulatory form were sufficiently dynamic.

CRA 2.0 can and should start from market opportunities and respond to market changes. Within the next two to four years, the U.S. government likely will rewrite the basic laws and regulations that govern financial market activities and behavior in response to the unraveling financial market conditions. This is a once-in-a-lifetime opportunity to make fair and just access to economic opportunities a foundation of the structure of U.S. economic financial markets. If we miss this opportunity, we will lessen the odds that economic and financial market recovery over coming years and decades will be full and robust and so put at risk the vitality of our long-term economic growth. ■

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The Community Reinvestment Act: 30 Years of Wealth Building and What We Must Do to Finish the Job

John Taylor and Josh Silver
National Community Reinvestment Coalition[1]

The Community Reinvestment Act (CRA) is a comprehensive law that has leveraged trillions of dollars in loans, investments, and bank services for minority and working-class neighborhoods. The CRA was passed in 1977 in response to the refusal of some banks to make loans available in minority and working-class communities. Since that time, the CRA has placed a continuing and affirmative obligation on banks to help meet the credit needs of the local communities in which they operate.[2] Further, not only has the CRA successfully deterred discrimination in lending, but it has also required that banks proactively assess and serve community needs in a safe and sound manner.

Our nation faces a serious foreclosure crisis, caused in part by widespread irresponsible lending. Had the CRA been applied to independent mortgage companies, investment banks, and other nondepository financial institutions, it is likely that the nation would not be gripped by a foreclosure crisis. The mandate to serve communities with safe and sound lending has resulted in bank lending that is considerably less risky than independent mortgage company lending. While banks have failed in the midst of this crisis, their failure rate is dwarfed by the wholesale loss of independent mortgage companies. Of the 169 institutions that ceased operations in 2007, 167 of them were independent mortgage companies.[3]

In celebration of more than 30 years of its existence, this paper will describe the CRA's accomplishments and the role of community organizations in the CRA's public participation process. In addition, it will describe what steps should be taken to strengthen and update the CRA.

I. How the CRA Works and the Role of Community Groups

The CRA requires that one of four federal agencies conduct CRA examinations: the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), or the Federal Deposit Insurance Corporation (FDIC). The agencies also consider the CRA performance of depository institutions when they apply for permission to merge.[4]

A CRA exam evaluates the extent to which banks serve local community needs and assigns a rating based on the assessment of the bank's service. Both the CRA exams and ratings are available to the public.[5] Further, CRA exams differ by the asset size and type of banks. Large Banks with assets over $1 billion undergo the

1 *NCRC is an association of more than 600 community-based organizations that promote access to basic banking services, including credit and savings, create and sustain affordable housing, promote job development, and ensure vibrant communities for America's working families. Our members include community reinvestment organizations, community development corporations, local and state government agencies, faith-based institutions, community organizing and civil rights groups, minority- and women-owned business associations, and local and social service providers from across the nation.*

2 *12 USC 2901, Section 802 imposes the affirmative and continuing obligation to serve credit needs consistent with safety and soundness.*

3 *Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, The 2007 HMDA Data, available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07draft.pdf.*

4 *The Federal Reserve Board conducts exams of state-chartered banks, the Office of the Comptroller of the Currency conducts exams for nationally chartered banks, the Office of Thrift Supervision conducts exams for federally chartered thrifts, and the Federal Deposit Insurance Corporation conducts exams for state-chartered banks.*

5 *Banks receive one of four ratings: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. The last two are considered to be failed CRA ratings.*

most rigorous exams, while smaller bank exams are streamlined.[6]

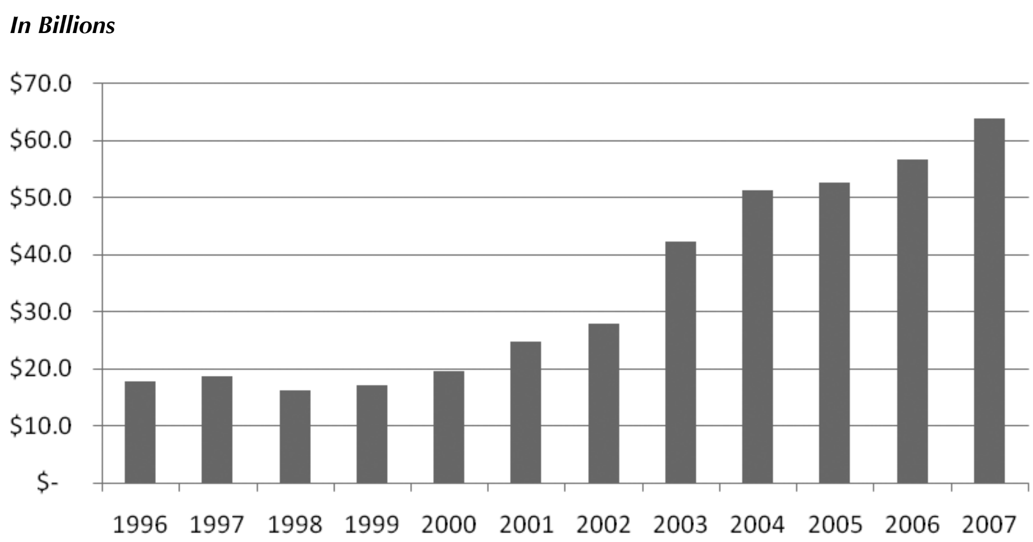
The federal agencies are required to consider public comments in issuing CRA ratings and rendering decisions on merger applications, making the public participation process a vital component of the CRA. Comments on a bank's CRA record often bolster the bank's performance. A few years ago, NCRC assisted one of its West Virginia members in commenting on WesBanco's CRA exam, detailing poor performance in making loans to minorities and low- and moderate-income (LMI) borrowers. Due in part to the comments, the bank nearly failed its CRA exam and in fact appealed its initial rating. While the bank ultimately passed its exam, the exam delay contributed to a significant slowdown in regulatory approval of a merger application submitted by the bank, motivating the bank to significantly improve its performance as evidenced in future CRA exams.

The CRA merger application process has been an important venue for community groups to approach banks about the credit needs of LMI borrowers. CRA agreements are often negotiated between banks and community groups during the merger application process. NCRC's report, "CRA Commitments," has documented that banks have made $4.6 trillion in CRA agreements and commitments to LMI and minority communities.[7] Since the publication of CRA Commitments, Bank of America pledged an additional $1.5 trillion during its takeover of Countrywide.[8] Overall, banks make considerably more home loans in geographical areas covered by CRA agreements than those that are not, as documented in a study conducted by Federal Reserve economists using NCRC's CRA database.[9]

II. The CRA's Record of Increasing Access to Bank Lending and Services

The CRA has leveraged substantial amounts of loans, investments, and bank services for LMI communities. According to publicly available data analyzed by NCRC, banks and thrifts (depository institutions) have made 373,404 community development loans totaling more

Chart: Total CRA Community Development Lending 1996 - 2007



Source: FFIEC CRA National Aggregate Report Table 3 (http://www.ffiec.gov/craadweb/national.aspx)

6 *The discussion in this section is based on the CRA regulation (see http://www.ffiec.gov/cra/regulation.htm for the regulation), the interagency Question and Answer document (see http://www.ffiec.gov/cra/qnadoc.htm), and NCRC's CRA Manual (http://www.ncrc.org/images/stories/pdf/cra_manual.pdf).*

7 *NCRC's CRA Commitments, available at http://www.ncrc.org/images/stories/whatWeDo_promote/cra_commitments_07.pdf.*

8 *See Bank of America's April 28 press release, available at http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8152.*

9 *Raphael W. Bostic and Breck L. Robinson, Do CRA Agreements Influence Lending Patterns? 31 Real Est. Econ. 31, 1 (2003): 23-51.*

than $407 billion since 1996. From 1996 to 2007, the annual dollar amount of community development loans more than tripled—from $17.7 billion to $63.8 billion, respectively (see chart).

The Treasury Department reports that CRA-covered lenders increased home mortgage loans to LMI borrowers by 39 percent from 1993 to 1998. This increase is more than twice that experienced by middle- and upper-income borrowers during the same period.[10] Likewise, a study conducted by the Joint Center for Housing Studies at Harvard University estimates that without the CRA, 336,000 fewer home purchase loans would have been made to LMI borrowers and communities between 1993 and 2000.[11]

Moreover, the CRA's effectiveness can also be measured by comparing the lending patterns of CRA-covered banks with those of lending institutions not covered by CRA exams. NCRC found that in 2006, depository institutions extended 23.5 percent of home purchase loans to LMI borrowers, whereas non-CRA-covered lenders extended 21.5 percent. NCRC's study "Credit Unions: True to Their Mission?" showed that over a three-year period, banks consistently outperformed credit unions in offering home loans to minorities, women, and LMI borrowers in a majority of states.[12]

Remaining true to its purpose of requiring banks to serve credit needs consistent with safety and soundness, the CRA is an important antidote to the predatory lending that has contributed to the foreclosure crisis. In its review of the Home Mortgage Disclosure Act (HMDA) data, the Federal Reserve found that home loans issued by banks are significantly less likely to be high-cost and exhibit risky features. The Federal Reserve showed that 34.3 percent of the home purchase loans issued by non-CRA-covered lenders were high-cost loans in 2005.[13] By contrast, only 5.1 percent of the home purchase loans issued by depository institutions and closely scrutinized on CRA exams were high-cost. In addition, from 2004 to 2006, independent mortgage companies extended between 55 percent and 63 percent of the high-cost piggyback loans. During the same time, depository institutions accounted for between 20 percent and 25 percent of the high-cost piggyback loans.[14]

The CRA mitigates home foreclosures. CRA exams reward banks for foreclosure-prevention efforts by giving banks points on their Lending, Investment, and Service Tests. Activities that earn CRA points include counseling, modifying loans, and investing in funds that finance loan modification. CRA exams provide clear incentives for banks to make safe and sound loans and penalize them for making loans that are unfair and deceptive.

III. How to Improve CRA Exam Criteria

While the overall framework of the CRA has been successful, the following need to be reformed.

A. The geographical coverage of CRA exams.
B. Whether CRA exams consider the behavior of mortgage company affiliates.
C. Consideration of minority borrowers and communities on CRA exams.
D. Evaluations for considering branching on CRA exams.
E. Data limitations that reduce the effectiveness of CRA exams.

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10 Robert Litan, Nicolas Retsinas, Eric Belsky, and Susan White Haag, The Community Reinvestment Act After Financial Modernization: A Baseline Report, U.S. Department of the Treasury, April 2000.

11 The Joint Center for Housing Studies at Harvard University, The 25th Anniversary of the Community Reinvestment Act: Access to Capitol in an Evolving Financial Services System, March 2002.

12 National Community Reinvestment Coalition, "Credit Unions: True to Their Mission?"

13 Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, Higher-Priced Home Lending and the 2005 HMDA Data, Federal Reserve Bulletin, September 8, 2006. See also Traiger and Hinckley, LLP, The Community Reinvestment Act: A Welcome Anomaly to the Foreclosure Crisis, January 7, 2008.

14 Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2007 HMDA Data," available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07draft.pdf.

If CRA exams become more rigorous in each of these areas, community groups and the public can participate more meaningfully in the CRA process. For example, if lending to minorities is considered by CRA exams, then public comments on lending to minorities become more relevant. Likewise, if CRA exam analysis of branching, home, and small business data becomes more robust, community groups will have more information with which to engage in substantive dialogue about banks' CRA performance.

A. *The Geographic Coverage of CRA Exams*

The geographic locations covered by CRA exams consist of metropolitan areas or counties that contain bank branches. When Congress enacted the CRA in 1977, banks received deposits and made loans through branches. While some banks still issue loans predominantly through branches, others make the majority of their loans through brokers and other non-branch means.

Though the CRA regulation stipulates that assessment areas include geographical regions containing bank branches, the regulation also states that assessment areas include other geographical regions in which the bank has originated or purchased a substantial portion of its loans.[15] Despite this regulatory clause, the federal agencies usually adopt a narrow definition of assessment areas for banks or thrifts that issue most of their loans through nonbranch channels. For these banks, it is not unusual to encounter CRA exams that cover only the geographical area of the bank's headquarters.

In 2007, NCRC identified several lending institutions that engaged in questionable practices, including refusal to make loans under a minimum amount (usually $75,000 or $100,000), refusal to make loans to row houses, and failure to offer loans within entire cities. NCRC research revealed that four banks engaged in these practices. Tellingly, only 11 to 13 percent of the loans investigated were in the banks' assessment areas.[16]

In addition to enabling discriminatory practices, narrow assessment areas defeat the the CRA's objective of banks responding to community needs. In one recent case, an NCRC member organization in Pennsylvania was concerned about the impact of a large bank merger on the bank's continued commitment to the organization's city. The newly merged institution would in fact be the largest lender (measured by the number of home loans) in the city. Because the bank did not have a branch in the city and the city was not in a CRA assessment area, the bank declined to engage in substantive discussions about future collaboration. Although it had a major lending presence in the city, the bank was not encouraged by CRA exam procedures to see how it could meet credit needs beyond home lending in that area.

The proposals in the CRA Modernization Act of 2007 address the inadequacies of assessment areas.[17] Under this bill, if a bank has captured one-half of one percent or more of the local lending market, a CRA exam would designate the geographic area served by the bank as an assessment area. A procedure such as this would ensure that the majority of a bank's loans and other financial activities are scrutinized by CRA exams.

B. *Whether CRA Exams Consider the Behavior of Mortgage Company Affiliates*

Under the CRA, banks have the option of including their nondepository affiliates, such as mortgage companies, on CRA exams. Banks are tempted to include affiliates on CRA exams if the affiliates perform admirably, but they will opt against inclusion if the affiliates are engaged in risky lending or discriminatory policies. This is counter to the essential purpose of the CRA, which is to ensure that the institution as a whole is meeting credit needs in a responsible manner.

Four nondepository affiliates of banks were identified by NCRC's fair-lending investigations (discussed above) as engaging in redlining or other discriminatory practices. These four affiliates were not included on their affiliated bank's CRA examinations. Current CRA examination procedures enable bank affiliates to engage in such practices undetected. The CRA Modernization Act of 2007 would end this serious gap in CRA enforcement by mandating the inclusion of affiliates on CRA exams.

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15 *See Section 345.41 of the FDIC's CRA regulation, available at http://www.fdic.gov/regulations/community/community/index.html.*

16 *Contact the National Community Reinvestment Coalition for more information regarding our fair lending investigations.*

17 *See http://thomas.loc.gov/cgi-bin/bdquery/z?d110:h.r.01289 for the text of HR 1289, the CRA Modernization Act of 2007.*

C. Consideration of Minority Borrowers and Communities on CRA Exams

On a CRA exam, lending to LMI borrowers and communities is examined in detail. A major part of the Lending Test consists of scrutinizing the percentage of a bank's loans made to LMI borrowers compared to the demographics of the bank's community and the percentage of loans made to LMI borrowers by the bank's competitors.

CRA exams have a fair-lending component that assesses whether a bank discriminated by rejecting qualified minority applicants or by steering minorities with good credit to subprime loans. While the fair-lending test is necessary, it does not assess whether banks are affirmatively making loans to minorities. In other words, a bank can employ nondiscriminatory policies but still make relatively few loans to minorities because it does not market to minority communities. If lending to minorities were an explicit criterion on CRA exams, then consistently low percentages of loans to minorities would contribute to a lower rating for the bank.

Given the evidence of lending disparities by race, NCRC has called for CRA exams to explicitly examine lending and services to minority borrowers and communities. NCRC's "Broken Credit System" report shows that minority neighborhoods received larger percentages of subprime loans than predominantly white neighborhoods, even after controlling for creditworthiness and other housing stock characteristics.[18] Researchers came to similar conclusions about high levels of subprime loans in minority neighborhoods after controlling for creditworthiness.[19]Another NCRC study, "Are Banks on the Map?" found larger disparities in branching by race of neighborhood than by income of neighborhood in 25 large metropolitan areas.[20] Overall, it is probable that a consideration of lending and branching by race of borrower and neighborhood would lessen the racial disparities in access to bank services and loans.

Prior to CRA regulatory reforms in the mid-1990s, CRA exams under "Assessment Factor D" would often assess performance of lending to minorities. An example of this approach is employed in the evaluation of Signet Bank, conducted by the Federal Reserve Bank of Richmond in 1996. If the regulatory agencies do not reinstate lending and service to minorities as criteria on CRA exams, Congress should amend the CRA to add lending and service to minorities as provided in the CRA Modernization Act of 2007.

D. Evaluations for Considering Branching on CRA Exams

Access to branches and deposit accounts is essential in order to assist people at low- or moderate-income levels in establishing savings and acquiring home and small-business loans. Furthermore, research conducted by the Federal Reserve demonstrated that banks offer a higher percentage of prime loans when they issue loans through branches than when they make loans through brokers.[21] NCRC's research for the Appalachian Regional Commission revealed that small-business lending is higher in rural counties with a greater number of bank branches.[22]

Because branching and access to basic banking services are vital to wealth building, the CRA Service Test should be rigorous and comprehensive, holding banks to a high standard of branching and service provision in LMI neighborhoods. Unfortunately, research has shown the contrary. A study conducted by the Center for Community Capital concluded that the CRA Service Test scores are likely to be inflated when low scores on the Lending Test and Investment Test confront banks with the possibility of CRA exam failure.[23]

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18 National Community Reinvestment Coalition, "Broken Credit System."

19 Paul S. Calem, Kevin Gillen, and Susan Wachter, "The Neighborhood Distribution of Subprime Mortgage Lending," October 30, 2002. See also Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter, "Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities," Housing Policy Debate 15, no. 3 (2004): 603–22.

20 "Are Banks on the Map," available at http://www.ncrc.org/images/stories/mediaCenter_reports/ncrc%20bank%20branch%20study.pdf.

21 Avery, Brevoort, and Canner, "Higher-Priced Home Lending" and "The 2005 HMDA Data."

22 "Access to Capital and Credit for Small Businesses in Appalachia," available at http://www.ncrc.org/pressandpubs/press_releases/documents/2007/NCRC%20Study%20for%20ARC.pdf.

23 Michael A. Stegman, Kelly Thompson Cochran, and Robert Faris, Center for Community Capital, University of North Carolina, Creating a Scorecard for the CRA Service Test: Strengthening Basic Banking Services under the Community Reinvestment Act, 2001. Also see the Woodstock Institute, Measuring the Provision of Banking Services for the Underbanked: Recommendations for a More Effective Community Reinvestment Act Service Test, March 2007. Of the 14 banks in Woodstock's sample with the highest scores on the Service Test, eight had branch distributions in low- and moderate-income communities that were well below the averages for all lenders as a group in the banks' assessment areas.

Diminished attention to branching on CRA exams should be addressed. The regulatory agencies should construct clear and objective measures for comparing the distribution of branches with the distribution of LMI neighborhoods and people in those areas. The agencies should also collect data on the number and percent of deposit accounts in LMI neighborhoods so that CRA exams contain substantive analyses on the distribution of deposit accounts instead of simple assertions that banks provide services to LMI consumers.

E. Data Limitations that Reduce the Effectiveness of CRA Exams

CRA exams cannot effectively measure bank performance if data are of limited quality. Federal agencies have used HMDA data in detail on exams, but further enhancements in the use of the data are necessary.

The agencies provide detailed tables on home-loan lending. The narrative and tables on CRA exams separately analyze home purchase, refinance, and home-improvement lending. This is necessary since the separate types of home lending respond to different credit needs.

As proposed and rejected in 2004, the same procedure of separate analysis should apply to mortgage purchases.[24] Purchases refer to secondary market activity involving banks buying loans from other banks and mortgage companies. Loan originations refer to loans made directly by a bank. If loan originations were analyzed separately from loan purchases, it would be more difficult for banks to manipulate CRA exams through the buying of loans made to LMI borrowers immediately before CRA exams.[25]

CRA exams should use the new pricing information in HMDA data to evaluate separately prime and high-cost lending. Just as home-purchase and refinance lending respond to different credit needs, so too do prime and high-cost lending. Also, it is important to ensure that banks making both prime and high-cost lending offer a balanced product mix to LMI borrowers and communities. This objective can be achieved only if prime lending and high-cost lending are analyzed separately.

While the major issue associated with HMDA data has been its use in CRA exams, the predominant issue regarding small-business data is that of quality. The federal regulatory agencies significantly lessened the quality of these data by exempting Intermediate Small Banks (with assets of $250 million to $1 billion) from requirements to collect and report it. As NCRC demonstrated in its report for the Appalachian Regional Commission, Intermediate Small Banks are an important source of credit for small businesses, particularly in rural areas and medium-size cities and towns.

Periodic national surveys sponsored by the Federal Reserve consistently point toward the likelihood of discrimination in small-business lending.[26] A powerful way to reduce disparities in lending is to provide publicly data on the number of loans made to minorities and women. Yet, the CRA small-business data lack information on the gender and race of the small-business owner.

Rep. James McGovern introduced the Access and Openness in Small Business Lending Act of 2003 (H.R. 1748), which would have required reporting the race and gender of the small-business owner and mandate additional demographic detail in the CRA small-business data.[27] In addition to passing a bill similar to McGovern's, it is suggested that Congress either pass a bill or urge the regulatory agencies to reverse their decision exempting Intermediate Small Banks from CRA small-business data reporting requirements.

IV. How to Improve CRA Ratings

Ratings on CRA exams are a critical element of the CRA process. Some banks issue press releases announcing Outstanding ratings, while low ratings can damage a bank's reputation. Ratings also figure prominently in

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24 In 2004, the federal agencies proposed separate data tables on originations and purchases only to abandon this proposal. See the February 6, 2004, Federal Register for the proposal, available at http://www.fdic.gov/regulations/laws/federal/04CRA.html.

25 The quality of HMDA data on loan purchases should be enhanced. Currently, Regulation C (the Federal Reserve regulation that implements the HMDA statute) requires data on loan purchases to include the census-tract location of property but not the race, gender, or income of the borrower. Banks should be required to collect the same information on borrower and neighborhood characteristics on loan purchases as they do on loan originations. Some banks collect complete information on loan purchases, while others do not. The rigor of CRA exams would be enhanced if data on loan purchases were made uniform. See 12 Code of Federal Regulations, Part 203, Section 203.4 for the data-collection procedure regarding purchases.

26 See NCRC's Access to Capital and Credit for Small Businesses in Appalachia for a discussion of the literature and the Federal Reserve–sponsored surveys available at http://www.ncrc.org/images/stories/mediaCenter_reports/ncrc%20study%20for%20arc.pdf.

27 See http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.01748.

the merger-application process. If ratings are inflated, the CRA will not be able to realize its full potential in leveraging bank financing and services for LMI communities. Grade inflation makes it difficult for community groups and members of the public to discern important differences in banks' overall performance and across assessment areas and component tests. Grade inflation therefore hinders the ability of community groups to comment meaningfully to banks and regulatory officials about various aspects of bank performance.

CRA Grade Inflation

The table below shows the current failure rate for banks has hovered between one and two percent in recent years (ratings of Needs to Improve or Substantial Noncompliance indicate a bank has failed its CRA exam). When ratings first became public in 1990, more than ten percent of banks failed their CRA exams.[28] For the five years thereafter, more than five percent of banks failed their CRA exams every year.

Banks improved their CRA performance over the years as they bolstered their efforts to make loans, investments, and services in low- and moderate-income communities. Yet, the low failure rate in recent years appears implausible. As discussed above, the Center for Community Capital demonstrated inflation in the CRA Services Test. In addition, Rick Marsico, in his book *Democratizing Capital*, reveals how quantitative criteria are applied in an inconsistent manner on CRA exams, suggesting that a number of CRA exams have ratings that cannot be justified.[29]

The CRA Modernization Act of 2007 contains a number of provisions that would help prevent grade inflation. The first is introducing more ratings. Currently, the CRA component tests (such as the Lending Test) have Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, and Substantial Noncompliance as possible grades. In contrast, the final rating on a CRA exam can be one of four grades: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. The final

Table: CRA Exam Ratings 1990 - 2007

Year	Outstanding		Satisfactory		Needs to Improve		Substantial Noncompliance		Total
	Count	Percent	Count	Percent	Count	Percent	Count	Percent	
1990	340	10.9%	2,474	79.5%	280	9.0%	19	0.6%	3,113
1991	407	8.3%	4,016	81.6%	453	9.2%	46	0.9%	4,922
1992	653	12.7%	4,067	78.9%	395	7.7%	40	0.8%	5,155
1993	941	14.7%	5,060	79.3%	355	5.6%	26	0.4%	6,382
1994	1,000	18.1%	4,249	76.7%	275	5.0%	15	0.3%	5,539
1995	1,363	24.3%	4,106	73.1%	138	2.5%	7	0.1%	5,614
1996	1,214	26.5%	3,275	71.5%	81	1.8%	11	0.2%	4,581
1997	829	22.4%	2,807	75.7%	59	1.6%	11	0.3%	3,706
1998	681	18.6%	2,915	79.6%	59	1.6%	7	0.2%	3,662
1999	679	18.6%	2,915	79.7%	55	1.5%	7	0.2%	3,656
2000	220	17.5%	1,001	79.6%	30	2.4%	7	0.6%	1,258
2001	132	10.6%	1,088	87.1%	23	1.8%	6	0.5%	1,249
2002	201	9.8%	1,820	89.0%	18	0.9%	5	0.2%	2,044
2003	283	10.1%	2,492	89.2%	17	0.6%	3	0.1%	2,795
2004	329	13.1%	2,170	86.1%	17	0.7%	3	0.1%	2,519
2005	244	15.9%	1,278	83.2%	10	0.7%	4	0.3%	1,536
2006	171	13.1%	1,109	84.9%	20	1.5%	6	0.5%	1,306
2007	154	10.5%	1,292	87.8%	20	1.4%	4	0.3%	1,470
Total	**9,841**	16.3%	**48,134**	79.5%	**2,305**	3.8%	**227**	0.4%	**60,507**

Source: FFIEC CRA Ratings Database

28 *See http://www.ffiec.gov/craratings/default.aspx for the database on CRA ratings.*

29 *Richard D. Marsico, Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act (Carolina Academic Press, 2005).*

rating should also include High Satisfactory and Low Satisfactory as possible grades. In this manner, the general public and the federal agencies would be better able to assess actual differences and gradations in performance.

If a low CRA rating in an assessment area triggered requirements for a bank to improve its performance, a bank would be more likely to serve all geographic areas, including smaller cities and rural areas. The CRA Modernization Act of 2007 would require federal agencies to address low ratings and would require public input in this process. If a bank receives a rating of Low Satisfactory or worse in any assessment area, it would be required to submit a CRA improvement plan to its regulatory agency describing how the bank intends to bolster its CRA performance in that specific area.[30] The general public would also be able to comment on the submitted plan. After the agency approves the CRA improvement plan, the bank would be required to submit quarterly reports for public monitoring purposes.

Another important reform would be to make the ratings appeal process transparent. The appeal process as currently structured is a one-sided affair enabling banks to secretly appeal ratings; this likely contributes to CRA grade inflation. Either banks should not have the right to appeal or appeals should be publicly announced with an opportunity for the general public to comment.

The importance of the rigor of the CRA exam has increased since the largest banks in the country have become much larger and will likely be involved in fewer mergers in the coming years. The top four banks (the new Bank of America after the Countrywide acquisition, the new JPMorgan Chase after the Washington Mutual acquisition, the new Wells Fargo after the Wachovia acquisition, and Citigroup) now control an incredible 52.8 percent of the nation's bank assets equaling $7 trillion.[31] At least two of the largest banks, Bank of America and Wells Fargo, are now close to the ten percent deposit cap. In other words, each of them owns about ten percent of the nation's deposits, meaning they cannot legally acquire other banks without divesting branches. Thus, since these banks are unlikely to undergo significant mergers in the near and medium term, the major means to hold them accountable for CRA performance is through the CRA examination process. Ratings must therefore become more meaningful and community organizations should have increased opportunities via public improvement plans to recommend how the very large banks can bolster their performance in geographies where their CRA performance is relatively weak.

V. Bolstering the Merger Application Process and Public Participation

The merger application process presents significant opportunities for federal agencies to enforce the CRA. Yet, the enforcement of community reinvestment obligations through the merger application process has been lacking over the last several years.

In Congressional testimony in 2007, an official representing the Federal Reserve Board testified that the Federal Reserve Board has held only 13 public meetings on mergers since 1990. This is less than one meeting per year in an era in which consolidations have profoundly changed the banking industry. In addition, a Federal Reserve Board representative stated that since 1988 the Federal Reserve Board received 13,500 applications for the formation of banks, or the merger of institutions involving bank holding companies or state-chartered banks that were members of the Federal Reserve System. Yet, only 25 of these applications were denied, with eight of the denials involving consumer protection or community-needs issues.[32]

Previously, the OTS required that a meeting be held between merging thrifts and community groups when requested by a community group that had submitted written comments pertaining to the merger. This procedure needs to be implemented by all the agencies. Meetings, as distinguished from public hearings, usually involve a relatively small number of stakeholders, including regulatory officials, a few community leaders,

30 The concept of an improvement plan builds on a procedure mandated by the current CRA regulation. At section 345.43 of the FDIC's version of the regulation, a bank with a less than Satisfactory rating shall allow the public to inspect a description of its efforts to "improve its performance in helping to meet the credit needs of its entire community." This description is to be updated quarterly.

31 The total industry asset levels are as of June 30, 2008, see the FDIC's Statistics of Depository Institutions, available at http://www2.fdic.gov/sdi/main.asp. The top bank holding company asset levels are as of September 30, 2008, see the Federal Financial Institutions Examination Council National Information Center (NIC), available at http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx. The NIC asset levels for the top holding companies appear to have incorporated the recent acquisitions such as JPMorgan Chase's acquisition of Washington Mutual and Bank of America's acquisition of Countrywide.

32 See http://www.federalreserve.gov/newsevents/testimony/braunstein20070521a.htm for Ms. Braunstein's testimony.

and representatives of the merging institutions.

In addition to meetings, a public hearing should be held when regulatory agencies receive several requests from community groups or citizens for a public forum. Meetings allow for in-depth dialogue and debate among a handful of important stakeholders. However, public hearings become necessary when hundreds of citizens and community organizations wish to testify. Regulatory officials must afford them the opportunity to testify so that the officials can understand how important the banks are to the affected communities.

In addition to holding more frequent hearings and meetings, the regulatory agencies should also bolster the rigor of its merger approval process. Since merger denials are rare, the quality of merger approvals becomes quite important in assuring continued community reinvestment. The agencies should increase the use of conditional merger approvals that require banks to improve CRA performance or to institute nondiscriminatory and antipredatory lending safeguards. Even in a case when the merger is approved without conditions, the federal agencies can describe any significant deficiencies in the CRA and fair-lending performance, and then indicate that they expect the bank to rectify these deficiencies. In fact, an "expectations" section would be beneficial as a regular feature of merger approvals and CRA exams. The section would explain in which geographic areas and in which component tests the bank has weaknesses and would suggest how the bank could improve the shortfalls (including partnering with community organizations or introducing new products or marketing approaches).

Federal agencies should also alter their stance regarding CRA agreements, since agreements have stimulated significant increases in responsible lending. They usually note in merger approval orders that CRA agreements are not required by the CRA regulation. In addition, they routinely note that they will not consider any CRA agreements in the merger approval process.[33] Instead, the federal agencies should either explicitly encourage CRA agreements or implicitly encourage them by extolling the benefits of collaboration between community groups and banks.

VI. The Adequacy of Federal Agency Antidiscrimination Reviews on CRA Exams

Evidence of discriminatory and illegal lending can result in downgrades of CRA ratings for banks if discrimination and illegal lending were widespread and the lender did not take action to end the practices. However, there is little evidence that the fair lending reviews of CRA exams are rigorously testing for discriminatory lending.

In most cases, even for the largest banks, the fair-lending section of the CRA exam reports in one to three sentences that the regulatory agency tested for evidence of illegal and discriminatory lending and that no such lending was found.[34] Yet there is no discussion of what precisely had been done to reach its conclusion.

In the past, agencies provided detailed descriptions in the fair-lending section of CRA exams under the "assessment factor" format of the exams. For example, under Assessment Factor F, which assessed evidence of discriminatory or illegal practices, the Federal Reserve Bank of Richmond in January 1996 conducted matched file reviews of more than 300 loan applications in a CRA exam of Signet Bank. The exam also described a regression analysis, which sought to determine if race was a factor in loan rejections.

A substantive fair lending review, similar to the one for Signet Bank, provides the general public with confidence that the regulatory agency performed a detailed anti-discrimination analysis. Based on their experience with banks, community groups can comment on whether the

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33 See, for example, http://www.federalreserve.gov/newsevents/press/orders/orders20080605a1.pdf. Footnote 35 on page 18 discusses CRA pledges.

34 For example, a federal agency had this to say on the CRA exam's fair-lending review of one large bank with several affiliates, a number of whom make high-cost loans: "We found no evidence of illegal discrimination or other illegal credit practices." That was the only sentence in the fair-lending review section. In another instance, NCRC examined a thrift that specialized in subprime lending. The CRA exam report for that thrift noted that it issued a high percentage of loans to low- and moderate-income borrowers. The CRA fair-lending review, however, did not describe if the examiner made any efforts to determine if the subprime lending was conducted in a nondiscriminatory manner or was consistent with safety and soundness (See Office of Thrift Supervision CRA exam of Eastern Savings Bank, FSB, Docket # 08183, August 2005). In another case, an exam mentioned that a bank specialized in adjustable-rate lending, but the fair-lending review did not mention whether the examiner assessed if the loans were offered in a nondiscriminatory manner and whether they were safe and sound. (See Federal Deposit Insurance Corporation CRA exam of Franklin Bank, SSB, Certificate Number # 26870, January 2005.)

fair-lending tests described by the exam scrutinized specific lending products or practices that are problematic. Detailed descriptions of fair-lending reviews enhance the rigor of the examination process by increasing transparency and promoting informed public dialogue.

Safety and soundness reviews should be integrated with the fair-lending review and the overall CRA exam. Examiners should disqualify from favorable consideration on CRA exams any subset of loans, such as nontraditional and subprime loans with multiple risky features, that exhibit delinquency and default rates much higher than industry averages.[35] If such risky lending is widespread, the CRA rating should be downgraded, especially if this type of lending targets LMI borrowers, minorities, and other classes of borrowers protected by the Fair Housing Act or the Equal Credit Opportunity Act.

Although the great majority of institutions failing because of unsafe and unsound lending have been independent mortgage companies not covered by the CRA, some of the failures were banks and thrifts.[36] The CRA exams of two of these lenders, Fremont Investment and Loan and Indymac, do not discuss the safety and soundness of their lending practices.[37] In Fremont's case, the FDIC issued a failed CRA rating on the exam after the FDIC issued an enforcement order requiring the bank to cease and desist from unsafe and unsound lending. The CRA exam preceding the enforcement order gave Fremont Investment and Loan an Outstanding rating. These two cases illustrate that safety-and-soundness reviews need to be uniformly rigorous, with findings clearly discussed on CRA exams.

VII. Less Frequent CRA Exams for Small Banks

The Gramm-Leach-Bliley Act (GLBA) of 1999 reduced the frequency of Small-Bank CRA exams. Under GLBA, Small Banks with assets under $250 million are examined only once every four years if they have a Satisfactory rating and once every five years if they have an Outstanding rating.[38] In contrast, banks with assets above $250 million are examined every two years.

When Small Banks are examined infrequently, they have less incentive to adhere affirmatively and continually to their reinvestment obligations. They also have reduced incentives to make sufficient loans to low- and moderate-income borrowers during the four- or five-year period between exams, and they may focus their efforts only during the last year or two before their exams. Increasing the frequency of Small Bank exams is necessary when considering that CRA exams are usually the only accountability mechanism, as Small Banks rarely merge.[39]

VIII. The Need to Extend the CRA to Nonbank Financial Institutions

In the 30 years since the enactment of the CRA, the financial industry has evolved incredibly. Banks now face more formidable competitors than they did in 1977. As long as these competitors remain uncovered by the CRA, it is likely that their lending will be less safe and

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35 Loans that exhibit problematic features highlighted by the interagency guidelines for subprime and nontraditional lending should be subjected to rigorous scrutiny on CRA exams. If such lending exhibits high delinquency and default rates, the lending should not count on CRA exams and should also be penalized in terms of reduced CRA ratings. See http://www.federalreserve.gov/newsevents/press/bcreg/20060929a.htm for the final version of interagency guidance on nontraditional lending, and http://www.federalreserve.gov/newsevents/press/bcreg/20070629a.htm for the final guidance on subprime lending. Another safety and soundness screen employed on CRA exams should be determining if any subset of loans violate the July 2008 Federal Reserve changes to its Regulation Z and HOEPA rules. See http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm.

36 According to the Federal Reserve's Bulletin article (http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07draft.pdf) on the 2007 HMDA data, 169 institutions ceased operations and did not report HMDA data in 2007; 167 of these institutions were independent mortgage companies not covered by CRA. A large number of these institutions closed due to unsafe and unsound lending practices.

37 See December 2004 Office of Thrift Supervision exam for Indymac, FSB; September 2005 FDIC exam of Fremont Investment and Loan. The FDIC Cease and Desist Order against Fremont of March 2007 and FDIC CRA exam of Fremont, dated August 2008.

38 The Gramm-Leach-Bliley Act of 1999 mandates that the frequency of CRA exams for small banks with assets below $250 million depends on their most recent rating. Small banks with a Satisfactory rating will undergo a CRA exam in four years; small banks with an Outstanding rating will undergo a CRA exam in five years. For the text of the Gramm-Leach-Bliley Act, see http://thomas.loc.gov/cgi-bin/query/z?c106:S.900:.

39 While the benefits of more frequent exams are clear, the costs of more frequent exams appear to be minimal. In their analysis on small-bank burdens, the federal banking agencies have found that CRA regulations "impose a modest information collection burden on small institutions – an average of ten burden hours per institution per year." Federal Register 64, no. 103, May 28, 1999, 29083–86.

sound than the banks and/or that they will offer a smaller portion of loans than banks to low- and moderate-income communities. Credit unions and independent mortgage companies do not offer as high a percentage of home loans to LMI borrowers as banks. NCRC's fair-lending investigation, discussed above, revealed that 26 of the 35 institutions engaged in redlining and other discriminatory practices were independent mortgage companies not covered by the CRA.

Congress needs to follow the example of the state of Massachusetts, which has covered credit unions with the CRA for a number of years and also recently enacted a community reinvestment requirement for mortgage companies. Similarly, the CRA Modernization Act of 2007 would require the application of the CRA to independent mortgage companies, and it would also require the application of the CRA to insurance companies by imposing HMDA-like data-disclosure requirements. A number of states already collect and provide data on insurance provision to the general public.[40]

Moreover, the CRA Modernization Act of 2007 would require the application of the CRA to securities firms. CRA exams would measure the extent to which securities firms are serving LMI and minority consumers. Wealth building would be augmented considerably if more people of modest means and minorities had access to mutual funds and similar products. In addition, if a law channeled more securities firm investments into minority and working-class neighborhoods, the economic development prospects of these communities would be significantly enhanced.

IX. Conclusion

In light of the present-day lending crisis and its disparate impact on minority and LMI communities, the CRA needs to be modernized and enhanced. The CRA has been effective in bringing trillions of dollars in loans, investments, and services to LMI communities, yet too many LMI and minority communities are still left out of the financial mainstream. If America is to become a truly financially inclusive society, the application of the CRA to banks by federal agencies needs to be strengthened. In addition, the CRA needs to be applied to nonbank financial institutions. The CRA's effectiveness will be bolstered further if reforms are initiated that facilitate community participation.

In summary, the following steps need to be taken:

Improve CRA Exam Criteria

- Assessment area procedures must be reformed so that a great majority of a bank's loans are on CRA exams.
- All nondepository affiliates of banks must be included on CRA exams.
- CRA exams should explicitly consider lending, investments, and services to minority borrowers and communities.
- Federal agencies need to enhance the rigor of the Service Test and increase data collection of bank deposit accounts (at least by income level) of neighborhoods. The Community Development Test for Intermediate Small Banks must also examine branching and deposit accounts more strenuously.
- CRA exams should separately consider purchases and loan originations, as well as prime and high-cost lending.
- The quality of CRA small-business data needs to be enhanced through the disclosure of the race and gender of the small-business owner.

Improve CRA Ratings

- CRA grade inflation needs to be counteracted by increasing the number of possible ratings.
- The ratings appeals process should be either nullified or made transparent with an opportunity for public comment.
- Low scores for any assessment area should trigger regulatory enforcement, including the submission of improvement plans.
- The rigor of CRA exams must increase, particularly for the largest banks, which are now less likely to merge. CRA exams thus become the major means of CRA enforcement for the new megabanks.

Bolster the Merger Application Process and Public Participation

- The agencies should hold more public hearings on merger applications and issue more conditional merger approvals.
- Merger approvals and CRA exams need to contain an "expectations" section detailing specific

40 Gregory D. Squires, Sally O'Connor, and Josh Silver, The Unavailability of Information on Insurance Unavailability: Insurance Redlining and the Absence of Geocoded Disclosure Data, Housing Policy Debate 12, no. 2, Fannie Mae Foundation, 2001.

improvements the agencies expect banks to undertake. Even in cases of merger approvals and passing CRA grades, balanced and comprehensive discussions in “expectations” sections could motivate enhanced lending, investing, and services by banks.

Bolster Federal Agency Antidiscrimination Reviews

- The CRA’s scrutiny of illegal and predatory lending practices should become more transparent and rigorous.
- Safety and soundness exams should be integrated with fair-lending reviews and CRA exams.
- Increase the frequency of Small Bank CRA Exams.
- The stretch-out of the Small Bank CRA exam cycle needs to be eliminated. Small banks should be examined as frequently as Large Banks.
- Extend the CRA to Cover Nonbank Institutions, Including credit unions, securities companies, mortgage companies, insurance firms, and investment banks. ■

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The CRA as a Means to Provide Public Goods

Lawrence B. Lindsey
The Lindsey Group

The Community Reinvestment Act (CRA) has proved to be a unique experiment in banking regulation. As the Federal Reserve Governor with responsibility for consumer regulation and community affairs oversight during much of the 1990s, I look back fondly on my experience, along with my good friend and then-Comptroller of the Currency Gene Ludwig, in working to design the current regulatory scheme of the act.

We and others designed those efforts to address the shortage of banking services in historically underserved communities in the 1990s. The problems then were real. Today, it is indisputable that access to banking services is far more widespread than it once was; that loans, particularly for real estate, have become far more abundant in underserved areas; and that awareness in the banking community of the need to serve the entire community has been enhanced. As such, the CRA reforms of the early 1990s should be viewed as a success.

However, conditions have changed since then, and the problems that preoccupied us a decade and a half ago have receded in importance. Therefore, a new look at the CRA is in order. To some extent, what has happened is reminiscent of the old curse, "beware of what you wish for, you might just get it." In some instances, too much credit poured into communities that once had too little, creating a whole new set of problems. It also goes without saying that conditions in the financial world have also changed.

One thing that has not changed is my view that the proper role for the CRA, as with other government activities, is to provide a clearly defined public good. A public good is one that is not provided by the marketplace because the costs to provide it exceed the benefits accruing to the provider. Public goods therefore are undersupplied because no one individual or organization believes it is worth it to invest the money in something from which they cannot reap the benefits.

The CRA addresses certain clearly defined public goods. These include access to banking services, provision of credit for real estate development in depressed areas, and (potentially) the provision of credit-related services such as consumer credit and home-buyer education. As is the case for all public goods, it is critical to identify why the private marketplace is unable to provide the good or service. Then, ideally, the rules and regulations should be crafted to address those particular problems.

Unfortunately, this "public goods" view of the CRA is not widely shared in the body politic, either among the CRA proponents and activists or among the act's opponents. Too often, the CRA is viewed and used as a vehicle for providing "private goods" that benefit particular groups or individuals. At times, this devolves into what I think of as the Willie Sutton view of the CRA. Sutton, you will recall, was asked why he robbed banks, to which he replied: "because that is where the money is."

The way the CRA is most commonly implemented only exacerbates this public goods problem. When a bank is seeking some regulatory favor, such as when it is applying for new branches or for a merger, the regulatory body approving the application focuses on its CRA ratings and overall CRA performance. Regulatory bodies by law must seek input from the affected communities. Well-organized community groups and elected officials know this and threaten to use this process to hamstring the bank's application. This is one of those facts that everyone knows but declines to discuss in polite company. At times, the process devolves into payments by the bank to community groups to do "community service." In return, the group either does not object or may even endorse the bank's application. It is all perfectly legal, I suppose, but it certainly does have the air of Willie Sutton about it.

This behavior is then viewed by many in the banking community and among those not typically disposed to government meddling in the economy as creating a "CRA tax." This group views the CRA as a cost of doing business, and the side payments and inefficient allocation of credit that may result as part of the price of doing something else the bank views as profitable. It is ironic that both those on the Left and the Right often view the

CRA the same way: as a means to extract resources from banks. Individuals may differ on whether the recipient is deserving, but it is hard to disagree that this kind of behavior is inefficient from a social or economic point of view. More important, the exchange does nothing to address the underlying issue of underprovided public goods. The resulting cynicism also can poison the well for truly constructive activities related to the CRA, of which there are many.

This emerging cynicism is evident in some of the calls for CRA expansion today. For example, it was suggested as recently as a year ago that the CRA be expanded to cover a whole new array of financial institutions, such as investment banks—back when we had investment banks. Similarly, in the name of leveling the playing field, people have called for including brokerage houses and other financial institutions. It is hard to make the intellectual leap from "serving an entire community," as commercial banks are required to do, to including an investment bank, brokerage, or hedge fund under the CRA umbrella. Frankly, this lack of compelling logic feeds the view that Willie Sutton is back in town.

Stepping away from the view of the CRA as a tax and spending program administered through the regulatory process will help determine whether the CRA can become a stable part of the American banking scene or whether it will remain a political lightning rod, drawing fire with the vagaries of the political process. This may be impossible to pull off. At the moment, CRA proponents are ascendant and groups that benefit from them will see no reason to compromise. But the ideological bent of the body politic will change again, and when it does, programs that pour money into groups like ACORN, which many find lacking in legitimacy, will become targets. Finding a stable rationale for the program is unpopular, but it will be the key to its viability.

In holding this view, I am caught between the views of most of the CRA community, which believes that the CRA is unambiguously good, and the views of CRA critics, who argue that it is unambiguously bad. It reminds me of when I was a professor at Harvard and was introduced on Boston's PBS station as an "educated conservative." I quietly wondered if they ever introduced people as educated liberals. But, this being Boston and Public Broadcasting, the show's host felt the need to explain to his listeners why they should waste their time on someone who didn't share their perspective. On the other hand, during the rewriting of the CRA regulations in the early 1990s, I was described in the American Banker as having been engaged in "politically correct theatrics." But it is in this centrist view where the "public goods" rationale for CRA lies.

The CRA as a Payment for Other Benefits Is Not a Public Goods Argument

One of the more sophisticated arguments for expanding CRA coverage to more institutions borrows heavily from the public goods position, but is nevertheless internally flawed. It is that these banks are about to receive a variety of other public good benefits and therefore should pay the price of taking on a "CRA obligation." Among the benefits supposedly being extended include access to the Federal Reserve's Discount Window (or similar lending facilities) and the possible extension of insurance protection such as deposit insurance.

Two points to be clear on: First, access should not be provided to the Discount Window for the private good benefit of the financial institution. The Discount Window and similar lending facilities do not exist to make the bank richer. They exist to provide a very important public good: temporary liquidity that prevents a financial problem from becoming systemic and thereby leading to a possibly more widespread financial meltdown. In fact, the Federal Reserve's Discount Window policy follows the 150-year-old advice of Walter Bagehot to "lend freely at a penalty rate." The purpose of the discount window policy is to, first, discourage banks from accessing the window; second, to provide the money if needed; and third, to structure the incentives so that banks repay their discount window loans as quickly as possible. This is hardly a private benefit and certainly not a justification for imposing another "obligation" on a financial institution.

The same can be said of deposit insurance. Before the advent of deposit insurance, the presumption was that the depositor was obliged to determine whether a bank was creditworthy. But here is a classic public goods problem. The cost of accurately ascertaining and then continuously monitoring the creditworthiness of a financial institution is prohibitive relative to the interest the depositor receives. The private market once solved this problem by having banks hold much greater reserves than they now do, thereby driving up the cost of borrowing and driving down the return to saving for the bank's customers. Even then, bank runs happened when investors and depositors suffered massive losses, followed by a loss of confidence (usually exacerbated by the public's inability to discern the bank's true condition and sometimes fanned by the bank's competitors). Again, if deposit insurance were a private-good benefit to the banks and not a public good, it is highly unlikely that Franklin Roosevelt would have proposed and Congress passed such insurance in the middle of the Depression. Deposit insurance is a public good.

The second major fallacy in using these public goods as justification for creating a CRA obligation is that public goods are provided in and of their own right and are never contingent on the provision of other public goods. Although some well-meaning people may reason that if an institution gets deposit insurance or access to the Discount Window it should also be covered by the CRA, the fact is there is no justification for such a position under the theory of public goods. What is therefore required is a description of what the CRA can do to address a public good problem in its own right, which justifies its existence, independent of other public policy issues.

CRA Public Good Number One: Access to the Payment System

There are three areas, I believe, where the CRA is entirely justified as a public good on its own merits. The first, and most important, is the need to provide payment services to the entire population. Today, these payment services take three forms: cash, checking, and electronic, more typically known as "plastic." The public good in question is the ability for the entire population to be linked in a fairly costless manner to these forms of payment.

The following illustrates why providing payment services is a public good. Consider the case of an employer or provider of public assistance, which supports the population on the income side. If an individual or a large class of individuals lacks access to the payment system, the position of the employer becomes awkward. Typically most employers pay employees by electronic transfer to their checking or other bank accounts. This is the cheapest and easiest means of payment for the employer. It also minimizes the chance of theft or embezzlement, and is by far the easiest way of complying with the various taxes that must be withheld from workers' paychecks and contributions for voluntary fringe benefits. Obviously, this requires that employees have a bank account. The widespread provision of banking services is thus a public good from which nearly every employer in the country benefits.

An employee, of course, may request a paper paycheck. That form of payment, however, is more costly both in time and in direct expense to both the employer and employee. Ultimately, however, the paycheck must either be deposited into a bank account or converted into cash. The former requires a bank. The latter requires some entity willing to cash the check. It is true that check cashing services have sprung up in the private sector to serve these individuals, but transaction costs are extremely high. It is not that these services are "gouging" their customers, but that their own transaction costs are quite high, particularly identity verification and the risks involved in recovering bad checks. This is clearly a high-cost and very inefficient substitute for standard banking services.

A similarly huge cost advantage exists in the case of payment for goods and services. Customers make purchases either using checks or electronic methods such as credit and debit cards, both of which require access to the banking system for settlement, or through cash. The latter technically does not need access to the banking system, but the widespread development of an ATM network has certainly shown the significant cost advantages and economies in cash balances that a banking system can provide. Firms also need access to banks for payment services, particularly for cash. Easy access to deposit windows at the end of the day or even access during the day for the proverbial roll of quarters greatly facilitates the conduct of commerce.

Given the benefits of banking services, their availability across a wide variety of neighborhoods and communities is also a public good. This was clearly brought home to me as a Fed Governor when I went on community tours and saw areas with large congregations of people but no banks. One place that sticks in my memory is Houston's Fifth Ward, a primarily African American community. Small businesses were few, and residents had to travel long distances to access banks. A major national banking institution opened a branch there, and within a year demand was so high that its only major problem was acquiring the land next door to add more drive-up teller windows.

The CRA requirements that retail banking institutions expand their services to the entire area they intend to serve is therefore quite legitimate in my view. This does not mean that the concentration of bank branches must be the same in every neighborhood or the same as it is in the center of town. The density of bank branches should still be subject to commercial considerations. Reasonable metrics for appropriate concentrations are easily calculated and the regulatory staffs at the Federal Reserve and the U.S. Comptroller's Office are capable of determining branch dispersion levels that meet minimum CRA criteria.

It is equally true that this requirement should not apply to financial institutions that do not provide retail access to the payment system. Nor does it follow under the theory of public goods that exemption from this CRA requirement means that we must find some other CRA requirement as a substitute. Remember, the provision of one public good does not depend on the provision of another. Just because Goldman Sachs provides no retail access to the payment system and is therefore not subject to a geographic test on the distribution of its nonexistent branches, it does not mean that CRA must invent some other "CRA tax" to impose on Goldman in the name of fairness. On the other hand, should Goldman decide to enter the retail banking business and provide branches to its clients in Scarsdale and Greenwich, then this aspect of the CRA should apply.

CRA Public Good Number Two: Real Estate Lending

Redlining is what garnered the CRA its greatest visibility—the demarcation of areas in which banks would not make loans. Interestingly, the practice of redlining did not start in the banking industry, but in government. During the 1950s and 1960s, New York was undergoing a dramatic transformation as people were moving to the suburbs in increasing numbers. City planners, notably Robert Moses, squared the city's budget commitments with the declining population and tax base by deciding to withdraw city services such as police protection from certain neighborhoods that were rapidly depopulating. Of course, the withdrawal of these services merely accelerated the decline of these neighborhoods.

In my five years as the Federal Reserve Governor responsible for the CRA, and in my capacity as chairman of the board of the Neighborhood Reinvestment Corporation (now known as NeighborWorks), I visited many inner-city neighborhoods and talked to a wide variety of their residents and community leaders. Clearly, the lack of access to banking services and lending was a concern, but rarely was it the primary concern. Invariably, the lack of some vital city service such as police or fire protection or decent schools was at the top of the list.

This experience demonstrated the public good nature of residential real estate. An individual could invest large sums of money in building a wonderful home in an otherwise depressed neighborhood and find that the investment was not reflected in the home's property value. As real estate agents are fond of saying when they sell homes: "Location, location, location."

However, the public good aspect of residential real estate also explains why banks and other financial institutions might choose not to make mortgage loans in a given neighborhood. If an individual is about to invest money in a building and there is little reason to expect that the investment will produce a commensurate rise in the value of the property, it would be a violation of the bank's fiduciary responsibility to its depositors to offer a loan to that individual. The collateral behind the loan would simply not justify the transaction.

Of course, this is where the problem of public goods becomes sticky. If it is not prudent for any financial institution to make a loan to an individual who is willing to invest in a property in a neighborhood, then money will not flow into the neighborhood. If money does not flow into that neighborhood, then no improvements will be made. If no improvements are made, then the condition of the neighborhood will never improve. A vicious circle develops.

The CRA provides one avenue for breaking this vicious circle, and with that a second public good justification for the act. The logic begins with a theoretical proposition. If it were possible for all banks servicing a metropolitan area to collectively guarantee that they would each make a given amount of loans to a depressed community, then at least the public good problem of arranging finance would be removed. Borrowers, lenders, and investors would not have to fear that their properties would face valuation problems because surrounding properties could not get the credit needed to make similar improvements.

The set of CRA regulations we developed in the 1990s builds on this theoretical foundation. Banks were required to geocode their loans by census tract; that is they identified where exactly they were lending. This lending metric was then measured in the context of the income distribution of the metropolitan area's census tracts, and banks' lending performance from a CRA context was based on that evaluation. In effect, the CRA established a set of geographically based soft quotas for banks to meet under the Lending Test.

No system is perfect, but this approach seemed optimal among the various constraints under which the CRA operates. First, it provided the framework to offer assurance of access to funds in underserved areas. Second, it allowed individual institutions to select which loans they wanted to make and even which underserved census tracts they wished to target, subject to an overall minimum threshold. Third, it emphasized measurable performance and not the subjective criteria of protests and public comment, which experience had taught were easily gamed.

As such programs go, the CRA regulations were indisputably successful. The question now being debated is whether the program was "too much of a good thing" and bears some responsibility for the so-called "subprime crisis" the country has been experiencing. There are undoubtedly some legitimate criticisms of CRA regulations in this regard, but responsibility for the credit cycle is much wider and includes the behavior of borrowers and lenders, regulatory breakdown, and political machinations of both parties.

The widespread finger pointing underway recalls the old lesson children are taught that when you point a finger at someone else you are simultaneously pointing three back at yourself. So, as someone who played a role in writing these regulations, let me take a look at those three fingers and consider some of the potential flaws in program design.

First, like all soft quotas, the CRA program was designed to meet the needs of the period in which the rules were written. But, by definition, the success of the program made those criteria somewhat outdated. In the early 1990s, the credit needs of these communities were horrifically unmet. Clearly, creditworthy (and profitable) individuals could be found, particularly given that the public good problem of lending in distressed areas was being addressed. These creditworthy borrowers got loans. As time went on, however, the requirements for the number of loans made did not change. In fact, it would be a real CRA black eye for a bank to reduce the number of loans it was making in a particular area. However, given that the most creditworthy borrowers had already received loans, a somewhat less creditworthy group had to take their place. As time went on, lending standards had to be relaxed to avoid any "backsliding" on an institution's CRA obligations. In this way, the CRA did contribute to a downgrading of credit standards.

Second, the Investment Test under the CRA and the related deals the Justice Department struck with Fannie Mae and Freddie Mac during the 1990s created a natural market for securitizing these loans. Of course, securitization was occurring in its own right on a wide scale, but most securitization involved fixed lending criteria established by the government sponsored enterprises (GSEs). Given the problems discussed in point one above, an enormous market opened for securities of nonconforming loans, which involved some CRA credit that fell short of the Investment Test. This was a good thing in that it allowed credit to flow to underserved areas in far greater quantities than before, but the securitization of nonconforming loans involved a much greater risk, with far more pernicious consequences, than the securitization of conforming loans. By definition, nonconforming loans are more idiosyncratic, harder to monitor and model, and generally more geographically or socioeconomically concentrated than conforming loans. The CRA did not recognize this risk, and in fact gave a reason to ignore the risks inherent in the process. In this way, the CRA and the related Justice Department arrangements with the GSEs exacerbated the securitization problems in the subprime crisis.

Third, the very fact of "opening the flood gates" on credit exacerbated a normal problem in credit cycles which tends to mask risk, and thereby leads to greater excesses in the cycle. The CRA itself was part of this, but hardly the major element. Rather, it was the changing of the rules of the game that caused an abrupt shift. The story is as old as credit cycles. When credit suddenly becomes more available in any market, demand rises for the assets being financed. The very fact of rising prices leads to a lower rate of defaults and loan losses given that the rise in asset prices allows troubled borrowers to dispose of the asset and repay the loan easily. The lending community tends to view this as a reduction in risk and therefore lends more, pushing asset prices up further, defaults down, and thereby leading to even more easing of credit terms and more excesses. When the cycle ends and prices start to fall, the fundamental riskiness of lending in this market not only returns but is magnified.

This latter observation is also a comment in general on the development and crash of the latest housing bubble. That bubble began to develop in the mid-1990s and took on steam, as all bubbles do, as the rising prices increased demand and still more credit. The CRA is not the cause of this phenomenon; the cycle has been well documented since at least the time of the South Sea Bubble in the 1600s. All bubbles are built on the fundamentals of human nature. Therefore, I am not saying the CRA caused the subprime crisis. But, it would be equally wrong to deny that the CRA played no part of that process.

Nor does it follow that the flaws in CRA design mean that the policy is a bad one. The world does not provide us with pristine policy options, only tradeoffs. Just as it was probably logical from a macroeconomic viewpoint to allow for the general expansion of credit in the 1990s and 2000s, so too was it logical to have a CRA program. Those who point fingers at particular entities and accuse them of being the "culprits" behind the crisis are wide of the mark.

On balance, there are two logical lessons from this experience. First, the Investment Test provides the wrong incentives for CRA lending; it is not truly meeting an obvious public goods market failure. Nonconforming loans require closer monitoring, and therefore securitizing them causes a greater breakdown than securitizing conforming loans. It follows that the wholesale expansion of the CRA to other financial institutions, creating an Investment Test obligation for them, will prove counterproductive.

Second, designers of the next set of CRA regulations must tackle a problem that has bedeviled the CRA from its inception. Does the CRA require banks to make loans that are less creditworthy than those the financial institution is making elsewhere? The experience of the last bubble indicates yes, although that was neither the intent nor the rhetoric of those who implemented the current CRA. Answering this question with a definitive NO in the next round of CRA reform would certainly dispel the idea that the CRA is a "tax" or worse. On the other hand, it strikes me as highly unlikely that the bulk of those pushing for CRA expansion would choose to definitively answer this question in the negative.

CRA Public Good Number Three: Consumer Education

The current financial meltdown includes individual stories of such debt and shockingly bad decisions that one has to wonder, "What were they thinking?" In some cases, the fault clearly lies with financial services providers who were deceptive or possibly even fraudulent. More commonly, lenders complied with the letter of the law, but competition for customers created ever more lenient credit terms. There is a legitimate debate about the proper roles of caveat emptor and caveat vendor, but the legal distinction here is not a public good question, given that it is a matter of placing the private burden of caution between borrower and lender.

What is a matter of public good is that borrowers sufficiently understand the role of finance in their lives such that they can make reasonably informed decisions. Increasing such knowledge not only lowers the likelihood of a taxpayer-funded bailouts, but it also lowers the cost of providing credit generally given that overall losses should be lower.

Public schools have begun to take on this challenge, and they are a natural way to provide such a public good. The curriculum is well intended, but from personal experience, teachers need more training themselves. My son had to do a monthly budget, a good learning experience. The budget included buying transportation, and the students were allowed to finance a car for 36 months. My son used an online monthly payment calculator that different car dealers offer. The teacher marked his budget wrong because apparently her notion of finance was to take the cost of the car and divide by 36! When I wrote in and pointed out that we have such a thing as interest in this world, she relented, apparently having learned something for the first time.

The notion that banks should meet the credit needs of their entire community might certainly include teaching basic financial literacy, since apparently the entire community (or vast portions of it) appears to lack it. Here the nonprescriptive nature of CRA might well be an advantage given that what is clearly needed is some creativity in how to provide consumer education. Some institutions use classes, others, particularly in bygone days, ran weekly savings programs in the schools. But if CRA regulators are looking for an alternative to the lending tests and branching tests described above, certainly funding of consumer education programs would warrant consideration.

Conclusion

The financial crisis the nation now finds itself in offers a natural opportunity to reconsider how the Community Reinvestment Act should be structured. But it is also a time when the central objectives of the financial regulatory community should be focused on other issues, notably capital adequacy and underlying safety and soundness. Although the political setting offers an opportunity for expanding the CRA, the economic setting will likely push the CRA to a back seat.

That is why it is critical that the CRA adopt a public goods stance and distance itself from a reputation of extracting commitments from banks. Once it is clear that the duty of the bank is to benefit the entire community, and not special pieces of it when community leverage is greatest, more people will support a sustainable CRA approach and compliance will be much easier. That should be the focus of the Congress in the next few years as it considers changes to the Community Reinvestment Act. ■

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Putting Race Explicitly into the CRA

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The Community Reinvestment Act (CRA) was designed to correct market failures thirty years ago. The reimagining of CRA must address the remnants of twentieth-century market and government failures with twenty-first century solutions. Financial institutions and regulators must revisit the intent of the CRA, which states that regulators are "to assess an institution's record of meeting the credit needs of its *entire community* [emphasis added], including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution."[1] I proffer that the entire community includes racial and ethnic minorities, and the CRA should be expanded to address directly these underserved parts of the community.

Federal Reserve Chairman Ben Bernanke, in his remarks at the Community Affairs Research Conference, identified racial discrimination as the first of several social and economic factors that led to the enactment of the CRA. Chairman Bernanke stated that "the CRA itself focused on the provision of credit to low- and moderate-income communities rather than on discrimination by race, sex or other personal characteristics. Legislation that addressed discrimination in lending explicitly included the Equal Credit Opportunity Act (ECOA)[2] and the Fair Housing Act."[3] Bernanke stated that the purpose of the CRA was to "rectify market failures."[4] While the market failures of the 1970s involved access to credit in low-income areas, the market failures of the twenty-first century fall along race lines. The new CRA should address the governmental and market failures associated with racial discrimination and racial market segmentation.

The ECOA and the Fair Housing Act were designed to address individual acts of discrimination, and while both include provisions to address disparate impact and systemic discrimination, they have failed to adequately address the market failures that perpetrate and perpetuate racial market segmentation and racial discrimination. This is best achieved by explicitly including race in the CRA, a change that would not require any new or enhanced legislative authority. In fact, §3608(d) of the Fair Housing Act states: "All executive departments and agencies shall administer their programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) in a manner affirmatively to further the purposes of this subchapter and shall cooperate with the Secretary to further such purposes."

Current market failures explain why upper-income African Americans in my hometown of Durham, North Carolina, are four times more likely to have a higher-cost loan than whites with similar incomes.[5] Market failures explain the fact that whites represent 55 percent of the population in poverty but only 30 percent of the people living in neighborhoods of concentrated poverty, while three out of four poor African Americans and Latinos live in these neighborhoods. Market failures explain why one in ten African Americans live in neighborhoods of concentrated poverty compared to one in 100 whites.[6] Market failures explain why rural and urban communities share histories of disinvestment and spatial isolation and yet experience poverty differently. Any revisions to the CRA must address these failures directly and require financial markets to adopt corrective measures.

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1 *12 U.S.C. 2901.*

2 *15 U.S.C. 1691 et seq.*

3 *42 U.S.C. 3601 et seq.*

4 *Ben S. Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges,"The Community Affairs Reserch Conference, Federal Reserve Board, Washington, DC, 2007.*

5 *National Community Reinvestment Coalition, "Income Is No Shield Against Racial Differences in Lending II: A Comparison of High-Cost Lending in America's Metropolitan and Rural Areas," Washington, DC, 2008.*

6 *Jason Reece, "Will you be my neighbor? Housing and neighborhood diversity in the US," lecture, February 19, 2008, Kirwan Institute, Ohio State University; and Reece, "Race, Class, and Opportunity: Understanding the Convergence and Divergence of Race and Class in the US.," lecture, January 16, 2008, Kirwan Institute. Both at http://www.kirwaninstitute.org/publicationspresentations/presentations/2008.php.*

Throughout American history there have been government failures that have explicitly restricted access and opportunity for racial and ethnic minorities. In particular, the Home Owners Loan Corporation (HOLC) and the Federal Housing Administration (FHA) established public policies that contributed to racial market segmentation and racial segregation.

HOLC institutionalized redlining through its rating system developed allegedly to identify risk associated with making loans.[7] HOLC established four categories of neighborhood quality with the lowest category reserved for African American neighborhoods and color-coded red. The HOLC gave the highest rating to neighborhoods that were "new, homogenous, and in demand in good times and bad" and specified that these neighborhoods were to be occupied by "American business and professional men." Although HOLC did not invent this system, it did place the full faith and credit of the United States behind the practice.

For decades, the FHA adopted HOLC ratings and the policies and practices that denied access to affordable mortgage products to African American borrowers. The FHA *Underwriting Manual* (1939) was crafted by Frederick Babcock, who wrote in his influential textbook *The Valuation of Real Estate (1932)* that "most of the variations and differences between people are slight and value declines are, as a result, gradual. But there is one difference in people, namely race, which can result in a very rapid decline. Usually such declines can be partially avoided by segregation and this device has always been in common usage in the South where white and negro populations have been separated."[8] Babcock believed that "among the traits and characteristics of people which influence land values, racial heritage and tendencies seem to be of paramount importance. The aspirations, energies, and abilities of various groups in the composition of the population will determine the extent to which they develop the potential value of the land."[9]

If only Babcock's influence had ended with the FHA. Unfortunately, he is considered a seminal figure in the academic and practical application of real estate appraisal practices.[10] While African American veterans returning from World War II benefited from the educational benefits associated with the GI Bill and established the foundation of today's African American middle class, Babcock's influence denied them access to VA loan programs established under the Serviceman's Readjustment Act of 1944.[11]

The FHA and VA loan programs made homeownership more than just a dream for the majority of Americans. Between 1934 and 1969, the home-ownership rate increased from 44 percent to 63 percent.[12] During this same period, less than one percent of all African Americans were able to obtain a mortgage.[13] During this period, the opportunity to create transgenerational wealth through homeownership was denied to minority households. As a result, white non-Hispanic households currently have a median net worth of $79,400, including home equity, compared to $7,500 for African American households.[14]

Thus, government failures encouraged and contributed to the racial wealth divide and the negative consequences it has had on my neighbors and my neighborhood. These decisions have benefited the majority at the expense of my community. This structural racism is a part of our national subconscious. Men like Babcock laid a foundation constructed on racial animus that has permeated our markets in ways that are as deadly and invisible as carbon monoxide.

Sadly, as we face the current mortgage credit crisis, we are repeating history through the adoption of "declining market" policies, the redefinition of credit risk in ways that continue the racial segmentation of our credit markets, and the assumption that the crisis was caused by providing access to credit to minority communities.

The explicit inclusion of race in the CRA offers us an opportunity to correct these government and market

7 K. T. Jackson, *Crabgrass Frontier: The Suburbanization of the United States* (New York: Oxford University Press, 1985).

8 Frederick Babcock, *The Valuation of Real Estate* (New York: McGraw-Hill, 1932), 91.

9 Ibid., 86.

10 N. Miller and S. Markosyan, "The Academic Roots and Evolution of Real Estate Appraisal," *Appraisal Journal*, 71(2) (2003): 172–84.

11 38 U.S.C. §§ 3451.

12 D. S. Massey, "Origins of Economic Disparities: The Historical Role of Housing Segregation," in *Segregation: The Rising Costs for America*, ed. J. H. Carr and N. K. Kutty (New York: Routledge, 2008), 39–80.

13 Reece, lectures at Kirwan Institute, 2008 (see note 6).

14 G. W. Domhoff, "Power in America: Wealth, Income, and Power,"from Who Rules America? Available at http://sociology.ucsc.edu/whorulesamerica/power/wealth.html.

failures, and would allow us to do more than just reduce the concentration of poverty and spatial isolation in neighborhoods of color. It would allow us to create opportunities for building real transgenerational wealth for minority families while protecting our nation's competitiveness in the global economy.

We have become painfully aware over the past few months that we live in a global society and the decisions we make have external costs and benefits far beyond our shores. If the United States is to remain globally competitive as we transition from the industrial to the information age, we cannot afford to leave communities of color behind. We must adopt strategies that will enable these communities to compete in the global marketplace by providing them with access to the capital they need for wealth creation and wealth retention in this new environment. Through a reimagining of the CRA, this can be accomplished through the support of both short-term and long-term strategies and market-based solutions.

Policy Proposals

The CRA should explicitly reward financial institutions that aggressively engage in investments in minority wealth creation and minority neighborhood development.

Doing so would provide opportunities for all members of the community, and would begin to close the racial wealth divide that was created by twentieth-century government and market failures. We can close the divide by investing in programs that promote wealth creation, educational attainment, and sustained employment for minorities. Examples of these kinds of investments that promote wealth creation include: affordable homeownership programs; scholarships for higher education; work-study matching funds; paid internships for students attending historically black colleges and universities; and jobs that provide a living wage.

In addition to supporting minority wealth creation, this new twenty-first century market must support and empower minority neighborhoods with investments in neighborhood-based initiatives. Examples of these kinds of investments include: support for neighborhood redevelopment; the creation of neighborhood anchors such as major retail and grocery stores; financing housing and infrastructure; brownfield and vacant-property development; and support for minority small businesses with technical assistance, affordable loans, and equity investments.

Through the CRA, we can promote public/private partnerships that encourage integrated and inclusive communities. These partnerships will develop initiatives that provide technical and public assistance in the design, packaging, and financing of neighborhood-based projects. These partnerships will promote employment opportunities for local residents and provide subcontracting opportunities for local minority and other community-based firms. The CRA can also be used to measure the extent to which banks do business with minority vendors, contractors, and professionals.

Explicitly including race in the CRA allows us to determine when, where, and how to effectively structure market interventions to correct past market failures. It allows us to develop strategies that challenge racial, social, and economic stratification by including a commitment to develop robust markets in minority communities. We must use the CRA and other public policy tools to correct market failures that support racial market segmentation and to create sustainable markets that are not dependent on the rationing of credit based on the observationally distinguishable characteristic of race. ■

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Community Reinvestment Emerging from the Housing Crisis

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

The Community Reinvestment Act

The CRA encourages federally insured banks and thrifts to meet the credit needs of the communities they serve, including LMI areas, consistent with safe and sound banking practices. Federal banking agencies periodically examine and rate the CRA performance of banks. Regulators consider a bank's CRA record in determining whether to approve its application for mergers with, or acquisitions of, other depository institutions. Banks and thrifts must have a Satisfactory CRA record if they or their holding companies are to engage in newly authorized financial activities, such as certain insurance and securities functions.

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

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

The CRA Reasonably Addresses Market Failures in Low-Income Communities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

These problems indicate that the CRA has not yet

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

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

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

16 *Ibid.*

17 *Ibid.*

18 *Ibid at 76–77.*

19 *Ibid at 2.*

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

21 *Ibid at 371–72.*

22 *Ibid at 375, tbl.1.*

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

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

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

The CRA Performance Context Should Include Affiliates of Banks and Thrifts

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

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

In principle, the Office of the Comptroller of the Currency (OCC) considers a bank's subsidiaries' assets in determining the performance context in which it operates.[29] Similarly, the assets and activities of all of the affiliates of a bank should also be considered in assessing the performance context within which a bank meets its obligations under the CRA. After all, a bank's affiliates are hardly irrelevant to the bank's business decisions, including how to meet the credit needs of their communities.

The Gramm-Leach-Bliley Act made a financial holding company's commencement of newly authorized activities, or its merger with newly authorized entities, contingent on Satisfactory CRA performance by all of its affiliate banks

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

26 *12 C.F.R. § 25.28(c) (2004).*

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

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

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

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

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

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

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

The CRA Service Test Should Focus on Innovative Products and Services

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

37 *Gramlich, "Booms and Busts."*

A Principle-Based Redesign of HMDA and CRA Data

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Community groups rely on the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA) databases to engage in advocacy. Those databases, however, have not kept up with recent financial innovations, particularly in subprime mortgage lending, and need to be reformed.

The authors of the Community Reinvestment Act of 1977 emphasized regulation through standards. It was a "hands-off" approach: on the one hand, banks could decide for themselves how most efficiently to design plans for fulfilling their local lending obligations, but, on the other, citizens had a right to know if depository institutions were fulfilling the housing needs of their communities.[1]

Armed with data from the HMDA and the CRA databases, users (consumer advocates, regulators, state attorneys general, municipalities, and reporters) have been active as monitors or advocates.[2] These same groups now find their reach limited by the mismatch between existing data and new financial products.[3]

The challenge facing policymakers is to adopt a principle-driven data standard that meets users' needs. Such a redesign should be relevant, universal, and substantive. *Relevant*, in an era after subprime innovation, means updating the data to account for new permutations in lending. *Universal* means that there are accepted definitions for data variables, both in the scope of their coverage and in how those numbers are calculated, so that all financial institutions report in the same way. *Substantive* means that it helps users to monitor lenders in fulfilling the requirements of the CRA. Substantive data contribute to answering questions about the fulfillment of credit across geographies, across income levels, and with respect to the race and ethnicity of borrowers.

These principles hew to the original legislative intent of the CRA. Policymakers should ask if data, as they are collected and distributed, currently serve that purpose. This is the appropriate lens for evaluating how well implementation of the CRA lives up to the intent of the law.

Data Shape the Dialogue

As one commenter put it, "We have learned from 30 years of CRA policy that what is measured gets done."[4] The fact that policy discussions have focused mainly on home mortgages reflects well on the HMDA data relative to the CRA data.

In a standards-based system, data are vital to enforcement. Most alternatives to the existing standards system would rely less on public access to data. Numerical targets, established through negotiation between banks and regulators, would not require public participation.[5] A cap-and-trade system, where banks could choose between making loans or buying credits, would also skirt input, particularly in communities where lending to low-income communities was deemed relatively less efficient.[6] A system of direct subsidies for community

1 12 U.S.C 2801 et seq., 89 Stat. 1125, Pub. L. 94-200 (1975).

2 Allen J. Fishbein, "The Ongoing Experiment with 'Regulation from Below': Expanded Reporting Requirements for the HMDA and CRA," Housing Policy Debate 3(2) (2003): 601–36. See also: Allen J. Fishbein, "The Community Reinvestment Act after Fifteen Years: It Works, But Strengthened Federal Enforcement Is Needed," Fordham Urban Law Journal 20 (1992): 293–310; Malcolm Bush and Daniel Immergluck, "Research, Advocacy, and Community Investment," in Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, ed. Gregory D. Squires (Philadelphia: Temple University Press, 2003), 154–68.

3 Richard Neiman, Testimony on behalf of the New York State Banking Department, Committee on Banks, Subprime Mortgages and Foreclosures in New York. New York State Senate, December 13, 2007.

4 Ellen Seidman, New America Foundation. Testimony before the Committee on Financial Services, U.S. House of Representatives, 2008, available at http://www.newamerica.net/files/CRA%20Testimony%202-13-08.pdf.

5 Peter Swire, "Safe Harbors and a Proposal to Improve the Community Reinvestment Act," 79 Virginia law Review 349.

6 Michael Klausner, "Letting Banks Trade CRA Obligations Would Offer Market-Based Efficiencies," American Banker, January 21, 1994, 26.

development and mortgage lending, paid for by general tax revenues, would shift the debate to government budget committees.[7]

The conversation surrounding the accommodation made by financial institutions to their communities has followed the evolution of the content of these databases. The original HMDA-based analyses were characterized as "redlining studies" that focused on the aggregate flows of capital into neighborhoods.[8] They focused on access to capital and less so on the terms of credit.[9] For example, analysts related lending volume in census tracts to the share of housing units in those tracts. When critics found fault with those studies, they pointed out that missing variables that were significant in underwriting might explain gaps in credit allocation: credit risk, demand for mortgage loans, and measures of equity.[10]

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) amended the rules to reveal more demographic information about borrowers. The act moved the focus away from redlining of whole communities and toward discrimination against individual borrowers. The Federal Financial Institutions Examination Council (FFIEC) amended the structure of the HMDA database to provide loan-level data, including recordkeeping for credit denials. Congress sought to link lending to LMI and minority borrowers, both on the individual and community level, as a *quid pro quo* for bailing out the failed savings and loan industry. FIRREA established authority for HMDA reporting to monitor lending in low-income and minority communities.[11]

The new data structure established a "golden age of the CRA."[12] The interplay of new variables (race, income, loan decisions) within loan-level data allowed analyses that until then had been set aside.[13] Community groups were emboldened to pursue their goal of "regulation from below." They could back up their assertions about neglect in low-income neighborhoods with relevant data. Studies identified that demand did exist for loans, but that credit was often denied.[14] Observers noted that community groups simultaneously "grew up, focusing less on confrontation and more on tangible results."[15] More than 300 "lending agreements" were signed.[16] Meetings, coinciding with the release of new data, focused on monitoring the extension of credit.[17]

Data remained relevant, and thus valuable, through the 1990s. After the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, mergers led to a set of very large banks. Community groups and large cities, as well as some media, used HMDA and CRA data to influence the approval process.[18] Banks responded proactively to the new environment. Many created community development departments to guarantee investment across their local communities.[19]

Although a change in 2005 offered interest-rate data on higher-cost mortgage loans, the value of HMDA and CRA data are now challenged; first, by the availability of

7 *Jeffrey Lacker, "Neighborhoods and Banking," Economic Quarterly 81(2) (1995): 13–38.*

8 *Kavous Ardalan, "Community Reinvestment Act: Review of Empirical Evidence," Academy of Banking Studies Journal 5(1) (2006): 25-42.*

9 *Ibid.*

10 *Mark Sniderman, "Issues in CRA Reform," Economic Commentary, Federal Reserve Bank of Cleveland, March 1, 1994, available at http://www.clevelandfed.org/Research/commentary/1994/0301.pdf.*

11 *Patricia A. McCoy, "The Home Mortgage Disclosure Act: A Synopsis and Recent Legislative History," Journal of Real Estate Research 29(4) (2007): 391–98.*

12 *Fishbein, "The Ongoing Experiment with 'Regulation from Below,'"601–36.*

13 *McCoy, "The Home Mortgage Disclosure Act," 391–98.*

14 *Alicia H. Munnell, Geoffrey M. B. Tootell, Lynn E. Browne, and James McEneaney, "Mortgage Lending in Boston: Interpreting the HMDA Data," American Economic Review. Working Paper 92-7 (1996), Federal Reserve Bank of Boston.*

15 *Gregory D. Squires, "Introduction: The Rough Road to Reinvestment," in Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, ed. Gregory D. Squires (Philadelphia: Temple University Press, 2003), 1–26.*

16 *Raphael Bostic and Breck Robinson, "Do CRA Agreements Influence Lending Patterns?" Real Estate Economics 31(1) (2003): 23–51.*

17 *Alan Schwartz, "From Confrontation to Collaboration? Banks, Community Groups, and the Implementation of Community Reinvestment Agreements," Housing Policy Debate 9(3) (1998): 631–62.*

18 *Ibid. See also: B. Dedman, "The Color of Money," Atlanta Journal-Constitution, May 1988, 1–4.*

19 *Ben Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges," Speech given at the Community Affairs Research Conference, Washington, DC, March 30, 2007.*

better products from private vendors; and second, by a sense that the data are less relevant.[20] HMDA does not capture many characteristics of subprime loans, a set of products that has substantially increased in volume,[21] particularly within underserved markets.[22] In 2007, for example, the leading provider, by loan amount, of non-high-cost mortgage loans to LMI borrowers was Countrywide Financial.[23] The data present a false positive. Users know that the lender issued more than $96 billion in adjustable-rate mortgages in the same year, but they have no alternative data source to describe more fully the impact on communities.[24]

Subprime lending is not about "access to credit" as much as it is about terms of credit. Subprime loans have increased opportunities for homeownership among low-income borrowers. Still, these loans concern policymakers because of "troubling reports of abusive and unscrupulous credit practices, predatory lending practices, which can strip homeowners of the equity in their homes and ultimately even result in foreclosure."[25]

The data's demise occurs at a time when community groups and the regulation of the larger mortgage market are troubled. Lending agreements are now infrequent. Anecdotal evidence suggests that credit needs are still going unmet by banks and thrifts. In low-income neighborhoods, a different set of fringe lenders (payday lenders, pawnshops, check cashers) often supply the bulk of financial services. Some assert that the CRA cannot function without more room for community groups to participate.[26]

The divergence of HMDA and CRA data from the innovation in the marketplace at a time of disruption in normal lending suggests that policymakers should examine how to modernize the data sets.

Countering the Critics

Data collection is itself the subject of much controversy within the dialogue surrounding the implementation of the Community Reinvestment Act. Critics of HMDA and the CRA contend that the costs of collecting and reporting data, when underwriting and credit scoring already identify opportunities in low-income geographies, is inefficient, expensive, and especially onerous to small banks.[27]

To be sure, tangible costs are associated with geocoding loans, hiring compliance officers, and doing paperwork. Still, a 1999 study estimated that a large bank would spend only about 600 hours of staff time per year to fulfill the rules.[28] The burden of reporting is easily relieved by data products already available in the marketplace. Private vendors have created data systems to aid financial institutions with reporting.

Some financial institutions have argued that distribution of HMDA and CRA data forces them to compromise the privacy of their clients.[29] There is some truth to this. The data sets do contain explicit information that reveals quite a lot when appended with other data sets. But

20 *Richard Neiman, Testimony on behalf of the New York State Banking Department, Committee on Banks, Subprime Mortgages and Foreclosures in New York, New York State Senate, December 13, 2007.*

21 *Michael Staten, "The New HMDA Pricing Data: What Can It Tell Us about Pricing Fairness?" Testimony before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, June 13, 2006.*

22 *Richard Williams, Reynold Nesiba, and Eileen Diaz-McConnell, "The Changing Face of Inequality in Home Mortgage Lending," Social Problems 52(2) (2005):181–208.*

23 *Federal Financial Institutions Examination Council, Home Mortgage Disclosure Act Database.*

24 *Countrywide Financial Corporation, SEC Form 10-K for year ended December 31, 2007, 65.*

25 *Remarks by Governor Edward M. Gramlich at the Community Affairs Research Conference of the Federal Reserve System, Washington, DC, April 5, 2001.*

26 *Raphael W. Bostic and Breck L. Robinson, "Do CRA Agreements Influence Lending Patterns?" Real Estate Economics 31(1) 23–51.*

27 *Jonathan Macey and Geoffrey Miller, The Community Reinvestment Act: An Economic Analysis, 79 Virginia Law Review 291 (1993). See also: Olaf de Senerpont Domis, "Truth-in-Lending, CRA Makes '10 Worst Rules' List," American Banker, January 31, 1995, 3; George Bentson, "It's Time to Repeal the Community Reinvestment Act," Cato Institute, Washington, DC, 1999, available at http://www.cato.org/pub_display.php?pub_id=4976; and General Accountability Office, "Race and Gender Are Limited for Non-Mortgage Lending," GAO-08-698, June 2008, available at http://www.gao.gov/new.items/d08698.pdf.*

28 *OMB Review, 64 Fed. Reg. 29,083, 29,084, 29,086 (Treasury Department, May 28, 1999).*

29 *William Apgar and Mark Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges," Paper presented at the conference Policies to Promote Affordable Housing, co-sponsored by the Federal Reserve Bank of New York and New York University, February 2002.*

these cries ring false in the greater context of "business as usual" practices. If banks were sincere in their desire to safeguard the financial information of their customers, they would not sell data to third parties. In 1999, privacy groups estimated that most Americans appeared in between 25 and 100 databases.[30] Financial institutions share and sell information to marketing groups or to third parties.

HMDA is a limited data set for groups without financial resources to pay for better information. A set of data providers (Loan Performance, First American CoreLogic, FiServ, Fitch Ratings, Case-Shiller, McDash Analytics) buy loan-level home mortgage data and then repackage the data for consumption by other lenders, analysts, and academics. Some nonprofit groups buy this information, but for the most part, it is too expensive for them.

Changes in Mortgage Lending Support Changes in HMDA Data Reporting

While many important questions can be asked about HMDA, more than a few observers point out that important criteria in underwriting are largely ignored by the HMDA data. A chorus of voices regularly attempts to characterize any claims generated from HMDA data as dubious. One senior vice president of a West Coast bank put it this way in a letter replying to a request for HMDA data: "Please also consider that the HMDA results tell only part of the story, since certain risk and other loan factors that affect pricing are not included."[31] The FFIEC concurs, observing that HMDA data lack information in important areas: credit history, debt-to-income ratio, and loan-to-value ratio.[32]

To shore up relevancy, some assumptions that drive the CRA need to be updated. Notions about underwriting were derived prior to credit scoring.[33] Internet and telephone applications, which are often taken through mortgage brokers, have weakened the link between branch banking and mortgage lending.[34] Only a small minority of loans are originated by covered lenders in their assessment areas.[35]

"Regulation from below" will be enhanced by new data that can track new features in lending, including characteristics of subprime loans. Table 1 lists new variables, or modifications to existing variables, that would match HMDA data to modern financial products.

The variables in Table 1 can help users in a variety of ways. Some will make the HMDA data sensitive to loan products with subprime characteristics. Some will help users test the safety and soundness of underwriting by identifying loans where borrowers will be challenged to make their payments. Some, like age, would help to monitor extension of credit to prohibited bases protected by the Equal Credit Opportunity Act.[36] Others, if used as independent variables (property type, owner occupancy), will reduce unexplained variations in loan pricing or access to credit. Data on down payments would fulfill a critique first recognized in 1961 by the U.S. Commission on Civil Rights.[37]

Those improvements would be aided by a complementary effort to ensure that current data reporting rules are observed. The second most frequent racial identity in 2001 was "information not provided."[38] Loan-denial data remain voluntary.

30 *Andrew Shapiro, "Privacy for Sale: Peddling Data on the Internet," Human Rights 26 (1999): 10.*

31 *Letter to the author. Lynn Greenwood, senior vice president, Home and Consumer Finance Group, Wells Fargo, July 30, 2008.*

32 *Federal Financial Institutions Examination Council, Press Release, September 11, 2008. At http://www.ffiec.gov/hmcrpr/hm091108.htm.*

33 *Hollis Fishelson-Holstine, "Credit Scoring's Role in Increasing Homeownership for Underserved Populations," in Building Assets, Building Credit, ed. Nicole Paul Retsinas and Eric S. Belsky (Washington, DC: Brookings Institution Press, 2005), 173–202. See also: R. E. Litan, N. P. Retsinas, E. S. Belsky, G. Fauth, M. Kennedy, and P. Leonard, "The Community Reinvestment Act After Financial Modernization: A Final Report," U.S. Department of the Treasury, 2001.*

34 *Joint Center for Housing Studies, "The Community Reinvestment Act: Access to Capital in an Evolving Financial Services System." Report prepared for the Ford Foundation, March 2002. From a pdf viewed at http://www.jchs.harvard.edu/publications/governmentprograms/cra02-1.pdf.*

35 *Ibid.*

36 *15 U.S.C. 1691; Regulation B, 12 CFR 202, section 202.2(z).*

37 *1961 U.S. Commission on Civil Rights Report (Washington, DC: United States Commission on Civil Rights, 1961).*

38 *E. K. Wyly and S. R. Holloway, "Invisible Cities: Geography and the Disappearance of Race from Mortgage Lending Data in the USA," Social and Cultural Geography 3(3) (2002): 247–82.*

Table 1: Some Substantive Improvements to the HMDA database

Variable	Outcomes	Relevant?	Uniform?
LOAN			
Loan-to-value	Loan amount to loan appraisal	Cash-out	Yes
Debt-to-income	Annual PITI (post-reset)/annual income	Ability to repay	Yes
Down payment	Money down (percent of price or loan amount)	Underwriting	Yes
Reset	Identify year of reset, or specify “fixed”	Clarity	Yes
Loan term	Less than 20, less than 30, or more than 30 years	Clarity	Yes
Loan purpose	Expand to include HELOCs and reverse mortgages	Predatory	Yes
Owner occupancy	Expand to include second home (non-investor)	Transparency	Maybe
Principal repayment	Negative amortization, interest-only, and/or balloon	Subprime	Yes
Escrow taxes/insurance	Yes/no	Ability to repay	Yes
Prepayment penalty	Yes/no	Subprime	Yes
Property type	Differentiate between personal and real property for manufactured housing	Clarity	Yes
Transaction Cost	If closing costs/loan amount >2 percent	Subprime	Maybe
Income	Expand to include stated income	Subprime	Yes
Piggyback loan	Explicit: yes/no, or no with PMI	Soundness	Maybe
BORROWER			
Age	Under 24, 25 to 39, 40 to 49, 50 to 59, 60+	Predatory	Yes
LENDER			
Channel	Broker, correspondent, bank, wholesale	Transparency	Yes

Updates to CRA Small-Business Data

Any observation about how to improve the CRA data begins from a dramatically different starting point. The CRA database does not use loan-level reporting. It also fails to account for the heterogeneity in business lending, and it allows subsidiaries of banks to avoid reporting on activity.

Small business lending activity lacks the standardization that exists in mortgage lending, and it is often more complicated. Amendments to data could clarify some of the instances where current reports appear vague. The CRA data set should be redesigned to meet the needs of community groups. Users want small business data that will answer questions about lending geography, as well as about the nature of the borrowers being served.

A small business CRA database built on a loan-by-loan level would transform the CRA, just as loan-level data previously transformed the power of HMDA data after FIRREA. The impact would be further enhanced by reporting on all actions with loan decisions. The following variables, if incorporated in loan-level format, would make that difference.

The apples-and-oranges nature of lending can be muted. Specific variables could help users categorize loans and businesses. Risk is very different among different business types. The North American Industry Classification System (NAICS) provides uniformly interpretable business typologies that would serve this need.

For loan terms, consider that more than one in four small businesses use a business credit card.[39] Yet, the

39 *National Survey of Small Business Finances, 1998.*

CRA does not distinguish between a credit card, a line of credit, and a complicated small business loan. A loan term variable could make this distinction. There also must be clarification of the following: degree of collateralization, the term of the loan, and loan characteristics.

Table 2 reflects the same principles that drive the agenda for reforming HMDA data. The new variables are both relevant and universal. They are relevant because they are important underwriting factors. Many come from the Small Business Administration's explanation of how it makes credit decisions.

These possible improvements would strengthen the ability of users to gauge how institutions are lending. The data would have wide use, given the connection between small business lending and job creation.

Job creation has been an important focus of community development since the Great Depression, yet those figures are not currently captured in CRA data.[40] "The principal goal of local economic development," it has been said, "is to stimulate local employment."[41] NAICS data, combined with loan amounts, suggest likely job benefits for users with input-output software. A job-creation variable would be useful for groups without access to input-output analysis.

The need to have race data is traditionally challenged by the corporate nature of borrowers. What corporation has a race or gender? SBA minority- and woman-owned designations already exist and provide an incontrovertible means for reporters to identify their business. An ongoing challenge to uniform interpretation is determining the location of a loan.

Community development lending could itself be enhanced by loan-level data reporting. Current reporting meets none of the principles outlined earlier.

Table 2: Small Business Lending Variables

Variable	Outcomes	Relevant?	Uniform?
LOAN			
Loan purpose	Capital expenditure, inventory, working capital	Heterogeneity	No
Loan decision	Originate, approve, deny, incomplete	Fair lending	Yes
Loan term	Categorical term length, or line of credit	Heterogeneity	Yes
Collateralization	Equity, real property, inventory, personal, other, none	Heterogeneity	Yes
Loan amount	Specify amount	Clarity	Yes
BORROWER			
Business type	Three-digit NAICS classification	Heterogeneity	Yes
Debt to equity	Liabilities/equity	Ability to repay	Yes
Working capital	Current assets/current liabilities	Ability to repay	Yes
Owner designation	Identify minority- or female-owned business	Fair lending	Yes
Revenue	Maintain in new database	Ability to repay	Yes
Franchisee	Yes/no	Management	Yes
Firm size	Categorical indicator of number of employees	Job creation	Yes
Firm experience	Categorical indicator of firm tenure	Job creation	Yes
Job creation	No, or quantity of jobs	Job creation	Yes

40 Jonathan R. Kesselman. *"Work Relief Programs in the Great Depression." In Creating Jobs: Public Employment Programs and Wage Subsidies, edited by John L. Palmer, (Washington, D.C.: Brookings Institution, 1978).*

41 *Edward J. Blakely and Ted K. Bradshaw, Planning Local Economic Development: Theory and Practice (Thousand Oaks, CA: Sage Publications, 1990), xvi.*

Financial institutions differ in their reporting of the data. The first step would be to break down reporting to the individual loan; next, attach basic descriptions of loan terms; and finally, add demographic information where possible.

Conclusion

The CRA's standards-based system must have useful data. These proposed data changes will bring HMDA and the CRA up to date with the new marketplace. The existing acts (HMDA, CRA, FIRREA) show us that data have a place in helping the public and regulators determine the extent to which financial institutions are serving the credit needs of their communities. The current credit crisis makes clear the need for these data. If this article had been written one year ago, it would have emphasized the eclipse of "access to credit" issues by "terms of credit" issues. In that paradigm, getting loans was a concern of the 1980s and 1990s. A year ago, the task of a community group was to warn consumers against the dangers of easy subprime loans. The data need to be updated to understand those products, particularly in the mortgage markets, but new challenges add to that expectation.

Once again, public concern is focused on access to credit. The lack of liquidity makes it more apparent that CRA data need to be enhanced. The lack of credit for small businesses is a compelling public policy problem.

Some unprecedented mergers also have regulatory implications. Three large megabanks (Bank of America, Wells Fargo, and JPMorgan Chase) collectively hold 32 percent of national deposits.[42] For consumer advocates, there has never been a time when the David-and-Goliath nature of the field was more evident. All three institutions have Outstanding CRA evaluations. And although some may take that as a verdict on their service to communities, it remains true that JPMorgan Chase and Bank of America have acquired some of the nation's largest subprime lenders (Washington Mutual and Countrywide). Moreover, both these institutions and their recent investment bank acquisitions (Merrill Lynch and Bear Stearns) all had healthy appetites for subprime loans on the secondary market in recent years.

History has set a precedent. FIRREA's reforms were prompted by the savings and loan crisis. There was a time when the idea that community investment was a *quid pro quo* attendant with FDIC insurance.[43] Taxpayer investment, as structured by the Troubled Assets Relief Program (TARP), potentially moves the debate back to that place and perhaps further.

The makeup of HMDA data was last revised in 2005. The last substantial change took place after FIRREA. While CRA data have remained in their current form since 1995, I have attempted to show how the data lag behind the marketplace. Today, there is a new awareness of the importance of lending among the public. For policymakers, this should represent an opportunity to restore the role of research and advocacy within the "regulation from below" that marked the best of the implementation of the CRA. ■

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42 Eve Tahmincioglu, "Just 3 'Superbanks' Now Dominate Industry," MSNBC.com, available at http://www.msnbc.msn.com/id/27441147.

43 Jonathan Brown, "Community Benefit Requirements for Banking Institutions: The U.S. Experience," (Washington, DC: Essential Information/Banking Research Project, 1991).

The Community Reinvestment Act: Good Goals, Flawed Concept

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My views about the Community Reinvestment Act (CRA) surely differ from those of many of the other individuals who will contribute to this volume. I believe that, despite the good intentions and worthwhile goals of the CRA's advocates, the CRA is an inappropriate instrument for achieving those goals.[1]

Fundamentally, the CRA is a regulatory effort to "lean on" banks and savings institutions, in vague and subjective ways to make loans and investments that (the CRA's proponents believe) those depository institutions[2] would otherwise not make. It is a continued effort to preserve old structures in the face of a modernizing financial economy. At base, the CRA is an anachronistic and protectionist effort to force artificially a local focus for finance in an increasingly competitive, increasingly electronic, and ever-widening realm of financial services. Further, ironically, the burdens of the CRA may well discourage banks from setting up new locations in low-income neighborhoods and thus providing local residents with better-priced alternatives to high-cost check-cashing and payday lending establishments.

There is a better way. First, to the extent that lending problems can be traced to discrimination against racial or ethnic groups or involving other categories of personal discrimination, the right tool is more vigorous enforcement of antidiscrimination laws—notably, the Equal Credit Opportunity Act of 1974.

Second, vigorous enforcement of the antitrust laws, especially with respect to mergers, is necessary to keep financial markets competitive, so that banks and other lenders are constantly under competitive pressure to provide attractive services offerings to their customers. If, for some reason, enforcement of the antitrust laws is deemed not sufficient in this respect, then policymakers should open entry into the business of banking to companies who have a business model of providing good value to low- and moderate-income households. Consistent with this focus, vigorous competition by any lender should not be permitted to veer off into predatory practices, in which aggressive sales personnel take advantage of unsophisticated customers who are insufficiently aware of better alternatives.

Third, to the extent that there are socially worthwhile lending opportunities that somehow are not being satisfied by existing lending institutions, these projects should be funded through the public fisc, in an on-budget and transparent process. The Community Development Financial Institutions Fund, authorized by the Riegle Community Development and Regulatory Improvement Act of 1994 and managed by the U.S. Treasury, is a good example of this kind of public funding mechanism. To the extent that its current funding levels are inadequate, they should be increased.

Finally, if public policy persists with something that resembles the CRA, the annual local lending obligations of banks should be explicitly quantified. These obligations could then be traded among banks, so that a system could arise that is similar to the "cap and trade" system that has proved so successful for dealing with sulfur dioxide emissions in a low-cost and efficient manner.[3]

I will not try to summarize the CRA or the extensive literature on it in this brief article. I have written about the CRA in the past.[4] Recent comprehensive reviews of

1 *This essay draws heavily on: White, Lawrence J. "Statement before the Financial Services Committee of the U.S. House of Representatives," February 13, 2008.*

2 *For the remainder of this essay I will use the word "banks" to include both commercial banks and savings institutions, unless otherwise indicated.*

3 *Klausner, Michael. "Market Failure and Community Reinvestment: A Market-Oriented Alternative to the Community Reinvestment Act." University of Pennsylvania Law Review 143 (May 1995): 1561–93; and Richardson, Christopher A. "The Community Reinvestment Act and the Economics of Regulatory Policy." Fordham Urban Law Journal 29 (April 2002): 1607–32.*

4 *White, Lawrence J. "The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction." Fordham Urban Law Journal 20 (Winter 1993): 281–92; White, Lawrence J. "Financial Modernization: What's in It for Communities?" New York Law School Journal of Human Rights 17 (Symposium 2000): 115–28; and White, Lawrence J. "Financial Modernization after Gramm-Leach-Bliley: What's in It for Communities?" in Financial Modernization after Gramm-Leach-Bliley, ed. Patricia A. McCoy. Newark, NJ: Lexis-Nexis, 2002.*

the CRA can be found in Apgar and Duda (2003),[5] Barr (2005),[6] and Bernanke (2007),[7] and a recent symposium on the CRA can be found in the *Western New England Law Review* 29, no. 1 (2006). The remainder of this article will expand on these ideas.

The Drawbacks of the CRA

Consider the basic concept of the CRA: Banks are somehow neglecting loan opportunities in the communities in which they have establishments—primarily in low- and moderate-income (LMI) communities—and must be forced to lend in those communities. Another version of this argument is that a bank that gathers deposits from customers that are located geographically close to that bank's physical location is "draining" deposits out of the community when it lends those funds elsewhere.

At its base, this concept rests on the notion either that: (a) banks are lazy (or ill-intentioned) and are inefficiently passing up profitable opportunities to lend to creditworthy customers in LMI communities, and so they must be forced to do so; or (b) they are monopolies with market power and excess profits that can be used to cross-subsidize the unprofitable loans in the LMI community that they can be forced to make. Either version has the flavor of the pre-1970s world of banks and banking, where competition was not especially vigorous and state and national regulations often impeded entry and prevented banks from branching outside their home communities, which thereby often created pockets of local market power.

Further, the notions that banks have special obligations toward "their" communities and that the communities need and deserve this protection again smack of that pre-1970s world of localized finance.

Let us instead consider lending in the context of the first decade of the twenty-first century. In that context, there are at least five bases for questioning the wisdom of the CRA. First, if loans are profitable, profit-seeking banks should already be making them. In this case, the CRA is redundant at best (but it is still costly because of the costs of compliance and of regulatory monitoring). Of course, banks make mistakes and may not be the perfect maximizers of introductory economics textbooks. But the CRA is based on the notion that banks systematically overlook profitable opportunities in LMI communities. And that seems unlikely in today's environment.

Alternatively, there may be spillover effects that cause single loans to be unprofitable but that would cause a group of loans to be profitable. In that case, we should expect to see banks forming joint ventures or other types of coalitions to "internalize" the externality and make these profitable loans.

On the other hand, if the loans are not profitable, then: (a) they require a cross-subsidy from the excess profits from other (super-profitable) activities of the bank; but in the increasingly competitive environment of financial services, there will be little or no excess profits; or (b) they will involve losses for the bank; or (c) they will be shirked and avoided, with accompanying cynicism. Neither of these last two prospects should be the basis for good public policy.

Second, why should a bank have a special obligation to lend to a specific local geographic area? What is special about local geographic areas or about the specific placement of physical bank locations? Should the bank also have an obligation to hire only employees who live in that same geographic area? Must it buy its desks from local merchants?

The localism orientation of the CRA is an anachronism that runs counter to the broad sweep of public policy in the financial services area, which has been to erase protectionist measures (such as restrictions on intrastate and interstate branching and the forced compartmentalization of financial services) and to place more trust in competition.

Further, the "draining deposits" notion ignores the substantial value to an LMI community of a bank that offers primarily deposit services and a few related services (such as check-cashing, cash transfer, and perhaps some personal loans). To the extent that community leaders are concerned that the community's citizens are using higher-cost alternatives, such as check-cashing offices

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5 *Apgar, William C., and Mark Duda. "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." Federal Reserve Bank of New York Economic Policy Review 9 (June 2003): 169–91.*

6 *Barr, Michael S. "Credit Where It Counts: The Community Reinvestment Act and Its Critics." New York University Law Review 80 (May 2005): 513–52.*

7 *Bernanke, Ben S. "The Community Reinvestment Act: Its Evolution and New Challenges." Speech presented at the Community Affairs Research Conference, Washington, DC, March 30, 2007.*

and payday lenders, they should welcome banks, even if the banks provide a limited menu of services. Ironically, the lending obligations of the CRA (and the extra burden of exiting an area if the operations there turn out to be unprofitable) may well discourage the establishment of branches in LMI areas in the first place. Barriers to exit are barriers to entry.

Third, why place this special obligation on banks? After all, there are many other categories of lenders for most of the types of loans that banks make. Are banks special? If so, in what ways are they special, and are those ways relevant for CRA purposes?

Banks are special in at least two important ways: (a) they (along with credit unions) provide federally insured deposits, which is an important benefit for financially unsophisticated customers who seek a safe place for their transactions accounts and for simple savings; deposit insurance also provides stability for the overall banking system by forestalling the kinds of depositor runs on banks that plagued American banking before 1933 (and that Britain revisited in September 2007 with its Northern Rock debacle);[8] and (b) commercial banks especially are important sources of credit for small and medium-size enterprises (SMEs).

Both special features are good arguments for vigorous antitrust enforcement, to ensure that bank mergers do not create anticompetitive environments in local markets for deposits and for SME lending. Neither provides an argument for imposing CRA requirements to make loans that they otherwise would not be inclined to make.

Fourth, in a dynamic setting, banks' choices of locations will surely be influenced by the regulatory burdens that accompany those choices. As noted above, to the extent that they consider decisions to locate in LMI areas as carrying extra regulatory burdens (and as involving greater difficulties of exit in the event that the location proves to be unprofitable), they are less likely to locate in those areas in the first place.

Fifth, the vagueness of the CRA's language—that banks should meet "the credit needs of its entire community, including low- and moderate-income neighborhoods"—has led to vague and subjective enforcement. Initially, enforcement focused on a bank's efforts toward serving its community and the documentation of those efforts; after 1995, enforcement focused more on documenting lending outcomes; in essence, pre-1995 regulation focused on inputs, while post-1995 regulation focused more on outputs. Although the latter is surely an improvement over the former, nevertheless the inherent vagueness of "needs" inevitably leads to the vagueness and subjectivity of enforcement. This cannot be the basis of good public policy.

In sum, the CRA is fundamentally at odds with the modern sweep of public policy with respect to financial regulation and with the reasons and arguments that underlie the direction that policy has taken. It emphasizes protectionism and localism and distrusts competition in an era when the sweep of policy is to reduce and eliminate local barriers and to rely more on competition than on forced lending. And by discouraging entry in LMI areas, the CRA may well be contrary to the long-term interests of the communities that it is intended to help.

There have recently been broader critiques of the CRA: that it encouraged banks to make subprime mortgage loans (which were then securitized) and thus the CRA bears major responsibility for the housing bubble of 1999–2006, and then for the mortgage-related securities crisis that began in 2007.

I believe that these broader critiques are badly aimed. It appears that the bulk of the subprime lending of the earlier years of this decade was made by nonbank lenders—that is, by "mortgage banks" that either securitized the mortgages themselves or that quickly sold the mortgages to securitizers. These nonbank lenders were not covered by CRA requirements. Further, the major financial difficulties that were related to investments in these mortgage securities were experienced mostly by investment banks (such as Bear Stearns, Lehman Brothers, Morgan Stanley, and Merrill Lynch) and by a large insurance conglomerate (AIG)—none of which was covered by the CRA. Where banks did experience difficulties that were related to subprime mortgages, such

8 *Apparently there was a modest-sized run on Washington Mutual Bank (WaMu) in September 2008 by insured and uninsured depositors before the Federal Deposit Insurance Corporation (FDIC) declared a receivership and arranged for JPMorgan Chase to absorb WaMu's deposits and assets. In March 2008, Bear Stearns experienced a "run" by short-term creditors that had similar characteristics to that of a bank run. And in September 2008, in the wake of Lehman Brothers' bankruptcy, a prominent money-market mutual fund (the Reserve Fund) experienced significant losses on the Lehman commercial paper that it held and declared that the value of its nominal one-dollar shares would be only $0.97 (it "broke the buck"), which then caused shareholder runs on money-market mutual funds more broadly (which caused the Federal Reserve then to offer guarantees on existing shares).*

as CitiBank, WaMu, Wachovia (having absorbed Golden West in 2006), IndyMac, and Countrywide, it appears that they were heavily involved in subprime lending because of its perceived profitability (and their underappreciation of the risks) and not because of CRA pressures.

The CRA has multiple flaws, but responsibility for the subprime mortgage lending and securities debacle does not appear to be one of them.

Better Public Policies

These criticisms of the CRA should not be interpreted to mean that no governmental actions are warranted. As I stated at the beginning, there is a better way to achieve the goals of the CRA's advocates.

First, discrimination by lenders of any kind with respect to racial or ethnic or other prohibited categories should be vigorously prosecuted under the Equal Credit Opportunity Act and any other available statute, such as the Fair Housing Act of 1968.

Second, the antitrust laws should be vigorously enforced, so as to keep financial markets competitive.

Third, if enforcement of the antitrust laws is deemed inadequate for encouraging sufficient competition in banking, then policymakers should allow entry into the business of banking by more companies, including those that have a business model of providing value to LMI households. It is indeed ironic that the same community groups that advocate for more banking services for LMI households were also those who lobbied the FDIC and the Congress during 2005–2007 (in alliance with the banking lobbyists, with whom the community groups are at odds with respect to efforts to expand the CRA's burdens on banks) to thwart Wal-Mart's efforts to enter the banking business by obtaining an industrial loan company charter from the state of Utah.

Instead, Wal-Mart and other retailing and industrial companies should be encouraged to enter banking preferably through a modification of the Bank Holding Company Act of 1970 or (as a last resort) through the granting of FDIC insurance to the otherwise qualified holders of Utah industrial loan company charters.[9] The potential problems for the safety and soundness of banks that would be posed by such companies' ownership of banks would be no more serious than the problems that are caused by current ownership structures, and they can be handled by the same regulatory tools that are currently used.[10]

Fourth, to the extent that there is a good social case for local lending and investment that local lenders somehow do not satisfy, those loans and investments should be funded through the public fisc, in an on-budget and transparent process. The Community Development Financial Institutions Fund is a good example and it should be expanded to replace whatever socially worthwhile projects would be eliminated if the CRA were repealed.

Finally, if the CRA remains in force, its vague and subjective regulatory enforcement should be replaced by a set of specific annual lending obligations that would encompass both originations and portfolio holdings. These obligations would then be tradable among banks. Those banks that were less efficient at originating and holding these types of loans could pay other banks that were more efficient at these activities to take over these obligations. This system, in addition to making more transparent the obligations that are often opaque, could achieve the kinds of efficiencies that have attracted attention to the "cap and trade" system for controlling sulfur dioxide emissions by U.S. electric utilities. ■

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9 *"Wal-Mart and Banks: Should the Twain Meet? A Principles-Based Approach to the Issues of the Separation of Banking and Commerce." Contemporary Economic Issues (forthcoming, 2009).*

10 *As noted in White (2009), it is anomalous that the local car dealer is permitted to own a bank, but AutoNation, Inc. (a publicly traded company that operates a large number of car dealerships) is not.*

Federal Reserve Bank of Dallas

A Banker's Quick Reference Guide to CRA

As amended effective September 1, 2005

This publication is a guide to the CRA regulation and examination procedures.
It is intended for bank CEOs, presidents, and CRA and compliance officers
as a tool for accessing CRA information quickly. Refer to Regulation BB and agency examination
procedures for more detailed information.

Table of Contents

Terms Used Throughout This Document

AA – assessment area(s)
CD – community development
CRA – Community Reinvestment Act
HMDA – Home Mortgage Disclosure Act
LMI – low- and moderate-income
LTD – loan-to-deposit

Definitions

Assessment Area(s) — One or more of the geographic area(s) that is delineated by the bank and used by the regulatory agency in evaluating the bank's record of helping to meet the credit needs of its community. It must, in general, consist of one or more MSAs or metropolitan divisions or one or more contiguous political subdivisions, such as counties, cities or towns. It must include geographies in which the bank has its main office, branches and deposit-taking ATMs, as well as the surrounding geographies in which the bank has originated or purchased a substantial portion of its loans. A bank may adjust the boundaries of its AA to include only the portion of a political subdivision that it reasonably can be expected to serve. An AA must consist only of whole geographies, may not reflect illegal discrimination, may not arbitrarily exclude LMI geographies and may not extend substantially beyond an MSA boundary or beyond a state boundary, unless the AA is located in a multistate MSA.

Community Development — Encompasses affordable housing (including multifamily rental housing) for LMI individuals; community services targeted to LMI individuals; activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs or have gross annual revenues of $1 million or less; or activities that revitalize or stabilize LMI geographies, designated disaster areas or distressed or underserved non-metropolitan middle-income geographies designated by the Board of Governors, FDIC and OCC.

Community Development Loan — A loan that has as its primary purpose community development; (except for wholesale or limited purpose banks) has not been reported or collected by the bank or an affiliate for consideration in the bank's assessment as a home mortgage, small business, small farm or consumer loan, unless it is a multifamily dwelling loan; and benefits the bank's AA or a broader statewide or regional area that includes the bank's AA.

Community Development Service — A service that has as its primary purpose community development, is related to the provision of financial services, has not been considered in the evaluation of the bank's retail banking services, benefits the bank's AA or a broader statewide or regional area that includes the bank's AA and has not been claimed by other affiliated institutions.

Discriminatory or Other Illegal Credit Practices — Activities that result in violations of an applicable law, rule or regulation, including, but not limited to, the Equal Credit Opportunity Act; the Fair Housing Act; the Home Ownership and Equity Protection Act; section 5 of the Federal Trade Commission Act; section 8 of the Real Estate Settlement Procedures Act; and the Truth in Lending Act provisions regarding a consumer's right of rescission.

Geography — A census tract delineated by the U.S. Bureau of the Census in the most recent decennial census.

Income Level – Geography
- **Low-Income** — Median family income less than 50 percent of the area median income
- **Moderate-Income** — Median family income at least 50 percent and less than 80 percent of the area median income
- **Middle-Income** — Median family income at least 80 percent and less than 120 percent of the area median income
- **Upper-Income** — Median family income at least 120 percent of the area median income

Income Level – Individual
- **Low-Income** — Less than 50 percent of the area median income
- **Moderate-Income** — At least 50 percent and less than 80 percent of the area median income
- **Middle-Income** — At least 80 percent and less than 120 percent of the area median income
- **Upper-Income** — At least 120 percent of area median income

Limited Purpose Bank — A bank that offers only a narrow product line, such as credit card or motor vehicle loans, to a regional or broader market and has received designation as a limited purpose bank from its supervisory agency.

Performance Context — A bank's performance is judged in the context of information about the bank and its AA, including
- demographic data on median income levels, distribution of household income, nature of housing stock, housing costs and other relevant data
- lending, investment and service opportunities
- the bank's product offerings and business strategy, capacity and constraints, past performance and the performance of similarly situated lenders
- the bank's public file and any written comments about the bank's CRA performance
- any other relevant information

Qualified Investment — A lawful investment, deposit, membership share or grant that has as its primary purpose community development.

Small Bank — A bank that, as of December 31 of either of the prior two calendar years, had total assets of less than $1 billion. **Intermediate Small Bank** means a small bank with assets of at least $250 million as of December 31 of both of the prior two calendar years and less than $1 billion as of December 31 of either of the prior two calendar years. Asset size designation will be adjusted annually based on the year-to-year change in the average of the consumer price index for urban wage earners and clerical workers.

Wholesale Bank — A bank that is not in the business of extending home mortgage, small business, small farm or consumer loans to retail customers and has received designation as a wholesale bank from its supervisory agency.

Small Banks

Performance Standards

Loan-to-deposit ratio
- given the bank's size and financial condition
- credit needs of the AA
- other lending-related activities
- considering seasonal variations

Percentage of loans and other lending-related activities in the AA

Record of lending and other lending-related activities to
- borrowers of different income levels
- businesses and farms of different sizes

Geographic distribution of loans

Action taken in response to written complaints with respect to CRA performance in the AA

Examiner Review

Loan-to-deposit analysis
- Using Call Reports or UBPR data, calculate an average LTD ratio using quarterly LTDs since the last exam.
- Determine the reasonableness of the average LTD ratio in light of the performance context.
- If the LTD ratio does not appear reasonable, additional consideration will be given to
  - number and dollar volume of loans sold to the secondary market.
  - innovativeness or complexity of CD loans and qualified investments.

Compare credit extended inside and outside AA.
- If available, use HMDA data, bank loan and other reports to analyze the extent of lending inside and outside AA, after testing the reports for accuracy.
- If loan data are not available, accurate or comprehensive, sample the loans originated, purchased or committed to and calculate the percentage of loan volume (by number and dollar volume) within the AA.
- If majority of the loans are not in the AA, thus not meeting the standards for satisfactory, give additional consideration to the performance context to determine the effect on overall performance.

Geographic distribution of credit
- Determine if there is a sufficient number and income distribution of geographies to provide meaningful analysis. If yes,
  - determine distribution of loans among low-, moderate-, middle- and upper-income geographies, using available bank loan data or sample. Identify groups of geographies, by income categories, where there is little or no loan penetration.

Income and revenue distribution of credit
- If available, use data about borrower income (individuals) or revenues (businesses) to determine the distribution of loans by borrower income and by business revenues. Identify categories of borrowers by income or business revenues that have little or no loan penetration.

If sufficient geographic or income/revenue data are not available to do an analysis of the distribution of credit, consider alternatives such as analyzing geographic distribution by street address rather than geography.

If there are geographies or income categories of low penetration, form conclusions about the reasons in light of the performance context.

Review complaints relating to the bank's CRA performance.
- Evaluate the bank's record of taking action, if warranted, in response to written complaints about its CRA performance.

If the bank chooses, review its performance in making qualified investments and providing services. Note: Performance with respect to qualified investments and services may be used to enhance a satisfactory rating but may not be used to lower a rating.
- Consider dollar volume, impact and innovativeness or complexity of qualified investments.
- Consider number of branches and ATMs and the services they provide, accessibility to LMI geographies, alternative service delivery systems, and record of opening and closing branches.

Small Banks – Performance Ratings

Characteristic	Outstanding	Satisfactory	Needs to Improve	Substantial Noncompliance
Loan-to-Deposit Ratio (considering seasonal variations and taking into account lending-related activities)	MORE THAN REASONABLE given the bank's size, financial condition and AA credit needs.	REASONABLE	LESS THAN REASONABLE	UNREASONABLE
Assessment Area(s) Concentration	A SUBSTANTIAL MAJORITY of loans and other lending-related activities are IN the AA.	MAJORITY IN	MAJORITY OUTSIDE	SUBSTANTIAL MAJORITY OUTSIDE
Borrower's Profile	EXCELLENT penetration among individuals of different income (including LMI) levels and businesses and farms of different sizes.	REASONABLE	POOR	VERY POOR
Geographic Distribution of Loans	The geographic distribution of loans reflects EXCELLENT dispersion throughout the AA.	REASONABLE	POOR	VERY POOR
Response to Substantiated Complaints	The bank has taken NOTEWORTHY, CREATIVE action in response to substantiated CRA complaints.	APPROPRIATE	INADEQUATE	UNRESPONSIVE
Investments	The investment record ENHANCES credit availability in AA.	N/A	N/A	N/A
Services	Record of providing branches and/or other services ENHANCES credit availability in AA.	N/A	N/A	N/A

Intermediate Small Banks – Lending Test

Performance Standards

Loan-to-deposit ratio
- given the bank's size and financial condition
- credit needs of the AA
- other lending-related activities
- considering seasonal variations

Percentage of loans and other lending-related activities in the bank's AA

Record of lending and other lending-related activities to
- borrowers of different income levels
- businesses and farms of different sizes

Geographic distribution of loans

Action taken in response to written complaints with respect to CRA performance in the AA

Examiner Review

Loan-to-deposit analysis
- Using Call Reports or UBPR data, calculate an average LTD ratio using quarterly LTDs since the last exam.
- Determine the reasonableness of the average LTD ratio in light of the performance context.
- If the LTD ratio does not appear reasonable, additional consideration will be given to
  - number and dollar volume of loans sold to the secondary market.
  - innovativeness or complexity of CD loans and qualified investments.

Compare credit extended inside and outside AA.
- If available, use HMDA data, bank loan and other reports to analyze the extent of lending inside and outside AA, after testing the reports for accuracy.
- If loan data are not available, accurate or comprehensive, sample the loans originated, purchased or committed to and calculate the percentage of loan volume (by number and dollar volume) within the AA.
- If majority of the loans are not in the AA, thus not meeting the standards for satisfactory, give additional consideration to the performance context to determine the effect on overall performance.

Geographic distribution of credit
- Determine if there is a sufficient number and income distribution of geographies to provide meaningful analysis. If yes,
  - determine distribution of loans among low-, moderate-, middle- and upper-income geographies using available bank loan data or sample. Identify groups of geographies, by income categories, where there is little or no loan penetration.

Income and revenue distribution of credit
- If available, use data about borrower income (individuals) or revenues (businesses) to determine the distribution of loans by borrower income and by business revenues. Identify categories of borrowers by income or business revenues that have little or no loan penetration.

If sufficient geographic or income/revenue data are not available to do an analysis of the distribution of credit, consider alternatives such as analyzing geographic distribution by street address rather than geography.

If there are geographies or income categories of low penetration, form conclusions about the reasons in light of the performance context.

Review complaints relating to the bank's CRA performance.
- Evaluate the bank's record of taking action, if warranted, in response to written complaints about its CRA performance.

Intermediate Small Banks – Community Development Test

Performance Standards

Number and amount of CD loans and qualified investments

Extent of CD services provided

Responsiveness of CD loans, qualified investments and CD services to CD needs and opportunities

(Optional) CD loans, qualified investments and CD services provided by affiliates, if they are not claimed by any other institution, and CD lending by consortia or third parties will be considered.

Examiner Review

Identify CD loans, qualified investments and CD services of the bank through:
- discussions with management.
- HMDA data collected by the bank, as applicable.
- investment portfolios.
- any other relevant financial records.
- materials available to the public.

Ensure activities qualify as CD.

Evaluate CD activities using performance context information and consider:
- the number and dollar amount of CD loans and qualified investments.
- the extent of CD services, including the provision and availability of services to LMI people, including through branches and other facilities in LMI areas.
- the responsiveness of CD loans, qualified investments and CD services to CD needs and opportunities.

Intermediate Small Banks – Lending Performance Ratings

Characteristic	Outstanding	Satisfactory	Needs to Improve	Substantial Noncompliance
Loan-to-Deposit Ratio (considering seasonal variations and taking into account lending-related activities)	MORE THAN REASONABLE given the bank's size, financial condition and AA credit needs.	REASONABLE	LESS THAN REASONABLE	UNREASONABLE
Assessment Area(s) Concentration	A SUBSTANTIAL MAJORITY of loans and other lending-related activities are IN the AA.	MAJORITY IN	MAJORITY OUTSIDE	SUBSTANTIAL MAJORITY OUTSIDE
Borrower's Profile	EXCELLENT penetration among individuals of different income (including LMI) levels and businesses and farms of different sizes.	REASONABLE	POOR	VERY POOR
Geographic Distribution of Loans	The geographic distribution of loans reflects EXCELLENT dispersion throughout the AA.	REASONABLE	POOR	VERY POOR
Response to Substantiated Complaints	The bank has taken NOTEWORTHY, CREATIVE action in response to substantiated CRA complaints.	APPROPRIATE	INADEQUATE	UNRESPONSIVE

Intermediate Small Banks – Community Development Performance Ratings

Outstanding	Satisfactory	Needs to Improve	Substantial Noncompliance
The bank's CD performance demonstrates EXCELLENT responsiveness to CD needs of its AA through CD loans, qualified investments and CD services, as appropriate, considering the bank's capacity and the need and availability of such opportunities for CD in the bank's AA.	ADEQUATE	POOR	VERY POOR

Large Banks – Lending Test

Performance Standards

Number and amount of loans in the AA

Geographic distribution of loans
- proportion of loans in AA
- dispersion of lending in AA
- number and amount of loans by geography classification (low-, moderate-, middle- and upper-income) in AA

Distribution based on borrower characteristics
- number and amount of home mortgage loans to low-, moderate-, middle- and upper-income individuals
- number and amount of small business and small farm loans by loan amount at origination and to small businesses and small farms with gross annual revenues of $1 million or less
- (optional) number and amount of consumer loans to low-, moderate-, middle- and upper-income individuals

CD loans
- number and amount
- complexity and innovativeness

Innovative or flexible lending practices to address the needs of LMI individuals or geographies

(Optional) Affiliate lending, if not claimed by any other institution, and lending by a consortium or third party will be considered.

Examiner Review

Identify loans to be evaluated by reviewing
- most recent HMDA and CRA disclosure statements.
- interim HMDA and CRA data collected.
- sample of consumer loans (if a substantial majority of business).
- other loan information provided by the bank.

Verify accuracy of loan data collected and/or reported.
- Affiliate loans may be claimed by only one affiliate.
- CD loans meet definition.
- The amount of third party, consortia or affiliate lending may not account for more than the percentage share of the bank's participation or investment.
- If reported, consumer loans must include all loans in a particular category (e.g., motor vehicle).

Evaluate lending volume both in number and dollar amount of loans within the AA for each type of loan, giving consideration to the performance context.

Analyze the geographic distribution of lending.
- Review information provided by the bank for insight into the reasonableness of its geographic distribution.
- Perform independent analysis as necessary. The analysis should consider:
  - number, dollar volume and percentage of loans made:
    - inside and outside AA.
    - in each geography and each income category of geography.
  - number of geographies penetrated in each income category.
  - number and dollar volume of housing loans in each geography compared with the number of housing units in each geography.
  - number and dollar volume of small business or farm loans in each geography compared with the number of small businesses or farms in each geography.
  - whether any gaps exist in lending activity for each income category, by identifying groups of contiguous geographies that have no or low loan penetration relative to the other geographies.
- If contiguous geographies have abnormally low penetration, the examiner may compare the bank's performance with that of other area lenders. Note: Banks are not required to lend in every geography.

Analyze distribution of lending by borrower characteristics.
- Review information provided by the bank for insight into the reasonableness of its lending distribution.
- Supplement with independent analysis of lending distribution by borrower characteristics as necessary and applicable, giving consideration to the:
  - number, dollar volume and percentage of home mortgages made to low-, moderate-, middle- and upper-income borrowers and make a percentage comparison of total home mortgage loans with the population in each income category.
  - number and dollar volume of small loans to businesses or farms by loan size of $100,000 or less, more than $100,000 but less than or equal to $250,000, and more than $250,000.
  - number and dollar amount of small loans to businesses or farms that had annual revenues of less than $1 million, and compare with total reported number and amount of small loans to businesses or farms.
  - loans made outside the AA if borrowers within the AA are adequately served and it would enhance the assessment of the bank's performance.

Review CD lending to determine the CD lending opportunities, the bank's responsiveness and the extent of its leadership.

Determine whether lending performance is enhanced by offering innovative or more flexible loan products by considering:
- if LMI borrowers are served in new ways or the loans serve creditworthy borrowers not previously served.
- the success of each product, including number and dollar volume of originations.

Large Banks – Data Collection

General

Collect and maintain data on loans to small businesses or farms captured in Schedule RC-C of the Call Report (loans originated or purchased).
- unique loan number or alphanumeric symbol
- dollar amount of the loan at origination
- location of the loan
- Indicate whether the gross annual revenues of the business or farm are $1 million or less.

Submit annually by March 1 the following data:
- for each geography, loans to small businesses and farms (loans originated or purchased), including
  - aggregate number and dollar amount of loans at origination in loan size categories of $100,000 or less, more than $100,000 but less than or equal to $250,000, and more than $250,000.
  - aggregate number and dollar amount of loans to businesses and farms with gross revenues of $1 million or less.
- aggregate number and dollar amount of CD loans (originated or purchased).
- home mortgage loans as required under Regulation C (HMDA).
- a list for each assessment area showing the geographies within the area.
- affiliate lending if affiliate lending is being considered.
- consortium or third-party lending if consortium or third-party lending is being considered.

Optional

Collect and maintain data for consumer loans (originated and purchased).
- unique loan number or alphanumeric symbol
- dollar amount of the loan at origination
- location of the loan
- gross annual income of the borrower that is considered in making the credit decision

Any other information concerning lending performance the bank chooses to provide

Large Banks – Lending Performance Ratings

Characteristic	Outstanding	High Satisfactory	Low Satisfactory	Needs to Improve	Substantial Noncompliance
Lending Activity	Lending levels reflect EXCELLENT responsiveness to AA credit needs.	GOOD	ADEQUATE	POOR	VERY POOR
Assessment Area(s) Concentration	A SUBSTANTIAL MAJORITY of loans are made in the bank's AA.	HIGH PERCENTAGE	ADEQUATE PERCENTAGE	SMALL PERCENTAGE	VERY SMALL PERCENTAGE
Geographic Distribution of Loans	The geographic distribution of loans reflects EXCELLENT penetration throughout the AA.	GOOD	ADEQUATE	POOR	VERY POOR
Borrower's Profile	The distribution of borrowers reflects, given the product lines offered, EXCELLENT penetration among customers of different income levels and businesses of different sizes.	GOOD	ADEQUATE	POOR	VERY POOR
Responsiveness to Credit Needs of Low-Income Individuals and Geographies and Very Small Businesses	Exhibits an EXCELLENT record of serving the credit needs of low-income individuals and areas and very small businesses.	GOOD	ADEQUATE	POOR	VERY POOR
Community Development Lending Activities	A LEADER IN MAKING CD loans.	MAKES A RELATIVELY HIGH LEVEL	MAKES AN ADEQUATE LEVEL	MAKES A LOW LEVEL	MAKES FEW, IF ANY
Product Innovation	Makes EXTENSIVE USE of innovative and/or flexible lending practices in serving AA credit needs.	USE	LIMITED USE	LITTLE USE	NO USE

Large Banks – Investment Test

Performance Standards	Examiner Review
Dollar amount of qualified investments **Innovativeness** and complexity of qualified investments **Responsiveness** of qualified investments to credit and CD needs **Degree** to which qualified investments are not routinely provided by private investors **Qualified** investments must benefit the AA or a broader statewide or regional area that includes the AA. **(Optional)** Qualified investments made by an affiliate bank will be considered if not claimed by any other institution.	**Identify** qualified investments. – Review investment portfolio. – At bank's option, review affiliate's investment portfolio. – Include qualified investments made since previous examination and qualified investments made prior to last examination still outstanding. – Include qualifying grants, donations or in-kind contributions of property made since last examination that have a primary purpose of CD. **Evaluate** investment performance. – benefit to assessment area or broader statewide or regional area that includes AA – has not been considered under lending or service test – if reported, that affiliate investments have not been claimed by another institution – dollar volume of investments made considering performance context – use of innovative or complex investments, particularly those not routinely provided by other investors – responsiveness to available opportunities and degree to which they serve LMI areas or individuals

Large Banks – Investment Performance Ratings

Characteristic	Outstanding	High Satisfactory	Low Satisfactory	Needs to Improve	Substantial Noncompliance
Investment and Grant Activity	An EXCELLENT level of qualified CD investments and grants, particularly those not routinely provided by private investors, OFTEN in a leadership position.	SIGNIFICANT OCCASIONALLY	ADEQUATE RARELY	POOR	FEW, IF ANY
Community Development Initiatives	Makes EXTENSIVE USE of innovative and/or complex investments to support CD initiatives.	SIGNIFICANT USE	OCCASIONAL USE	RARE USE	NO USE
Responsiveness to Credit and Community Development Needs	Exhibits EXCELLENT responsiveness to credit and CD needs.	GOOD	ADEQUATE	POOR	VERY POOR

Large Banks – Service Test

Performance Standards

Retail Banking Services

Distribution of branches among each geography classification

Record of opening and closing branches, particularly those located in LMI geographies or primarily serving LMI individuals

Availability and effectiveness of alternative systems for delivering retail banking services in LMI geographies and to LMI individuals

Range of services provided in each geography classification and the degree the services are tailored to meet the needs of those geographies

Community Development Services

Extent of CD services provided

Innovativeness and responsiveness of CD services

Examiner Review

Retail Banking Services

Determine from the bank's public file the distribution of branches among each geography classification in the AA and the banking services provided, including hours and available products.

Identify any material differences in hours or services available at each branch.

Evaluate the record of opening and closing branch offices and its effect, particularly on LMI geographies or individuals.

Evaluate the accessibility and use of alternative systems for delivering retail banking services in LMI areas and to LMI individuals.

Assess the quantity, quality and accessibility of service-delivery systems provided in each geography classification.
- Consider the degree to which services are tailored to the convenience and needs of each geography.

Community Development Services

Identify CD services of the bank and, at its option, services through affiliates.

Ensure CD services meet the definition of CD service.

Evaluate CD services using performance context information and consider:
- innovativeness and whether they serve LMI customers in new ways or serve groups of customers not previously served.
- the degree to which they serve LMI areas or LMI individuals and their responsiveness to available service opportunities.

Large Banks – Service Performance Ratings

Characteristic	Outstanding	High Satisfactory	Low Satisfactory	Needs to Improve	Substantial Noncompliance
Accessibility of Delivery Systems	Delivery systems are READILY ACCESSIBLE to the bank's geographies and individuals of different income levels in its AA.	ACCESSIBLE	REASONABLY ACCESSIBLE	UNREASONABLY INACCESSIBLE TO PORTIONS OF	UNREASONABLY INACCESSIBLE TO SIGNIFICANT PORTIONS OF
Changes in Branch Locations	Record of opening and closing of branches has IMPROVED the accessibility of its delivery systems, particularly to LMI geographies and/or LMI individuals.	NOT ADVERSELY AFFECTED	GENERALLY NOT ADVERSELY AFFECTED	ADVERSELY AFFECTED	SIGNIFICANTLY ADVERSELY AFFECTED
Reasonableness of Business Hours and Services in Meeting AA Needs	Services ARE TAILORED TO CONVENIENCE AND NEEDS OF its AA, particularly LMI geographies and/or LMI individuals.	DO NOT VARY IN A WAY THAT INCONVENIENCES	DO NOT VARY IN A WAY THAT INCONVENIENCES	VARY IN A WAY THAT INCONVENIENCES	VARY IN A WAY THAT SIGNIFICANTLY INCONVENIENCES
Community Development Services	A LEADER IN PROVIDING CD services.	PROVIDES A RELATIVELY HIGH LEVEL OF	PROVIDES AN ADEQUATE LEVEL OF	PROVIDES A LIMITED LEVEL OF	PROVIDES FEW, IF ANY

Strategic Plan Option*

Performance Standards

In general, a plan must meet the following criteria:
- Maximum term is five years, and multiyear plans must have annual interim goals.
- Banks with multiple AA may prepare a single strategic plan or multiple plans and may have AA not covered by a plan.
- Affiliated institutions may submit a joint plan if the plan provides measurable goals for each institution.

Bank must seek public participation in plan development by
- informally seeking suggestions from the public in the AA covered by the plan during its development.
- formally soliciting public comment for at least 30 days by
  - publishing notice in a general circulation newspaper in each AA covered by plan.
  - making copies of plan available for review.

Requirements for submission of the plan include
- submitting to supervisory agency at least three months prior to proposed effective date.
- providing a description of efforts to seek suggestions from the public.
- providing any written public comments received.
- if initial plan was revised based on public comment, submitting initial plan.

The plan must contain the following:
- measurable goals for helping to meet credit needs, particularly of LMI areas and individuals.
- address lending, investment and service performance categories with an emphasis on lending and lending-related activities.
- specify measurable goals that constitute a satisfactory rating.
- for consideration of an outstanding rating, must specify outstanding goals.

Examiner Review

Review the following:
- the approved plan and any approved amendments
- the agency's approval process files
- written comments from the public since the effective date of the plan

Determine if the bank achieved goals for each AA by
- reviewing plan's measurable goals.
- identifying the bank's actual performance.
- comparing goals with actual performance.

Evaluate any unmet goals and identify if the overall plan goals were "substantially met" based on
- number of goals not met.
- degree to which goals were not met.
- relative importance of unmet goals to the overall plan.
- why the goals were not met.

* A strategic plan assessment may be chosen as an alternative assessment method by any bank if the plan has been submitted and approved by the bank's supervisory agency. The plan must be in effect, and the bank must have been operating under the approved plan for at least one year.

Public File

Requirements for All Banks

Written comments (current year and prior two calendar years)
- received from the public that specifically relate to bank's CRA performance
- any response to the comments by the bank

CRA performance evaluation within 30 business days of receipt

Branch information
- list of branches with their street addresses and geographies
- list of branches opened or closed during current year and prior two calendar years, their street addresses and geographies
- list of services generally offered and any material differences in availability or cost of services at particular branches
- (optional) information regarding availability of alternative systems for delivering retail banking services

Map of each AA
- showing boundaries of the area
- identifying the geographies contained within the area (either on the map or in a separate list)

Any other information the bank chooses to provide

If applicable
- HMDA disclosure statement (prior two calendar years) within three business days of receipt
- strategic plan
- efforts to improve performance if bank's previous CRA rating was less than satisfactory (updated quarterly)

Additional Requirements Based on Asset Size

Banks other than Small and Intermediate Banks

- CRA disclosure statement (prior two calendar years) within three business days of receipt

(Optional) Number and amount of consumer loans (prior two calendar years)
- to low-, moderate-, middle- and upper-income individuals
- located in each geography classification
- located inside/outside the AA

Small and Intermediate Small Banks

Loan-to-deposit ratio
- for each quarter of the prior calendar year
- (optional) additional data on its loan-to-deposit ratio

CRA Ratings

Small Banks

Outstanding

– if the bank meets the rating descriptions and standards for Satisfactory for each of the five core criteria and materially exceeds the standards for Satisfactory in some or all of the criteria to the extent that an outstanding rating is warranted
or

– if the bank's performance with respect to the five core criteria generally exceeds Satisfactory and its performance in making qualified investments and providing branches and other services and delivery systems in the AA supplements its performance under the five core criteria sufficiently to warrant an overall rating of Outstanding

Satisfactory

– if the bank meets each of the standards for a Satisfactory rating
or

– if exceptionally strong performance with respect to some of the standards compensates for weak performance in others

Needs to Improve or Substantial Noncompliance

– depending on the degree to which a bank's performance has failed to meet the standards for a Satisfactory rating

Intermediate Small Banks

Outstanding

– if the bank is rated Outstanding on both the lending and CD tests or if the bank is rated Outstanding on one test and at least Satisfactory on the other test

Satisfactory

– if the bank receives at least a Satisfactory rating on both the lending and CD tests

Needs to Improve or Substantial Noncompliance

– depending on the degree to which a bank's performance has failed to meet the standards for a Satisfactory rating on a test

Large Banks

Component test ratings that reflect the bank's lending, investments and services are assigned.

Component Test Ratings	Lending	Investment	Service
Outstanding	12	6	6
High Satisfactory	9	4	4
Low Satisfactory	6	3	3
Needs to Improve	3	1	1
Substantial Noncompliance	0	0	0

Preliminary composite rating is assigned by summing the component test ratings for lending, investment and service tests and referring to the chart below.

Points	Composite Assigned Rating
20 +	Outstanding
11 – 19	Satisfactory
5 – 10	Needs to Improve
0 – 4	Substantial Noncompliance

No bank may receive a composite assigned rating of Satisfactory or higher unless it receives at least Low Satisfactory on the lending test. The assigned rating can be no more than three times the score on the lending test.

Strategic Plan

Bank must identify satisfactory measurable goals and, to be considered for an Outstanding rating, must identify a separate group of outstanding measurable goals that substantially exceed the Satisfactory level.

An Outstanding rating will be assigned if the bank exceeds its plan goals for a Satisfactory rating and substantially achieves its plan goals for an Outstanding rating.

A Satisfactory rating will be assigned if the bank substantially achieves its plan goals for a Satisfactory rating.

A Needs to Improve or Substantial Noncompliance rating will be assigned if the bank fails to substantially meet its plan goals for a Satisfactory rating, unless the bank elects in its plan to be evaluated under the appropriate alternative large or small bank assessment method.

All Banks

Evidence of discriminatory or other illegal credit practices adversely affects the evaluation of a bank's CRA performance.

A final overall CRA rating is assigned.

– Banks with branches in just one state will receive one set of component ratings. Banks with branches in two or more states and banks with branches in two or more states of a multistate MSA will be assigned component ratings for each state or multistate MSA.