

# The CRA and the Subprime Crisis

BY RENEE COURTOIS HALTOM

The Community Reinvestment Act didn't cause it, but there are still opportunities for improvement

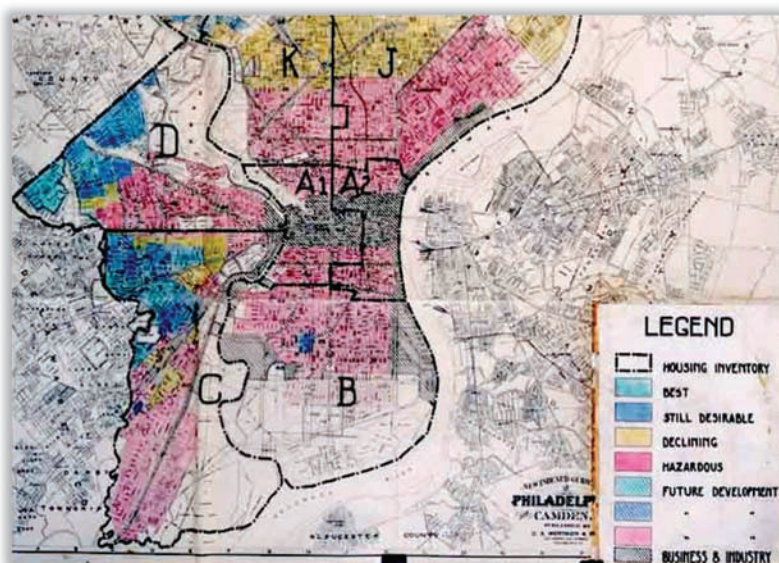
For more than 30 years, the Fed and the other bank regulators have been responsible for evaluating the extent to which banks meet the lending needs of their communities. The Community Reinvestment Act, or CRA, sets this obligation, and regulators can hold up the expansion plans of banks that fail to perform well, so there is strong incentive for them to comply. Since the CRA may push banks into what are perceived to be riskier lending areas, onlookers ranging from think-tank analysts to policymakers have wondered whether it played a large role in fueling the subprime lending boom and bust. Some critics even say the crisis is proof that the CRA should be abolished, while others argue it played at most a small part in the housing boom and bust of the past decade.

The CRA was originally designed to attack the urban decay that took off after World War II. Policymakers viewed the deterioration of urban

cores as partly the result of constrained credit to resident homeowners and businesses. Sometimes this was the result of explicit discrimination through “redlining,” which most CRA historians trace back to a 1930s effort by the federal Home Owners’ Loan Corporation (HOLC), a New Deal-era organization created to prop the real estate industry.

The HOLC was asked to assess real estate lending risks of 239 U.S. cities. Officials drew color-coded maps based on perceived risks and assigned the color red to the riskiest areas, defined in part as having a high concentration of African-Americans. Although the government retreated from explicitly racial policies after a Supreme Court decision in the late 1940s striking down racial deed covenants, banks mimicked the practice and continued to profile neighborhoods into the 1970s. They applied stricter lending terms to the (typically) minority borrowers within those neighborhoods, or refused to lend at all.

Discrimination wasn’t the only cause of constrained credit; market frictions also existed. Borrower risk was harder to assess in the late 1970s when the Act was created, particularly in unpioneered markets. Relatively fewer home sales in underserved areas made real estate appraisals difficult. By the same token, borrowers in lower-income markets tend to have sparser credit history from which to assess risk. The first bank to enter an underserved market had significant work to do to investigate the risks and prospects of borrowers, but once the inroads were made, information proved difficult to keep proprietary. This led to the “first mover” problem in which no bank had sufficient incentive to extend loans or even establish a branch in underserved areas.



*The Community Reinvestment Act was created to prohibit redlining, shown in this Philadelphia area map. Banks literally drew a line around certain low-income, often ethnic, neighborhoods and placed limits on lending to them.*

HOME OWNERS' LOAN CORPORATION MAP FROM THE RECORDS OF THE FILIBY/NATIONAL ARCHIVES

Thus the CRA was created to induce banks to extend loans that they presumably would not have otherwise. This was rationalized by the government support banks receive through deposit insurance and access to the Fed's discount window. Government and ultimately taxpayer support seemed to imply an obligation to meet the credit needs of entire communities, not just the safest lending risks.

The CRA also fit the spirit of the day. Lawmakers passed the CRA in 1977 amidst a chain of similar laws aimed toward strengthening access to credit services for poorer populations and minorities. Those included the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974, both of which focused explicitly on racial discrimination. The CRA's main provisions omit mention of race, instead focusing more broadly on low-to-moderate (LMI) income communities. The Act states that financial institutions have an "affirmative obligation" to meet the credit needs of the local communities in which they are chartered. In practice, banks are rated on three categories of activity — lending to borrowers in LMI communities, investment in community development, and financial services, ranging from the availability of ATMs to financial education — and how that activity is distributed across neighborhoods and borrowers of different income thresholds. The weights applied to each of those categories vary by bank asset size, but lending — consumer, homeowner, small-business loans, among other types of credit — is weighted highest.

There are no explicit lending quotas under the CRA, but regulators can hold up the merger or expansion plans of a bank that fails to achieve a passing rating of "Satisfactory" or "Outstanding." CRA ratings began to be published in 1989, and advocacy groups began to use the newly available data to protest the plans of banks that did not perform well on CRA exams through the public comment process and merger hearings. This intensified the imperative to perform well on CRA exams, especially after restrictions on interstate branching were lifted in the mid-1990s and bank merger applications surged. Banks responded by ramping up their CRA programs.

The CRA's passage in 1977 was not without controversy. Opponents voiced arguments that aren't much different from those of the CRA's critics today: It would distort markets, unduly burden financial institutions, and encourage, if not mandate, unsound lending. The latter argument has escalated following the subprime mortgage lending boom and bust. Many economists, both supporters and opponents of the CRA, argue that it did not play a large role in the crisis. At the same time, most regulators and community development practitioners agree that its current form is somewhat outdated in the modern financial system.

### **Does the CRA Lead to Unsound Lending?**

The role of the banking system is to allocate credit to its most productive uses. The modern banking system is generally based on the premise that banks can accomplish this goal most efficiently if they are able to make loans which are

most profitable to them within the bounds of safety and soundness regulations. Accordingly, the 1977 CRA language emphasized that all CRA-related loans should comply with normal safety and soundness standards. Rather than inducing banks to extend unduly risky loans, the CRA was couched as a way to force banks to look harder to identify profitable lending opportunities in LMI areas that they otherwise might have avoided. If constrained credit was the result of discrimination and market frictions — as opposed to heightened credit risk in LMI areas — then in theory the CRA could increase LMI lending without sacrificing safety or profitability.

Most studies have found that the CRA had a net positive effect on lending to LMI communities, though some mixed results have stemmed from the difficulty of controlling for the myriad other factors that affect lending. For instance, lending to LMI populations has certainly increased faster than higher income lending, but this could also reflect coincident factors such as fair lending laws and a stronger cultural norm against discrimination.

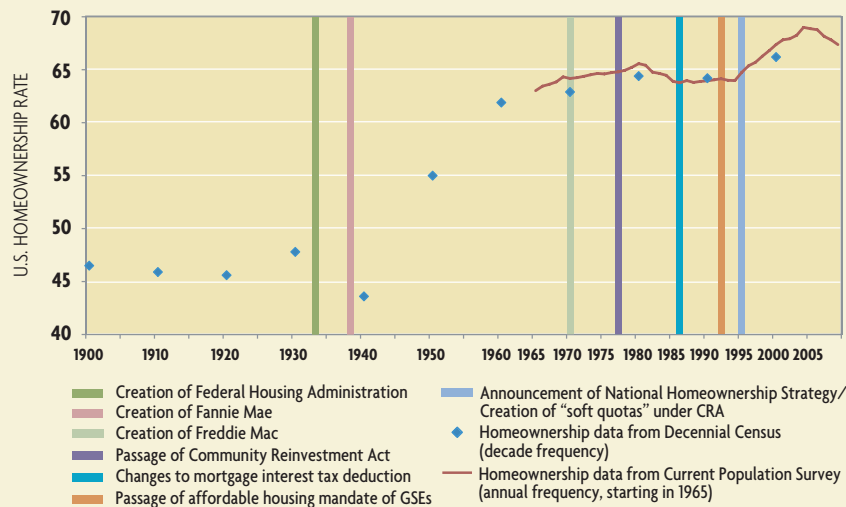
A 2003 study by economists Robert Avery, Paul Calem, and Glenn Canner of the Federal Reserve Board looked at census tracts, or geographic areas, just above and just below the LMI threshold of 80 percent of median family income. At the 1990 census, tracts just below the threshold had lower homeownership and higher vacancy rates than households just above the threshold. By 2000 there was very little difference between them. The CRA would have focused on households just below the threshold, so the authors conclude that at least part of the improvement in LMI households most likely resulted from the CRA.

It is also likely that the CRA resulted in loosened lending standards in some cases. Critics point to at least one significant change that may have had this effect. The original CRA framework consisted of 12 criteria that granted banks credit for attempts to locate LMI lending opportunities. Critics and advocacy groups argued that banks could skirt the CRA's intent by showing they had investigated loan opportunities without actually making loans. In general, practitioners also thought CRA procedures were too vague to be applied consistently. In 1995, CRA regulations were revised with a focus on measurable lending outcomes, and part of the current assessment criteria includes the extent to which banks use "innovative or flexible" lending practices to extend loans. This specificity made CRA examination and compliance much less costly, and, as the Avery, Calem and Canner study shows, LMI lending increased in the same time period.

But the change came with an unintended side effect, according to former Fed governor Lawrence Lindsey, who oversaw CRA regulation during his tenure. Eventually LMI markets became better served, but the new "soft quotas" did not change. "In fact, it would be a real CRA black eye for a bank to reduce the number of loans it was making in a particular area," Lindsey wrote in a 2009 manuscript on the CRA published jointly by the Boston and San Francisco

## U.S. Homeownership and Housing Policy

Many policies historically have explicitly or implicitly supported homeownership.



SOURCE: U.S. Census Bureau

Feds. “[G]iven that the most creditworthy borrowers had already received loans, a somewhat less creditworthy group had to take their place. As time went on, lending standards had to be relaxed to avoid any ‘backsliding’ on an institution’s CRA obligations.”

But the 1995 changes came more than a decade before most of the financial crisis seeds were sown. There have been no substantive changes to CRA regulations since the mid-1990s to cause a major change in LMI lending trends, yet the subprime crisis is rooted mainly in mortgages extended between 2004 and 2007. That implies other factors caused the more recent boom in subprime lending and deterioration of lending standards. One probable factor is that it became increasingly profitable for all types of mortgage lenders, even those not subject to the CRA, to sell mortgages on the secondary market during the recent boom. After good credit risks were met, it appears lenders may have lowered lending standards in order to continue participating in this booming and profitable market.

Data, too, suggest institutions covered by the CRA were not a large enough part of the subprime market to contribute significantly to the crisis. A 2008 Federal Reserve Board of Governors study analyzed 2006 data made public through the Home Mortgage Disclosure Act (HMDA). During the 2005-2006 peak in subprime lending, half the volume of higher-priced mortgages, which researchers often interpret to reflect subprime borrowers, was originated by nonbank mortgage companies not covered by the CRA. Only 6 percent of all higher-priced loans in 2006 were made by CRA-covered institutions or affiliates to LMI borrowers or neighborhoods in their CRA assessment areas, the researchers found.

Those loans performed better than loans made by nonbanks, research suggests. A study of California data during the boom by San Francisco Fed researchers Elizabeth Laderman and Carolina Reid found that mortgages extended in a lender’s CRA assessment area were significantly less likely to be in foreclosure than those extended by inde-

pendent mortgage companies not subject to the CRA, after controlling for borrower, loan, and neighborhood characteristics. Interestingly, the performance of loans made by CRA lenders relative to non-CRA lenders — a statistical output called an odds ratio — is actually better within banks’ assessment areas than outside of them. This may reflect that loans in CRA assessment areas face an additional level of scrutiny by regulators through CRA exams’ on-site reviews and file checks, the authors suggest.

Slicing the data in a number of ways suggests that the CRA does not bear large responsibility for the subprime crisis, even if it encourages lower lending standards in some cases. “There are undoubtedly some legitimate criticisms of the CRA regula-

tions in this regard, but responsibility for the credit cycle is much wider and includes the behavior of borrowers and lenders, regulatory breakdown, and political machinations of both parties,” Lindsey writes.

Perhaps more important is that the spirit of the CRA is reflective of America’s long-standing policy stance in favor of homeownership. Such policies have spanned decades and political parties (see chart). The government has insured mortgages through the Federal Housing Administration, created a vibrant secondary market for mortgages through Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac — in the early 1990s committing those agencies to an affordable housing mandate — and offered a variety of tax benefits reducing the cost of homeownership. Most recently, U.S. homeownership took an upward leap after 1995 when President Clinton adopted the National Homeownership Strategy, the first comprehensive national initiative explicitly designed to push homeownership to record levels. One of the Strategy’s many features was an explicit commitment to reducing lending standards for borrowers who would otherwise not qualify for mortgages. Homeownership went from around 64 percent, where it had more or less hovered for decades, to a peak of about 69 percent in 2004 and 2005.

As Lindsey notes, many factors affect homeownership rather than any one initiative. However, taken together these policies may have conveyed ongoing government support of the housing market and reduced the propensity of lenders, markets, and regulators to question loosened lending standards and investment in housing. As a result of the recent fallout, many policymakers, though certainly not all, now say that the “American Dream” of homeownership is not the right choice for everyone despite its benefits to many.

### Re-asking the Question

There are better-founded criticisms of the CRA than its role in the subprime lending crisis. It has become clear that the CRA in its current form has not kept up with the fast-

changing financial system. Many argue that the CRA's geographic focus is misplaced in an increasingly boundary-less electronic banking system. The share of consumer loans outstanding, for example, that are held by CRA-regulated commercial banks has declined by 40 percent in the last three decades (until the financial crisis, when it recovered some), so the CRA misses a lot of the action. And should lending continue to receive the majority of the weight on CRA exams? The subprime crisis proved that more lending is not always better. Other financial services such as tailored savings vehicles and consumer education could be a better way to support LMI communities.

As academics and regulators consider how to reposition the CRA to fit today's financial landscape, many are also asking again what problem the CRA is intended to solve. Is it meant to correct market frictions? To supplement antidiscrimination laws by altering banks' incentives? To help solve a social problem? The answers to these questions matter for whether and how CRA regulations are updated, broadened, or eliminated.

There is little doubt that the market frictions that appear to have constrained LMI lending are lower today than even 15 years ago. That may partially be a testament to the CRA itself. Banks have become much more skilled at mining profitable lending opportunities in LMI areas. Technological progress and credit-scoring innovations have made it cheaper for banks to assess risks and tailor safe lending products to borrowers who may otherwise be perceived as too risky to consider. Many experts believe the CRA initially helped push banks into lending areas they may have otherwise ignored, eroding some of the information barriers that previously existed. More recently, banks have formed creative partnerships with community organizations in order to identify profitable development and lending opportunities.

These inroads have helped dispel the notion that LMI lending cannot be profitable. A 2000 Board of Governors study commissioned by Congress surveyed large banks about their CRA activity. The 143 responding banks — representing about half the assets of the banking industry at the time — reported that 77 percent of CRA-related mortgages were

at least marginally profitable, compared to 94 percent of the portfolio as a whole (including CRA-related mortgages).

To the extent that market barriers are lower today, the CRA in effect acts as a tool for redistribution. Banks pay an implicit tax for that redistribution equal to the considerable compliance costs and any foregone profits from induced lending. Historically, this has been justified, at least for CRA supporters, as a *quid pro quo* in exchange for government and ultimately taxpayer support of the banking system. (This argument also is one reason why nonbank lenders are currently excluded from the CRA.) The stability that government support buys for the financial system is intended as a public good, but banks undoubtedly benefit. Economists asked whether banks adequately pay for this benefit in the late 1990s when lawmakers were considering the repeal of the Glass-Steagall Act, says economist Lawrence J. White of New York University's Stern School of Business. Government support amounts to a subsidy, argued one side, while the other pointed out the considerable regulatory burden associated with being a bank.

"Banks are subject to extensive regulation at least partly *because* they are special, because they have deposit insurance, because they have access to the Fed," White says. "Do banks benefit from being generally the only provider of financial services who get to offer this insurance to their customers? Yes, of course. But there are lots of other costs that are involved in being a depository institution that sop up much, if not all, of the gain," he says.

Even if banks still aren't judged to be adequately repaying taxpayers for that service, White says, why not make the tax explicit and therefore more efficient? "If that's the desire, levy a tax that would go into a CRA fund. Let's be clear and transparent, rather than levy the tax through this vague, opaque process" — that is, latent redistribution through the CRA.

One positive outcome of the subprime crisis is that the discussions casting undue blame on the CRA seem also to have led policymakers to revisit the law and its possible flaws, bringing immediacy to the resolution of these important issues. **RF**

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