

# The Community Reinvestment Act and the Recent Mortgage Crisis<sup>1</sup>

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

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

## Regulatory Efforts to Meet Credit Needs in Underserved Markets

In the 1970s, when banking was still a local enterprise, the Congress enacted the CRA. The act required the banking regulators to encourage insured depository institutions—that is, commercial banks and thrifts—to help meet the credit needs of their entire community, including low- and moderate-income areas. The CRA

does not stipulate minimum targets or goals for lending, investments, or services. Rather, the law provides incentives for financial institutions to help meet the credit needs of lower-income people and areas, consistent with safe and sound banking practices, and commensurately provides them favorable CRA consideration for those activities. By requiring regulators to make CRA performance ratings and evaluations public and to consider those ratings when reviewing applications for mergers, acquisitions, and branches, the Congress created an unusual set of incentives to promote interaction between lenders and community organizations.

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

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

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

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

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

## Evidence on the CRA and the Subprime Crisis

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

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

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

law could have made to the subprime mortgage crisis.

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

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

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

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

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

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

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

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

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

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

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

Unfortunately, the available data on loan performance do not let us distinguish which specific loans in lower-income areas were related to the CRA. As noted earlier, institutions not covered by the CRA extended many loans to borrowers in lower-income areas. Also,

some lower-income lending by institutions subject to the law was outside their local communities and unlikely to have been motivated by the CRA.

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

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

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

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

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

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

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

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

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

## Conclusions

Our findings are important because neighborhoods and communities affected by the economic downturn will require the active participation of financial institutions. Considering the situation today, many neighborhoods that are not currently the focus of the CRA are also experiencing great difficulties. Our recent review of foreclosure data suggested that many middle-income areas currently have elevated rates of foreclosure filings

and could face the prospect of falling into low-to-moderate income status. In fact, 13 percent of the middle-income Zip codes have had foreclosure-rate filings that are above the overall rate for lower-income areas.

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

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

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

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

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