# 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.

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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

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

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]

*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]

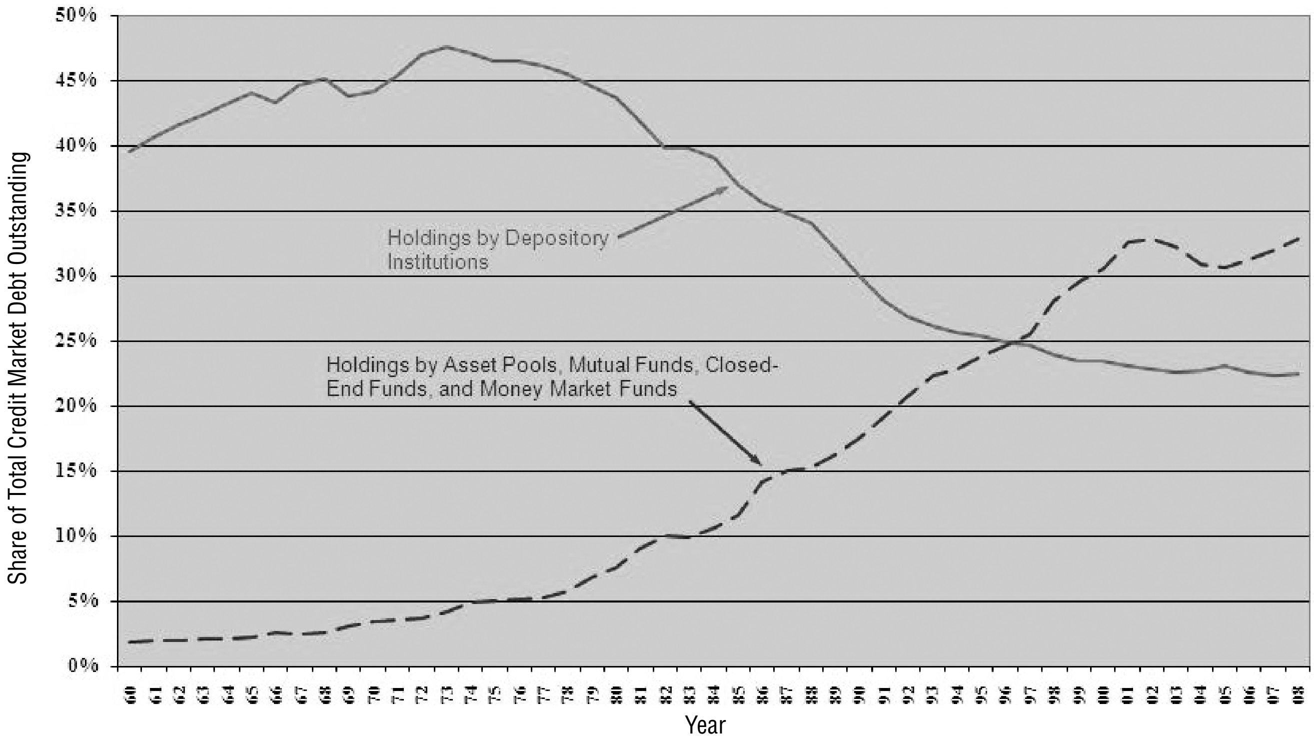
95 *Board of Governors of the Federal Reserve System. Flow of Funds Accounts of the United States. (Washington, DC: FRB, August 2008) available at www.federalreserve.gov/releases/z1/.*

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.*

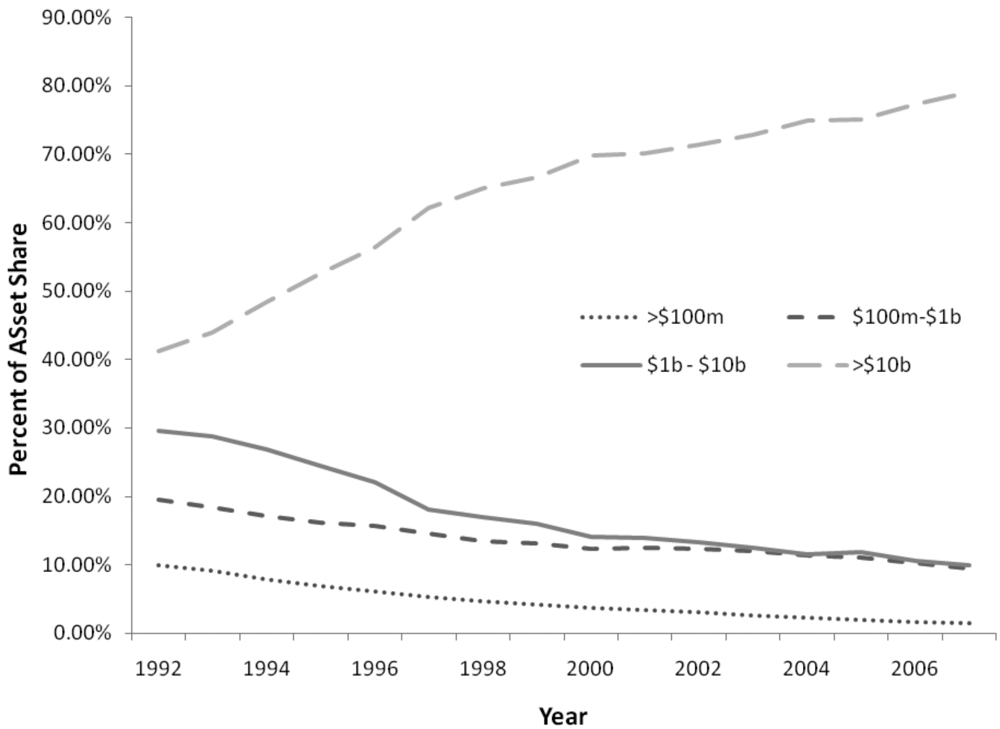
Furthermore, the evolution to global credit markets has made the financial services business more competitive, driven by the rise of nonbank entities, and more dependent on national and international capital markets. One result is that financial products have become more complex and sophisticated, and 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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