Policy Analysis

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# The Community Reinvestment Act
## Looking for Discrimination That Isn't There

by George J. Benston

## Executive Summary

Congressional attempts to enact banking and financial services reform in recent years have stumbled over the Community Reinvestment Act. That act originally was meant to deal with "redlining," the alleged refusal of banks to lend to residents of poorer urban, often racial-minority areas. But critics maintain that qualified applicants do not, in fact, suffer unwarranted discrimination and that CRA simply adds to the costs of banking, in the end often harming the very consumers the act was meant to protect.

CRA, enacted in 1977, and its 1975 predecessor, the Home Mortgage Disclosure Act, were initially intended simply to collect data on where banks lend money. However, over the years HMDA and CRA reporting costs have increased. Further, CRA is used to delay or prevent banks' acquiring or merging with other banks, closing branches, and the like when no illegal acts are involved.

HMDA and CRA have yielded few benefits to consumers. Researchers using the best available data find very little discernible home-mortgage lending discrimination based on area, race, sex, or ethnic origin. Furthermore, interstate banking; wider branching; and improved technology, which has engendered nationwide—indeed, global—competition, have meant greater availability of mortgage loans. Today there is no indication that qualified borrowers are turned down.

Further, many large banks "cream skim," that is, make loans to the better credit risks in central cities and to minorities to meet CRA requirements. This practice takes business from smaller, often minority-owned banks that have traditionally served those communities and clients.

The Clinton administration wants an even stricter CRA. But more than two decades of its operation suggest that repealing rather than tightening the act would be the economically and socially responsible thing to do.

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*George J. Benston is the John H. Harland Professor of Finance, Accounting, and Economics, Goizueta Business School, Emory University, and a member of the Shadow Financial Regulatory Committee.*

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## A Brief History of the Acts

Racial and gender discrimination by lenders generally has been illegal since 1968, when the Equal Credit Opportunity Act was passed. It was followed by the Home Mortgage Disclosure Act of 1975. Although often seen as the predecessor of the Community Reinvestment Act of 1977, HMDA did not grow out of a desire to prevent racial discrimination in mortgage lending. Ironically, it was enacted in part as a result of the desire of white homeowners, particularly in Chicago, in the 1970s to keep African-Americans from moving into their neighborhoods.[1]

To understand this, it is necessary to recall that African-Americans who had moved from the rural South to northern cities in the 1940s and 1950s faced housing discrimination that confined them to badly maintained and overcrowded inner-city neighborhoods. But by the 1960s the economic conditions of many African-Americans had improved, and they wanted better housing.

In 1968 Martin Luther King was assassinated and riots followed in cities across the country. Many concerned policymakers believed that people would not burn down homes if they and their neighbors owned them. President Lyndon Johnson instructed the Federal Housing Administration to discriminate in favor of minorities, rather than against them as the agency had been doing since its inception in 1934. The FHA designed and guaranteed very-low-down-payment, interest-rate-subsidized mortgages, for which urban properties were eligible. Lenders were encouraged to and did make those loans to minorities and poorer people generally. In Chicago, had only conventional loans been available, relatively few African-Americans could have come up with the required 20 percent down payment or met the stringent credit standards for home purchases. Those strict borrowing criteria were the result of a Depression-era law in Illinois that forced lenders to wait about two years or longer and incur high costs if they found it necessary to foreclose on defaulting mortgage borrowers. Lenders applied those stringent criteria to conventional (not government-guaranteed) mortgages to weed out borrowers who might default.

Many African-Americans who were able to secure FHA-insured mortgages moved into somewhat more prosperous, often white ethnic neighborhoods in Chicago. But sloppy FHA underwriting and fraudulent practices by some real estate firms often forced those borrowers to overpay for houses that were in poor condition and that they could not afford to maintain. The result was abandoned houses and neighborhood deterioration. That is the source of the pejorative term “FHAing a neighborhood.” White residents of deteriorating neighborhoods in Chicago as well as other cities believed that if banks and thrifts were forced to make conventional loans in their neighborhoods, then only buyers who were unlikely to default (people like them) would purchase local property. Residents of other cities experienced similar situations as houses bought by poorer people with almost-no-down-payment FHA-guaranteed mortgages were abandoned when the owners could not meet payments or repair and maintenance costs.

Furthermore, studies by community activists in the early 1970s revealed that banks and thrifts made many more mortgages on suburban properties than on houses in the cities.[2] The authors of those studies claimed that the lending patterns they found were the result of banks’ and thrifts’ refusing to make mortgages or home improvement loans on central-city properties, thereby causing those areas to deteriorate.

HMDA, enacted in 1975, was designed to make banks’ and thrifts’ mortgage lending practices more transparent, presumably to pressure or shame them into making more central-city mortgages. The act simply required lenders to report the number and amount, but not the terms, of mortgages made (and, since 1990, applied for but denied) by census tract. Those data were supposed to allow banking supervisors and the public to determine the extent to which individual lenders were serving their communities.

But the Indianapolis, Brooklyn, and other studies on which HMDA was based did not take account of loans made by mortgage bankers or privately funded mortgages, neither of which was covered by the act at that time, and both of which were more common in the central cities than in the suburbs. The studies also did not consider that differences in lending might reflect greater demand for mortgages in the suburbs, or other relevant factors.

Supplementing HMDA was the Community Reinvestment Act of 1977. That law was based on an incorrect belief that banks and thrifts actually "redlined" communities. Then-senator William Proxmire (D-Wisc.), principal sponsor of CRA, expressed the accepted view at that time:

> By redlining . . . I am talking about the fact that banks and savings and loans will take their deposits from a community and instead of reinvesting them in that community, they will invest them elsewhere, and they will actually or figuratively draw a red line on a map around the areas of their city, sometimes the inner city, sometimes in older neighborhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighborhood.[3]

Like HMDA, CRA was directed only at banks and thrifts; other mortgage lenders were excluded. (Unlike HMDA, CRA still covers only banking organizations.) Banks' lending practices with respect to neighborhoods and poorer people are separately examined by special supervisory staffs of several federal regulatory agencies, and those evaluations are made public. From the politician's point of view, this is an inexpensive way to address an alleged problem, since it does not require major expenditures of government funds.

At the time CRA was enacted, bankers were not too upset. They were not required to allocate funds to particular areas of cities or to particular borrowers, nor were they forced to make unsound loans. Rather, banks and thrifts were simply subject to criticism if they did not appear to adequately serve their market areas, as defined by banking supervisors. But normally those banks suffered few penalties in the early years of CRA.

A bank would face a serious potential problem, though, if it had to get approval from regulators for some change in its status, such as merging with or acquiring another bank. In that case, complaints might be lodged against the bank and regulators might refuse to honor the bank's request, even if the bank previously had received a satisfactory CRA rating. However, at that time, restraints on branching and the prohibition on interstate banking limited banks' demands for regulatory approval.

## Evidence of Geographic Redlining

Academic researchers have studied the redlining allegation and found it wanting.[4] Those studies did not rely on HMDA data alone, because those data did not provide information on mortgage terms, borrowers' financial situations and credit histories, the supply of mortgages from lenders other than banks and thrifts, and, of great importance, the demand for mortgages in central-city compared with suburban areas. Indeed, many studies did not use the HMDA data at all.

Two such studies compared the demand for and supply of home mortgages in four cities—Rochester, New York; Cincinnati, Ohio; Indianapolis, Indiana; and Nashville, Tennessee.[5] My colleagues and I chose those cities because community groups claimed that their central areas were redlined. We gathered data on mortgages made in the allegedly redlined central areas and roughly comparable suburbs of those cities; our data

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included interest rates, maturities, and down payments, as well as house prices and characteristics of properties. We included loans made by mortgage bankers and other lenders. Buyers of homes in the older, central-city neighborhoods and buyers of homes in suburban areas of the same cities were interviewed to learn of their mortgage-related problems. Neither group experienced much difficulty in obtaining the mortgages (FHA or conventional) they wanted. In particular, buyers of suburban homes said they were not kept from buying homes in the central cities because of problems in obtaining mortgages. We estimated unmet demand for mortgages by interviewing central-city homeowners who had tried to sell their houses. Those people, we reasoned, would know whether or not potential buyers had problems getting mortgages, perhaps because of redlining. Almost none said that a sale had not been made for that reason (and those few who complained said that only blacks could get loans). Nor did homeowners in the central cities complain that they were unable to obtain home improvement loans. Other well-structured studies also found no evidence of redlining or unwarranted geographic discrimination.[6]

Thus, the claim that lenders redlined or were biased in making loans for the purchase of homes in central cities is not supported. Nor did the studies find that financial institutions discriminated against actual or potential borrowers on the basis of the racial or ethnic composition of neighborhoods.

## Charges of Racial Discrimination

Renewed concerns that loans were being denied to potential homeowners, in this instance on the basis of race, were themselves based on several factors. A number of newspapers published exposés beginning in 1988 that analyzed the HMDA data that were readily available from the Federal Reserve Board in computer-readable form. The *Atlanta Journal-Constitution* published a series in May 1988 that was awarded a Pulitzer Prize. A *Detroit Free Press* series ran in June 1988, and the *Washington Post* series was published in June 1993. Those articles included maps and charts showing the racial composition of census tracts together with the number of mortgages made by reporting banks and thrifts. Those data, which still did not include loans made by mortgage bankers and privately funded mortgages, gave the impression that banks and thrifts were making fewer loans than were demanded in predominantly black areas.

### More Denials of Black Applicants

In 1989 HMDA was amended as part of the Financial Institutions Reform, Recovery, and Enforcement Act. That amendment required all mortgage lenders, not just banks and thrifts but mortgage banks as well, to report the race or ethnic origin, gender, and annual gross income of loan applicants. A Federal Reserve Board analysis of those 1990 data, covered widely in the press, revealed that African-Americans were more likely than other racial groups to use Federal Housing Authority or Veterans Administration loans, 52 percent compared to 25 percent of white borrowers.[7] Further, two-thirds of lower-income black homebuyers purchased homes in the inner city, compared to two-fifths of whites. In addition, acceptances of loan applications were considerably lower in largely minority census tracts, 57 percent compared to 76 percent. Press reports especially focused on figures that seemed to show higher rates of denials of African-American and Hispanic applicants who had about the same reported income as whites. Federal Reserve Board economists tried to explain that the HMDA data did not take account of differences in the mortgage applicants' wealth as well as liabilities, employment history, and credit record, among other relevant variables that lenders should and do consider. But reporters downplayed or ignored those points.

In 1992 researchers at the Federal Reserve Bank of Boston attempted to deal with the limitations of the HMDA data by collecting information on some 30 variables that they believed were related to lending decisions.[8] They found that much, but not all, of the difference between minority and nonminority denial rates was explained by those variables. Their finding of an average remaining black denial rate of 17 percent compared to a denial rate of 11 percent for whites was widely publicized.

Subsequently, David Horne, an economist at the Federal Deposit Insurance Corporation, analyzed the 70 FDIC-supervised banks studied by the Boston Fed. As reported in his 1997 study, Horne found some important mistakes in the data.[9] For example, 69 applicants were recorded as having negative net worth (57 of them were approved for mortgages), and 116 applications were for loans that were supposed to have been excluded from the study (e.g., refinancings and investments). He found that including more relevant measures of the borrowers' credit history, such as past delinquencies and whether the borrower met the lenders' credit standards, the lenders' inability to verify the data submitted by the applicant, and information about the borrowers' ability to cover closing costs, explained the divergence in denial rates of black and white applicants. Furthermore, 49 of the 70 banks (70 percent) did not reject any minority loan applications; 2 of the remaining 21 banks were responsible for over half the denials of black applicants. Both of those banks, one of which was minority owned, had conducted extensive minority outreach programs and participated actively in affordable-housing programs. In addition, Harold Black applied the Boston Fed model to black- and white-owned banks operating in the same standard metropolitan statistical area.[10] He found that black applicants were denied loans at significantly higher rates by the black-owned than by the white-owned banks.

It is neither surprising nor evidence of racial discrimination that banks specializing in loans to minorities have high denial rates. Those banks are likely to get a large number of marginal applicants and, hence, will have a relatively large percentage of denials. On the other hand, a bank that discriminated against African-Americans would have had a very low denial rate for those borrowers, if that bank let realtors know that it would consider applications only from financially "very well qualified" individuals and that it would "very carefully" scrutinize applications by "certain" individuals.

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### Defaults by Black Mortgagors

Data on defaults might seem to be a good way of learning whether lenders discriminate against African-Americans. If lenders discriminated by accepting only the most creditworthy black applicants while accepting marginally qualified white applicants, whites would default proportionately more than blacks. In fact, there are no studies that report this finding, and several that report the contrary.[11]

However, the fact that the available data show higher average default rates for black than for white mortgagors should not be interpreted as demonstrating that lenders discriminate against whites, that is, accept only the best-qualified white borrowers but marginally qualified black borrowers. Higher default rates for blacks compared to whites need not be racially determined any more than a higher rate of denial is racially determined. Rather, both statistics could be due to other factors that happen to be associated with the borrowers' race.

A 1996 analysis by Robert Avery and colleagues examined factors related to defaults on mortgages made through special "affordable-housing" programs to low- and moderate-income households.[12] That inquiry found that the Federal Home Loan Mortgage Corporation's (Freddie Mac's) "Affordable Gold" loans, which go to poorer applicants, had a 60-day delinquency rate that was about 50 percent higher than that of a control group of traditionally underwritten mort-

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gages with similar loan-to-value ratios and dates of origination for similar types of property in similar regions of the country. The most important reason for the higher delinquencies was a shortfall of mortgagors' funds to make down payments and other outlays. Indeed, Affordable Gold mortgagors who were allowed to meet part of the minimum down-payment requirement with funds provided by a third party had delinquency rates four times higher than the control group. In those cases loans were made to individuals with marginal qualifications, exemplified by the fact that they could not meet down payment requirements. The mortgagors' race was not the relevant factor.

Three private mortgage insurance companies, Mortgage Guarantee Insurance Corporation, GE Capital Mortgage Insurance Corporation, and United Guarantee Corp., also analyzed delinquencies among their "affordable-housing" mortgagors.[13] They also found much higher delinquency rates on loans for which the borrower received much of the down payment from the seller or another third party. Further, they found much higher delinquency rates among mortgagors with no or adverse credit histories, higher ratios of debt payments to income than the traditional guideline levels, and less than one or two months of cash reserves at closing.

Recall that, to reanalyze the Boston Fed's data, FDIC researcher David Horne used measures of credit risk similar to those found to be related to defaults. With those variables included, there was no evidence of racial discrimination. Thus, it appears that there is reason to doubt that Boston banks denied mortgages to African-Americans because of their race. Indeed, there is very little evidence of racial discrimination by any banks or thrifts.[14]

### CRA and Mortgage Lending to Minorities and in Poor Neighborhoods

Three aspects of bank lending (or failure to lend) to minorities and people who want to buy homes in poor neighborhoods should be examined: (1) the risks and profitability of such lending; (2) the effect of CRA and HMDA on loans made to and in presumably discriminated-against people and areas; and (3) the effect of this lending on neighborhood revitalization.

*Risks and Profitability.* Evidence on the first aspect is provided in the *Report to Congress on Community Development Lending by Depository Institutions*, submitted by the Board of Governors of the Federal Reserve System.[15] Section 910 of the Housing and Community Development Act of 1992 required this report to compare "the risks and returns to insured depository institutions of residential, small business, and commercial lending in low-income, minority, and distressed neighborhoods with the risks and returns of such lending in other communities." That detailed report contains a wealth of data comparing profits, defaults, and nonperforming loans according to various personal factors. Included are data on race and income, type and amount of loan, and type of property being sold. Overall, the report found no consistent relationship between risk to lenders and the profitability of loans and the average income level of the residents of a neighborhood or a neighborhood's racial or ethnic composition. The study also found that banks that made loans to minorities and on properties located in distressed areas were not more profitable than other banks.

These relationships were examined further in a 1997 study by Federal Reserve Board economists Glenn B. Canner and Wayne Passmore. They extended and confirmed their earlier (1995) finding that banks that made relatively more loans to people living in poorer areas and minority areas were as profitable as banks that did almost no or only a moderate amount of such lending.[16]

Thus, it appears that banking organizations and other institutions make loans to minority and lower-income borrowers for the same reason that businesses in general serve the public—to generate profits with an acceptable level of risk. Not surprisingly, then, research finds that banks making mortgages to minorities and poorer borrowers are not adversely affected.

Perhaps of greatest importance, the profitability/risk findings are inconsistent with the claim that potential minority borrowers or distressed neighborhoods suffer unfair discrimination. If such discrimination were taking place, banks that served minorities and poor neighborhoods would tend to be more profitable and incur less risk. This would be because they could charge higher rates and cream skim in those neighborhoods, that is, make only the most profitable, least-risky loans.

*Effect of CRA on Additional Loans.* The second aspect to consider is whether the CRA examinations and reports and the newspaper articles using HMDA data actually pressure or encourage banks to make additional loans to low- and moderate-income homebuyers. Federal Reserve economists studied changes in home purchase loans made to lower-income and minority households and on properties located in lower-income and minority neighborhoods during 1992–93 and 1993–97.[17] They found that these mortgages increased by a much higher percentage than did similar loans made to high-income and white homebuyers. The percentage increase was greatest for minority homebuyers. For example, between 1993 and 1997, mortgages made to all borrowers increased by 30 percent, while mortgages made to minority borrowers increased by 63 percent.

However, when the data are examined closely, the possible relationship between increased CRA enforcement or awareness and a relatively greater increase in mortgages to low-income black and other minority homebuyers in low-income neighborhoods is not clear. Douglas D. Evanoff and Lewis M. Segal, economists at the Federal Reserve Bank of Chicago, examined data through 1995 and found that the growth in mortgage lending during the early 1990s, when CRA reporting and enforcement accelerated, was not much different from that experienced earlier.[18] Those economists took into account the variables usually associated with the number of new mortgage loans, such as the number of house sales. Poor neighborhoods did experience greater growth in mortgages relative to richer neighborhoods in the 1990s, but the rates of increase were about equal before and after 1992. Approvals of applications from low-income homebuyers increased more than approvals of applications from the other groups in 1991 and 1993 but not in the other years through 1995. New mortgages on homes in poorer neighborhoods grew at rates similar to those for homes in richer neighborhoods. New mortgages for blacks and other minorities increased proportionately more than those for whites in the period 1993 through 1995. Denial rates for blacks and other minorities appear to have declined somewhat over the 1990s.

Additional evidence is provided in a 1999 study by Federal Reserve Board researchers of home-purchase mortgages made by banking organizations (banks and thrifts), to which CRA applies, and other mortgage lenders (mortgage bankers and credit unions), which are not subjected to CRA but must report data as required by HMDA. Avery et al. measured home-purchase lending in 1993 and 1997 in counties that had and did not have branch offices of banks.[19] They reported the numbers for all, minority, and low-income borrowers and for loans made on properties in minority and low-income neighborhoods.

In 1993 and 1997, institutions not subject to and subject to CRA made about the same percentage of mortgages to lower-income borrowers and neighborhoods as they did to all borrowers; about 60 percent of those mortgages were made by banking organizations and 40 percent were made by other institutions. However, lenders *not* subject to CRA made a somewhat higher percentage of the mortgages obtained by minority borrowers and neighborhoods than did banking organizations—about 55 percent compared to 45 percent.[20] Furthermore, banking organizations made a substantial number of

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mortgages in counties in which they did not have branch offices, an extension that is not required (indeed, that might be discouraged) by CRA, which encourages banking organizations to serve their local communities. In 1997 those lenders made about the same number of loans to lower-income and minority borrowers and in lower-income and minority neighborhoods in counties where they did and did not have branch offices. Thus, market forces rather than CRA seem to be driving the provision of mortgages.

*Neighborhood Revitalization.* The evidence on the first and second aspects of lending by banks (profitability/risk and mortgages made) bears on the third aspect—the effect of CRA and HMDA on neighborhood revitalization. Although CRA may (or may not) have encouraged banks to make mortgage loans to poorer and minority homebuyers, there is no evidence, one way or the other, that it has fulfilled its mandate to aid communities.

Perhaps there have been no studies of the effect of CRA on neighborhoods because the answer is obvious. The market for mortgage lending has been very competitive. Standardization of mortgages and the expansion of Freddie Mac and Fannie Mae (originally the Federal National Mortgage Association), together with and partially driven by improvements in technology, have resulted in a national, indeed, an international, market for home mortgages. There are no barriers to the entry of mortgage bankers. In most communities, potential homebuyers and real estate brokers can place mortgages with dozens, often hundreds, of lenders. Newspapers carry comparative rates. Information and applications can be obtained by telephone inquiry, and mortgage bankers often will come to the applicant's home. Mortgages also can be made through the Internet.

Consequently, it is very likely that all profitable demand for mortgages is met. Indeed, in 1996 Federal Reserve of Richmond economist Jeffrey M. Lacker reviewed much of the evidence on redlining and racial discrimination. He concluded, "There is little conclusive evidence that banks fail to meet the credit needs of low-income neighborhoods per se."[21] Even if there are some lenders who are racially biased, are not competent to deal with minorities, or misperceive the risks and misestimate the costs of dealing with people who are different from themselves, it is very likely that other profit-seeking lenders would gladly take the business.

## Extension of CRA

In 1989 the scope of CRA examinations and reports to the public was expanded. Banks and thrifts were rated by examiners on 12 "assessment factors." Two factors evaluated how well the institution dealt with community groups, three with the institution's marketing efforts, two with the geographic distribution and record of opening and closing offices, three with community development, and only two with overt discrimination. With the exception of a few quantitative measures, the evaluations necessarily were subjectively determined by the examiners.

Despite the evidence that banks were lending profitably but not overprofitably to minorities and in poor and distressed communities and despite the absence of any study showing that potential borrowers in those areas were not well served, in 1993 federal banking regulators proposed greatly extended and much more detailed and costly CRA reporting requirements. If those requirements had been adopted, banks and thrifts with more than $250 million in assets would have had to report greater amounts of data on the number and amount of loan applications, denials, approvals, and purchases by census tract for 10 kinds of loans—those to consumers, small farms, four sizes of small businesses, and for four types of residential real estate. Smaller banks would have been subject to somewhat simpler, but still considerable, reporting requirements. The Shadow Financial Regulatory Committee, a private group of academic economists and lawyers who specialize in financial services, reviewed and opposed this proposed change. In Statement 105, February 14, 1994, the SFRC said:

> There is little evidence that CRA has had an appreciable impact on credit flows to disadvantaged communities and persons. Rather, it has evolved into a costly and ineffective credit allocation scheme that tends to benefit primarily those vocal special-interest groups capable of extracting concessions from lenders. Past experience has shown credit allocation programs to be expensive to administer, difficult to target, virtually impossible to monitor, and ineffective in helping targeted borrowers.[22]

The regulatory agencies partially withdrew the proposed change. In May 1995 new CRA regulations to be phased in over two years were issued by the federal banking regulatory agencies. The first data-reporting requirements took effect in 1996. CRA examinations under the new rules started in July 1997. The new regulations exempted smaller banks, those with assets under $250 million that were not affiliates of a $1 billion or larger holding company, from the reporting requirements. Those smaller banks, nevertheless, were still subject to CRA requirements, but with less well-defined factors being measured and, perhaps as a consequence, even greater exposure to subjectivity on the part of examiners.

The 12 assessment factors against which banks had been evaluated were replaced with 3 new tests: lending (the most important), investment, and service. Data on loans made to residential homebuyers, as per the HMDA reports, and loans under $1 million made to small businesses and farms (those with revenues below $1 million) had to be reported by census tract. Investments to be measured include support of community development banks, other than loans; purchases of securitized mortgages on multifamily houses located in low- and moderate-income areas; and contributions to community groups. The service measure reflected primarily the placement of branches in low-income communities.

Although the distribution of loans measured by the new tests was somewhat more quantitative than that measured by the 12 assessment factors used before 1995, the evaluation by examiners was still subjective. The General Accounting Office reviewed the new guidelines, found that they presented problems similar to the ones presented by the previous regulations, and recommended that significant efforts be made to improve examiner training and the quality of data used in evaluating performance.[23]

CRA reports are supposed to help determine the extent to which all banks taken together make loans to borrowers in low- and moderate-income areas and to small businesses. There is no guarantee that such potential borrowers receive particular percentages of mortgage loans. An analysis of 1993 HMDA data by Canner and Passmore shows that relatively few loans are made to or, apparently, demanded by individuals in low-income areas. Canner and Passmore point out that there are likely to be economies of scale in serving that market, and they find that some banks and thrifts specialize in making loans to such potential borrowers. Those banks are as profitable as are other banks, which indicates that low-income borrowers and areas are well served.[24] Direct measures of possible unmet demand, in any event, cannot be obtained from HMDA data or CRA reports.

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## Adverse Effects of CRA

CRA has been costly to banks and thrifts, both directly and indirectly. A direct cost that affects all banks is preparing the required HMDA and CRA reports. Other direct costs include hiring compliance officers, dealing

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with CRA examiners, and meeting with community groups. Indirect costs include delay in obtaining regulatory approval for mergers, acquisitions, and branch changes; legal and other costs incurred in replying to complaints, despite the banks' having previously received satisfactory CRA reports; and "paying off" community activists by making unprofitable and loss loans to people and groups they favor.

Anjan V. Thakor and Jess C. Beltz found that, in 1992, CRA cost the 445 relatively small banks that they surveyed 4.5 percent of their pretax income and 0.25 percent of their total assets, on average.[25] They found that costs are higher for smaller banks and banks located in more highly populated areas. For large banks the relative amounts probably are considerably smaller than the percentages reported by Thakor and Beltz.

CRA also has had at least three important adverse effects on borrowers and distressed neighborhoods. First, it appears that loans made by banks attempting to fulfill CRA obligations have simply drawn customers from other lenders who otherwise would have served them, although perhaps on less beneficial terms to the borrowers. In particular, minority-owned banks have complained that they suffered from having to compete with subsidized lending by banks that are willing to make unprofitable loans to obtain regulatory approval of a merger or acquisition. There is reason for concern that future minority borrowers will be poorly served, because the banks that previously would have served them will have been driven from the market and the banks that no longer need regulatory approval will no longer offer subsidized loans to minorities.

Second, CRA makes it almost impossible for banks to close branches in distressed neighborhoods. Although keeping such branches open might benefit some people, it has the unintended adverse effect of discouraging other regulated institutions from entering minority neighborhoods and offering banking services that might turn out to be unprofitable. Consequently, individuals who could benefit from checking, savings, consumer loans, and other banking services will be denied the convenience and benefits of competition by additional institutions.

Third, some borrowers are likely to be harmed by the CRA policy of requiring all banks to be involved in lending to members of specified groups. A bank might have expertise in lending to members of some other group (such as Polish-Americans or Chinese-Americans) or to companies that happen to be owned by persons other than those considered by CRA examiners to be disadvantaged. If all banks must show that they seek to serve a specified group, nonspecified groups are likely to be served less well.

## Discovering Lending Discrimination

Given CRA's and HMDA's considerable cost and few discernible benefits, should those laws be repealed? Because racial discrimination has been an unfortunate part of American history, some might argue that it is not enough that minorities as a whole are being well served by the banking system as a whole. Consequently, policymakers should ensure that not even one bank is allowed to discriminate unfairly in lending or that not even one individual suffers unfair discrimination. To that end it might be argued that, if not for HMDA data and CRA reports, regulators and the public would not know whether or not a bank was discriminating unfairly against some members of certain groups.

But more effective and less costly procedures are now being used by the federal banking agencies. For several years now, bank examiners have been applying statistical models to determine the extent to which individual banks might be discriminating unfairly against minority and female mortgage applicants. Using a bank's mortgage application data, the models take into account the expected relationship between specified borrower and property characteristics and predict whether a loan might be expected to be granted or denied. The Federal Reserve has used general models, such as that developed by the Federal Reserve Bank of Boston for its 1992 study.[26] The Office of the Comptroller of the Currency has employed models that take into account the situation at individual banks.

Mitchell Stengel and Dennis Glennon, economists at the OCC, report that those bank-specific models are much more reliable than general models. Indeed, they find that general models (such as the Boston Fed model) indicate discrimination against minorities, while the OCC's model, which takes into account the actual procedures used by individual banks, does not.[27]

Whether general or bank-specific models are used, loans that are granted or denied contrary to expectation (as predicted by the model) are examined further to determine if the race, ethnicity, or gender of the applicant or borrower played a role.

Unfortunately, the federal regulatory agencies have not made the data and results of those examinations available to the public. From personal inquiries, I have learned that they have found very few, if any, instances in which there are not good business or other explanations for mortgages not having been made to minorities or women or that were, but should not have been, made to majority or male applicants. Among those explanations are additional borrower-specific data that were not included in the model (such as aspects of the applicant's credit record), data corrections that were misrecorded (but not changed) in the application (such as misstated employment and sources and amounts of income and sources of down payments), and loans that were miscoded as ordinary mortgages (applicants were turned down because they did not qualify for special programs).

However, the federal banking agencies should undertake a systematic study of the examiners' data. They should report whether many, only a few, or no banks have discriminated unfairly against potential mortgagors. The percentage of minority and female applicants for mortgages that, upon detailed examination, appears to have been denied unfairly should be presented in a report, much as the limited and potentially misleading HMDA denial data are now reported.

Some evidence, though, may be gleaned from actions taken by the Department of Justice. The Federal Deposit Insurance Corporation Improvement Act of 1991 requires bank regulatory agencies to refer to DOJ cases in which they have "reason to believe" there is or they perceive to be a "pattern or practice" of possibly illegal discrimination. Of the some 8,000 banks and thrifts that are examined annually for compliance with CRA and the anti-discrimination statutes, the banking agencies referred 4 in 1992, 13 in 1993, 25 in 1994, and 10 in 1995.[28] Of those 48 referrals, legal action was taken in 6 cases (4 of which were settled by consent agreements, with complaints filed in 2), 23 were returned to the bank regulators for administrative action, and 9 were dismissed because no cause was found or there was insufficient information. In addition, on the basis of HMDA data, DOJ independently brought 10 actions, 9 of which were settled with consent decrees. Even assuming that the DOJ complaints were valid, it appears that very few banks are discriminating unfairly.

In addition, the U.S. Department of Housing and Urban Development is charged with enforcing the Fair Housing Act and other civil rights laws. It makes referrals to the DOJ, makes grants to private organizations to investigate possible FHA violations, and itself investigates complaints. From 1989 through 1995 HUD processed 2,356 fair lending complaints brought against real-estate lenders and companies. Of those, 896 cases, or 38 percent, were "conciliated," that is, HUD brokered a deal between bank and borrower. Another 720 cases, or 31 percent, were dismissed administratively, apparently because HUD found them to be without merit. And in 717 cases,

**In 1992 CRA cost 445 relatively small banks 4.5 percent of their pretax income and 0.25 percent of their total assets, on average.**

The Equal Credit Opportunity Act constrains bank employees' ability to communicate with potential borrowers.

or 30 percent, HUD investigated and found that no violation had occurred. In only 23 cases, or 1 percent of the total, did HUD find lenders guilty of unfair discrimination. HUD referred only 9 of those 23 cases to DOJ.[29]

## Helping Minority Homebuyers

The fact that potential borrowers are rarely denied loans because of economically irrelevant characteristics does not imply that the poor or minorities have an equal chance to obtain mortgage loans. Often they are inexperienced in the borrowing process. They often do not know whether or not they have the financial assets to buy and maintain a home, or what they must do to qualify for a loan. Some bankers have attempted to help such borrowers understand the mortgage lending process so they can decide whether they can become homeowners. However, the exercise usually is costly and beyond most bankers' experience. Furthermore, many of the individuals most in need of help are not comfortable asking bankers for that help or receiving it from them.

Fannie Mae has developed a means of helping poorer and inexperienced people get through the borrowing maze. Its interactive computer program that is made available to community counselors "walks" potential homeowners through a series of questions about the location and price of a house they want to buy and their ability to qualify for a mortgage and afford to own the house.[30] Information about the potential homeowner's credit record is downloaded from the files of the principal credit information companies, and the counselor puts in the applicant's salary, savings, and financial obligations. The program determines whether the person qualifies for various supported lending programs and puts in the applicable interest rate and down payment.

If such loans cannot be obtained, the interest rate and fees on other loans are put in and the program computes the required monthly payment, down payment, and closing costs. If the person cannot qualify for a loan, the program indicates the changes that are required, such as improving the person's credit standing, finding a less expensive house, and increasing the down payment. The program can construct a budget showing how the person can save enough for the down payment. Alternatively, the counselor can advise such would-be borrowers that they cannot afford to buy and maintain a house. If the person does qualify, the program completes a loan application and forwards it to lenders who have agreed to accept such applications. If the lender verifies or accepts the accuracy of the information, a loan is made.

It would be excessively costly for most banks to provide this service to many low-income potential homebuyers. One reason is that the Equal Credit Opportunity Act constrains bank employees' ability to communicate with potential borrowers. Bank employees' advice on what an applicant must do to qualify for a loan triggers a formal application with the required documentation and disclosures. This paperwork is fraught with potential for error, which could result in severe regulatory penalties. Hence, most banks permit only highly trained employees to accept applications. In addition, bank employees who advise minorities not to buy houses or to look for less expensive houses might be charged with discrimination. In either situation, the potential homebuyer, as well as the bank, would not be well served.

## The Case for Repealing HMDA and CRA

The rationale for both HMDA and CRA is not valid today and probably was not valid when those laws were enacted. Nevertheless, those "disclosure" statutes have been expanded to require ever more detailed and extensive reporting. The agencies charged with enforcing the statutes and evaluating those reports have created bureaucratic structures involving extensive costs in agency personnel, reporting costs to regulated institutions, and even micromanagement of financial institutions.

HDMA and CRA were predicated on the assumption that the banking and thrift industry failed to deliver adequate credit services in some urban neighborhoods and on the belief that significant improvement could result from supervisory pressures. No credible evidence has been published demonstrating the validity of the assumed credit failure. As scholars have looked deeper into mortgage lending, they have found little evidence of unfair discrimination against individuals on the basis of race or gender. Very few of the nation's more than 14,000 depositories have even been charged with illegal discriminatory practices.

Further, the evolution of financial markets over the past 25 years has eroded materially any market monopoly position that banks and thrifts might once have enjoyed. Other providers of credit, such as mortgage companies, credit unions, and finance companies, continue to increase their share of the market at the expense of banks and thrifts. Indeed, Avery et al. report that the nonbanks made about 38 percent of the mortgages in the 1993–97 period (the total does not include lenders who do not report HMDA data).[31] In addition, banking deregulation that allowed interstate banking and encouraged intrastate branching has created even more competition and access to loans. Lending via the Internet has further expanded homebuyers' access to mortgage loans.

HMDA and CRA may have forced some banks and thrifts to serve some customers whom they previously did not serve. It is not clear, though, that those customers would not have been well served by other lenders or that the loans made actually benefited the borrowers or the neighborhoods in which they bought houses. It is clear that competition and just good business sense have been effective in encouraging most, if not all, banks to offer loans to creditworthy mortgagors without regard to their race, gender, or other irrelevant personal attributes. Thus there is no case for and every case against retaining CRA and HMDA.

**Competition and just good business sense have been effective in encouraging most, if not all, banks to offer loans to creditworthy mortgagors without regard to their race, gender, or other irrelevant personal attributes.**

## Notes

1. George J. Benston, "Mortgage Redlining Research: A Review and Critical Analysis," Federal Reserve Bank of Boston, Conference Series no. 21, October 1979, pp. 144–46.

2. Among those studies are "Why Do Neighborhoods Deteriorate? Red-Lining in Indianapolis," Coalition to End Neighborhood Deterioration, 1975; and "Take the Money and Run! Redlining in Brooklyn," New York Public Interest Research Group, Inc., 1976. Nine of these studies are described and critiqued in George J. Benson, Dan Horsky, and H. Martin Weingartner, *An Empirical Study of Mortgage Redlining,* Monograph Series in Finance and Economics, no. 1978-5 (New York: New York University Graduate School of Business Administration, Salomon Brothers Center for the Study of Financial Institutions, 1978), pp. 4–34.

3. *Congressional Record*, June 6, 1977, S. 8958.

4. Notable among these are Richard F. Muth, "Yields on Inner-City Mortgage Loans," Federal Home Loan Bank of San Francisco, 1979; and Andrew L. Holmes and Paul Horvitz, "Mortgage Redliing: Race, Risk, and Demand," *Journal of Finance* 49 (1994): 81–99. Additional articles are described, critiqued, and referenced in the following articles: Benston, "Mortgage Redlining Research," pp. 144–95; Anthony M. Yezer, ed., *Fair Lending Analysis: A Compendium of Essays on the Use of Statistics* (Washington: American Bankers Association, 1995); George J. Benston, W. Curt Hunter, and George G. Kaufman, eds., *Discrimination in Financial Services* (Boston: Kluwer Academic Publishers, 1997), also published as a special double issue of *Journal of Financial Services Research* 11 (February–April 1997).

5. See Benston, "Mortgage Redlining Research," pp. 144–95; and George J. Benston and Dan Horsky, "The Relationship between the Demand and Supply of Home Financing and Neighborhood Characteristics," *Journal of Financial Services Research* 5 (1992): 72–87.

6. See Benston, "Mortgage Redlining Research," for a review and critique of these studies; the papers presented in Yezer for critiques of research on redlining that use HMDA and other data; and the papers presented in Benston, Hunter, and Kaufman for recent studies. Also, for a review of other studies and bibliographic references, see Douglas D. Evanoff and Lewis M. Segal, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending," Federal Reserve Bank of Chicago *Economic Perspectives*, November–December 1996, pp. 19–46.

7. Glenn B. Canner and Delores S. Smith, "Home Mortgage Disclosure Act: Expanded Data on Residential Lending," *Federal Reserve Bulletin* 77 (November 1991): 859–81.

8. Alicia H. Munnell et al., "Mortgage Lending in Boston: Interpreting HMDA Data," *American Economic Review* 86 (March 1996): 25–53.

9. David K. Horne, "Mortgage Lending, Race, and Model Specification," *Journal of Financial Services Research* 11, nos. 1–2 (1997): 43–68.

10. Harold Black, "Discrimination in Financial Services," *Journal of Financial Services Research* 11, nos. 1–2 (1997): 189–204.

11. James A. Berkovic et al., "Mortgage Discrimination and FHA Loan Performance," *Cityscape: A Journal of Policy Development and Research* 2 (1992): 9–24.

12. Robert B. Avery et al., "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, July 1996, pp. 621–48.

13. Ibid., pp. 644–45.

14. Through 1995 the Department of Justice had issued 10 complaints against financial institutions for alleged violations of the Fair Lending Acts. In all but one of those, DOJ obtained consent decrees with the accused institution. None has gone to court. In particular, Decatur Federal (Georgia) was charged with discrimination on the basis of the findings from a statistical model, similar to that used by the Boston Fed. That analysis, however, is subject to the same shortcomings as the Boston Fed's analysis; in addition, the DOJ misused the model. See Harold A. Black, "HMDA Data and Regulatory Inquiries Regarding Discrimination," and Andrew L. Sandler and Jonathan Biran, "The Improper Use of Statistics in Mortgage Lending Discrimination Actions," in Yezer, pp. 147–62. The action brought against Chevy Chase (Maryland) alleged only that the bank did not open offices in predominantly African-American areas. I have not seen analyses of the other cases, which are described briefly in U.S. General Accounting Office, "Fair Lending: Federal Oversight and Enforcement Improved but Some Challenges Remain," Report GAO/GGD-96-145, August 1996.

15. Board of Governors of the Federal Reserve System, *Report to Congress on Community Development Lending by Depository Institutions* (Washington: Federal Reserve Board, October 1993).

16. Glenn B. Canner and Wayne Passmore, "Home Purchase Lending to Low-Income Neighborhoods and to Low-Income Borrowers," *Federal Reserve Bulletin*, February 1995, pp. 71–103; and Glenn B. Canner and Wayne Passmore, "The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks," Federal Reserve Board Finance and Economics Discussion Series, no. 7, 1997.

17. Avery et al., "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," Table 8; and Robert B. Avery et al., "Trends in Home Purchase Lending: Consolidation and the Community Investment Act," *Federal Reserve Bulletin*, February 1999, pp. 81–102 and Table 4, p. 92.

18. Evanoff and Segal.

19. Avery et al., "Trends in Home Purchase Lending." The research examined the hypothesis that bank consolidations (which were extensive during these years and which resulted in branch office closings) reduced the number of mortgages made to minorities and lower-income homebuyers. The paper concludes that this did not occur.

20. Derived from ibid., Table 4.

21. Jeffrey M. Lacker, "Neighborhoods and Banking," Federal Reserve Bank of Richmond *Economic Quarterly* (Spring 1995): 14.

22. Shadow Financial Regulatory Committee, "Proposed Revisions to Community Reinvestment Regulations," Statement 105, February 14, 1994, *Journal of Financial Services Research* 8 (1994): 233–34.

23. U.S. General Accounting Office, *Community Reinvestment Act: Challenges Remain to Successfully Implement CRA* (Washington: Government Printing Office, 1995).

24. Canner and Passmore, "The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks."

25. Anjan V. Thakor and Jess C. Beltz, "An

Empirical Analysis of the Costs of Regulatory Compliance," in *Proceedings: The 29th Annual Conference on Bank Structure and Competition* (Chicago: Federal Reserve Bank of Chicago, May 1993), pp. 549–68. The data were obtained from a mail survey. Only 4 percent of the responding banks had assets of more than $500 million.

26. The procedure employed is described by Robert B. Avery et al., "Using HMDA Data as a Regulatory Screen for Fair Lending Compliance," *Journal of Financial Services Research* 11 (1997): 9–42.

27. A summary of the study is given in Yezer, pp. 57–64.

28. U.S. General Accounting Office, "Fair Lending: Federal Oversight and Enforcement Improved but Some Challenges Remain," p. 39 ff.

29. Ibid., pp. 48–51.

30. See Fannie Mae, Desktop Home Counselor.

31 Avery et al., "Trends in Home Purchase Lending."

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