

The Community Reinvestment Act: Outstanding, and Needs to Improve

Roberto Quercia and Janneke Ratcliffe*
The UNC Center for Community Capital

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 Satisfac-

tory 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

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- 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.ffiec.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

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.

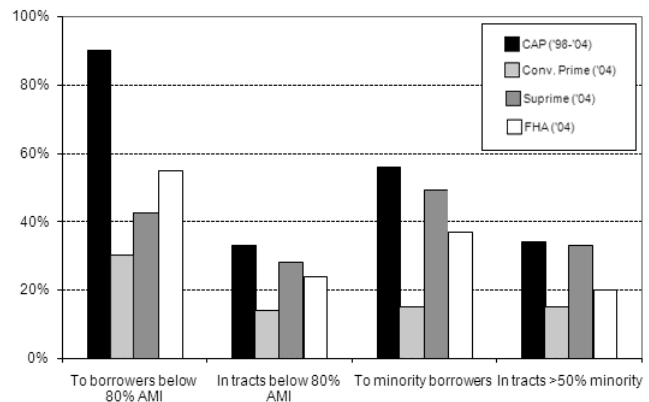
How CAP Loans Serve the Market

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 analysis²⁹ 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 Ratcliffe³¹ 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.

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 Rate³²
(Subprime Loans Compared to CAP Loans)

Suprime Loan Feature			Default Rate of Subprime Loans vs CAP	
			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 eval-

uates 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

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).

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

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 loop-

hole 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.

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/story/ef7d2a9b-3040-48fc-8da8-f71fd8436e8110>.

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. ■

Roberto G. Quercia directs the UNC Center for Community Capital and is a professor of City and Regional Planning and a faculty fellow at the Center for Urban and Regional Studies. Quercia has conducted extensive research on neighborhood dynamics and poverty for government agencies, municipalities, community organizations and private entities, including the U.S. Department of Housing and Urban Development, U.S. Congressional Budget Office, Government Accountability Office, Fannie Mae and the Federal Home Loan Mortgage Corp. He currently serves on the editorial boards of Housing Policy Debate and Housing Studies and on the Research Advisory Council of the Center for Responsible Lending and has held appointments at the University of Texas, the University of California, Berkeley, the Wharton Real Estate Center (University of Pennsylvania) and the Urban Institute in Washington, D.C. He received a PhD in City and Regional Planning from the University of North Carolina at Chapel Hill, an MA in Urban and Regional Planning from the University of Hawaii at Manoa and a degree in architecture from Universidad Nacional de Buenos Aires, Argentina.

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).

Janneke Ratcliffe is associate director for the UNC Center for Community Capital, which she joined in 2005, bringing 20 years experience in financial services and community development finance. She has served as executive director of a small business lending nonprofit. She spent ten years in GE Capital's mortgage subsidiary in risk management, product development, and strategic planning. She worked for seven years at one of the country's leading community development financial institutions where she helped develop a new funding source for commercial lending through the New Markets Tax Credit Program. Throughout her career, she has worked on facilitating the flow of financial services to households and communities.

Michael A. Stegman is the director of policy and Housing for the Program on Human and Community Development at the Chicago-based John D. and Catherine T. MacArthur Foundation. He serves as the Foundation's lead observer of domestic policy issues, working to translate policy trends and position program strategies

in affordable housing, community change, mental health, juvenile justice, education, and urban and regional policy within the larger context of local, state and national policy developments. Stegman is a member of the Richmond Federal Reserve Bank Community Development Advisory Council and an emeritus Fellow of the Urban Land Institute. Prior to joining the Foundation he was the Duncan MacRae '09 and Rebecca Kyle MacRae Professor of Public Policy, Planning, and Business at UNC Chapel Hill, Chairman of the Department of Public Policy and founding director of the Center for Community Capitalism. He has been a consultant to the Fannie Mae Foundation, HUD, the Treasury Department, the Community Development Financial Institutions Fund, and the U.S. Government Accountability Office. During his tenure as Assistant Secretary for Policy Development and Research at HUD, Stegman was named as one of Washington's 100 most influential decision makers by the National Journal. Stegman has written extensively on housing and urban policy, community development, financial services for the poor, and asset development policies.