

Low-income neighborhoods' access to credit does not depend on the Community Reinvestment Act.

Should CRA Stand for “Community Redundancy Act”?

BY JEFFERY W. GUNTHER

A BSENT GOVERNMENT INTERVENTION, would low-income communities find themselves cut off from access to lending services despite the potential presence of creditworthy borrowers? For advocates of the Community Reinvestment Act (CRA), the answer is a definite yes. Passed as Title VIII of the Housing and Community Development Act of 1977, CRA is perhaps the government's most well-known attempt to enhance the availability of credit. The legislation requires that federal banking regulators encourage commercial banks and thrifts to help meet the credit needs of the communities in which they are chartered, consistent with safe and sound operations. Advocates claim CRA is necessary because the lending patterns produced by unfettered financial markets would be unfair in the sense that creditworthy low-income borrowers and neighborhoods would tend to be cut off from receiving loans. As evidence that CRA is working, advocates point to dramatic growth in mortgage lending in low-income neighborhoods, especially in the mid-1990s.

Despite wide acceptance of the claims made by CRA's advocates, those claims are conceptually and observationally unfounded. Economic theory and empirical evidence indicate that the reason for recent growth in lending to low-income neighborhoods is not CRA, but the effectiveness of market forces in breaking down the types of financial barriers that were prevalent when CRA was enacted. In reality, deregulation and new technologies have promoted competition and precipitated a great broadening of the credit market. As a result, CRA is not necessary to ensure access to credit by all

segments of our economy. Moreover, CRA's redundancy is not without significant costs, some of which are associated with a particularly regrettable type of regulatory burden involving the imposition of conflicting demands on banks.

INTERVENTION APOLOGETICS

IN THE 1970S, CREDIT MARKET RIGIDITIES IN THE FORM OF regulatory restrictions, information barriers, and coordination problems helped make the case for CRA. However, largely as the result of deregulation and new technology, today's financial marketplace far exceeds yesterday's in its ability to serve an array of customers—a fact that CRA advocates conveniently ignore. Notwithstanding the dramatic changes that have reshaped the financial services sector, formal arguments for CRA proceed along the same lines as 25 years ago.

The regulatory structure in place when CRA was enacted did not foster competition, and supporters of CRA still like to think of the local bank as “the only game in town.” From the 1930s through the 1970s, financial institutions faced numerous, stringent restrictions on the types of products and services they could provide, the geographic scope over which they could operate, and the range of interest rates they could offer depositors or charge borrowers. Furthermore, strict chartering requirements raised the cost of establishing new financial entities.

Also contributing to the lack of competition among financial institutions was limited information technology, which hampered the ability of out-of-market institutions to enter less competitive markets. And information costs may have hurt low-income neighborhoods in other ways. Insofar as lenders could assess the creditworthiness of individuals only with great uncertainty, they may have seen residence in a low-

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income neighborhood as indicative of unobservable factors that would detract from a borrower's overall repayment capacity. Using neighborhood as a proxy for repayment capacity may have been profitable if information on certain borrower characteristics, such as job stability, was difficult or costly to obtain but nevertheless correlated with place of residence. However, this practice would have disadvantaged low-income communities by restricting credit to all individuals in a neighborhood, even those who were creditworthy.

Similarly, questions about the value of a property pledged as collateral reduce the expected value of a loan to the lender. Because lending volume and real estate appraisal activity were limited in low-income neighborhoods in the 1970s, uncertainty about property values may have been particularly high. That lack of information may have worked against any growth in lending to low-income communities. Individual lenders may have been less interested in expending the resources required to generate more information on property values if they thought doing so would resolve uncertainty in the real estate market generally and thereby benefit competitors.

Coordination problems also may have restricted low-income communities' access to credit. The value of any property is typically influenced by the value of others in the same neighborhood. If an owner remodels and repaints an older home and adds new landscaping, the entire street generally benefits. Conversely, when a single property is allowed to deteriorate, the entire street can suffer. As a result of such spillover effects, existing and potential low-income homeowners in the 1970s may have hesitated to make improvements if they believed other residents would not follow suit or, worse yet, would allow their properties to deteriorate. Similarly, lenders may have hesitated to finance improvements to a particular property if they felt the overall neighborhood was likely to remain in poor condition.

REALITY CHECK

CRA'S ADVOCATES ARGUE THAT THE TYPES OF PROBLEMS that existed in 1977 when the legislation was enacted remain today, thereby implying the financial services marketplace lacks appropriate self-correcting mechanisms. The flow of credit to low-income neighborhoods has increased greatly, and some believe that CRA is responsible and that, absent the law, previously neglected neighborhoods would see their supply of credit cut off. In reality, however, government lending mandates are unnecessary because the dynamics of the financial services marketplace have improved the conditions that may have limited access to lending services in the past.

Changes in the Credit Market The removal of interest rate, geographic, and other artificial restrictions has worked with technology to transform the once static financial industry into a fast-paced, competitive environment involving all sorts of

players. Forgoing profitable lending opportunities in today's financial marketplace would mean, in most cases, giving a boost to competitors. If a lender were to cut off access to credit for a low-income neighborhood, the profit motive would lead another lender to move in and fill the void.

The subprime mortgage market, which makes funds available to borrowers with impaired credit or little or no credit history, offers a good example of competition at work. In the past, subprime borrowers were often seen as a captive segment of the mortgage market, with few opportunities to obtain credit. But in the early 1990s, increased competition in the mortgage market overall led to a surge

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in subprime lending by specialty lenders. Today, large mainstream lenders are also increasing their presence in the subprime mortgage market, and subprime borrowers are benefiting from increased access to funds. They are not limited to a single institution or compelled to settle for the first one that will provide credit. While individual cases of fraud and abuse tend to be well publicized, they represent a small portion of subprime lending. The vast majority of subprime borrowers—many of whom have relatively low income—have benefited from the growth in this market.

Information barriers have been substantially reduced since the 1970s. Rapid advances in computer, telecommunication, and financial technology have brought us from the 1970s, when lending decisions were primarily based on personal contact and loan officer discretion, to the information age, in which many such decisions are increasingly automated and often made across great distances. Financial institutions now have access to large databases rich with information on individual borrowers and their neighborhoods. Real estate transaction information, including prices, is widely and instantly available in a variety of forms. With all that information in hand, lenders are increasingly moving to automated systems for underwriting and risk-based pricing. Those developments have boosted competition and enhanced access to the credit market.

Spillover effects and the associated coordination problems are important considerations in both low-income neighborhoods and relatively affluent communities. Several factors suggest that private initiatives can solve coordination problems through the creation of formal coordinating mechanisms. Real estate developers, for example, largely play a coordinating role, and neighborhood associations facilitate group decisions about potential spillover effects. Enhanced information flows have arguably made

coordination efforts less difficult than in the past, irrespective of neighborhood type. In addition, CRA itself does not provide for a coordinating mechanism and appears ill suited to address potential coordination problems.

CRA's Effects Is CRA needed to encourage financial institutions to pursue profitable lending activities in low-income neighborhoods? Without repealing the legislation, it may be difficult to demonstrate conclusively CRA's current effects. It is possible, though, to determine whether lending trends are consistent with the view that CRA is not responsible for the recent growth in lending in low-income neighborhoods.

Progress based on technology, financial innovation, and competition—not CRA—has broadened the financial services marketplace.

Lenders subject to the Home Mortgage Disclosure Act (HMDA) are required to report detailed information on the home-purchase loans they originate, including the location of the property backing each loan. By dividing HMDA data between financial institutions covered directly or indirectly by CRA and those institutions not covered at all, it is possible to determine which group of lenders has been more active in low-income neighborhoods. The analysis used here defines low-income neighborhoods as census tracts having a median household income less than 80 percent of the median for the corresponding metropolitan statistical area. Commercial banks and savings associations are directly covered by CRA. Because mortgage and finance companies affiliated with those types of lenders may also be influenced by CRA, they are included in the group of CRA-covered lenders as well. Credit unions and independent mortgage and finance companies are not covered by CRA.

If CRA were the driving force behind the recent increases in home-purchase lending in low-income neighborhoods, we would see evidence of a treatment effect. Lenders subject to the "CRA treatment" would have refocused their activity toward CRA objectives to a greater extent than lenders in the untreated control group. However, there is little evidence of such a treatment effect. To the contrary, it was lenders in the control group that refocused their efforts in line with the mid-1990s boom in lending in low-income neighborhoods. In fact, lending in low-income neighborhoods grew faster than other types of lending at institutions not covered by CRA, whereas low-income lending grew at the same rate as other types of lending activity for CRA-covered lenders.

As a group, lenders not covered by CRA devoted a growing proportion of their home-purchase lending to low-income communities, with the community lending share of their loan portfolios rising from 11 percent in 1993 to 14.3

percent in 1997. That expanding portfolio share implies that for financial institutions outside CRA's reach, lending in low-income communities grew faster than other lending activity. Moreover, those institutions are not a small part of the total lending picture. Lenders not covered by CRA accounted for just under 40 percent of all one- to four-family home-purchase loans extended in low-income neighborhoods in 1997. Those findings indicate CRA lending mandates are not necessary to invoke a significant focus on lending in low-income neighborhoods.

In contrast, CRA-covered lenders, as a group, devoted about the same proportion of their home-purchase loans to low-income neighborhoods in 1997 as they did in 1993. In both years, their community-lending share was about 11.5 percent. Even though those institutions were subject to CRA, their lending in low-income communities grew no faster than other lending.

Those results would not be expected if CRA were the impetus for increases in lending in low-income neighborhoods. The data, however, are consistent with deregulation and technological advances leading to lower information costs and increased competition in the mortgage market. Independent mortgage companies tend to have more leeway to specialize in relatively risky lending than their more conservative and more heavily regulated counterparts in the banking industry. It is not surprising, then, that independent companies took the lead in focusing on lending activity in the riskier segments of the mortgage market. More recently, CRA-covered lenders have increased their participation in low-income lending through the purchase of previously independent companies.

Growth in lending to low-income neighborhoods by institutions outside CRA's jurisdiction suggests deregulation and technological advances have increased competition, lowered information costs, and increased access to financial services. As a result, a good part of the lending in low-income neighborhoods by financial institutions subject to CRA also might reflect those factors, rather than CRA lending mandates. The available data support that proposition. Most of the recent growth in lending by CRA-covered institutions in low-income neighborhoods has occurred in areas where the institutions do not operate banking offices and have no CRA obligations. The inescapable conclusion is that progress predicated on technology, financial innovation, and competition—not CRA—has broadened the U.S. financial services marketplace.

SPLIT PERSONALITY

CRA IS NOT NECESSARY TO ENSURE THAT ALL SEGMENTS OF our economy enjoy access to credit. Nevertheless, the legislation remains, as do the substantial costs it entails, including those associated with the imposition of conflicting demands on banks. In particular, a tradeoff exists between

the credit-enhancing objectives of CRA and the risk-constraining objectives of safety and soundness standards. That is not to say banks necessarily alter their behavior in an effort to please CRA or safety and soundness examiners. If the CRA exam process rewards aggressive growth and lending strategies, it cannot be inferred from that situation alone that aggressively managed banks adopt such strategies in order to obtain superior CRA ratings. Other motivations may be at work. Similarly, conservatively managed banks typically have their own reasons for seeking to avoid high risk. Nevertheless, the point remains that a regulatory framework should be viewed as particularly dysfunctional if a given action, such as the assumption of additional credit risk, results in praise from one supervisory corner but concern from another.

The regulation implementing CRA was adopted in 1978, amended in 1989, and revised in 1995. Since July 1990, CRA ratings have comprised four levels: 1, outstanding; 2, satisfactory; 3, needs to improve; and 4, substantial noncompliance, as directed in the 1989 amendments. As the above discussion indicates, CRA is often associated with lending in low-income neighborhoods. It is important to note that the original (1978), amended (1989), and revised (1995) regulations implementing CRA prominently feature objectives and guidelines related to the total volume of lending activity conducted in a bank's entire market area, irrespective of borrower income levels. In that regard, CRA has much to do with enhancing the overall supply of bank credit. The possibility arises that favorable CRA ratings might reflect aggressive financial strategies designed to support an expansion of lending activity.

In contrast, bank regulators use very different criteria in assigning safety and soundness ratings. In 1979, federal agencies adopted the Uniform Financial Institutions Rating System. The resulting ratings originally were derived from on-site evaluations of five factors: capital adequacy (C), asset quality (A), management (M), earnings (E), and liquidity (L). The CAMEL rating system was amended on January 1, 1997, to include a sixth component. The new S component focuses on sensitivity to market risk, such as the risk arising from changes in interest rates. Like the earlier CAMEL ratings, the CAMELS ratings comprise five levels: 1, basically sound in every respect; 2, fundamentally sound but with modest weaknesses; 3, financial, operational, or compliance weaknesses that cause supervisory concern; 4, serious financial weaknesses that could impair future viability; and 5, critical financial weaknesses that render the probability of near-term failure extremely high. For simplicity, the term *camel* can apply to both CAMEL and CAMELS ratings. In contrast to CRA ratings, the CAMEL rating system is clearly directed at containing risk.

Given the opposing perspectives on bank credit underlying CRA and safety and soundness ratings, in addition to

the bank-level costs associated with CRA compliance efforts, current regulatory policies engender a conflict. Although safety and soundness concerns are a factor in CRA ratings, banks are encouraged to boost the supply of credit in their market areas. In contrast, the primary focus of the safety and soundness exam process is the containment of risk in general and credit risk in particular. Moreover, the conflict becomes even more severe to the extent that lending in low-income neighborhoods, which figures prominently in CRA regulations, entails a particularly high level of credit risk.

Aggressive Strategies I have statistically analyzed the conflict between CRA and safety and soundness. The data contain 16,212 pairs of CAMEL and CRA ratings assigned from 1991 through 1996, along with other variables characterizing bank operations. Of the observations, 1,933 are problem CAMEL ratings and 581 are problem CRA ratings. (Problem ratings are 3 or higher.) Among the problem institutions, 196 have problem CRA and problem CAMEL ratings.

The statistical results for small banks (those with assets under \$250 million) provide the strongest evidence of conflict between CRA and safety and soundness. The small-bank sample accounts for most of the data and contains 14,459

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observations, including 1,777 CAMEL problems and 524 CRA problems. Although some evidence of conflict exists for the large banks, the following discussion is limited to the small-bank results.

After controlling for management effectiveness, the results indicate that higher levels of lending activity, as measured by a bank's loan-to-asset ratio, *increase* the chances of a problem safety and soundness (CAMEL) rating. In contrast, increases in lending activity tend to *reduce* the chances of a problem CRA rating. The analysis shows that aggressive lending strategies help CRA ratings but hurt safety and soundness ratings.

Data-availability constraints increase the difficulty of testing whether a focus on lending in low-income neighborhoods also contributes to conflict between CRA and safety and soundness. The majority of banks headquartered in rural areas are not required to report HMDA data. That exemption and other related factors mean that inclusion of a variable indicating the degree to which a bank's lending activity is devoted to low-income neighborhoods results in a dramatic reduction in the number of observations available to the analysis. Based on the results from that much smaller sample, evidence suggests that increases in the

proportion of home-purchase mortgage volume extended to borrowers in low-income neighborhoods raise the chances of a problem CAMEL rating. The finding casts doubt on the typical claim made by CRA advocates that lending in low-income neighborhoods is relatively innocuous in terms of financial safety and soundness. Somewhat surprisingly, the results indicate no effect of lending in low-income neighborhoods on CRA ratings, after controlling for the influence of total loan volume and other factors. The results for overall lending activity are robust with respect to the inclusion of the low-income lending measure; that is, increases in the loan-to-asset ratio are still found to help CRA ratings but hurt CAMEL ratings, after controlling for the potential influence of the mix of lending activity.

Necessary Retrenchment In addition, after controlling for management effectiveness, reductions in profitability, as measured by a bank's return on assets, increase the chances of a problem CAMEL rating. And reductions in profitability further tend to boost the chances of a problem CRA rating. A similar pattern occurs with measures of asset quality. Increases in troubled assets raise the chances of a problem rating on both CRA and safety and soundness exams.

Those results support the view that financial difficulties can adversely affect CRA ratings by necessitating a retrenchment in CRA-related activities. When a bank encounters financial problems, current legislation and regulations governing the safety and soundness exam process dictate financial retrenchment and corrective action to avoid possible speculative or fraudulent endgames by bank owners and managers, while, at the same time, facilitating either the bank's financial recovery or, if necessary, its prompt closure. The statistical results are consistent with the view that the CRA exam process does not take into full account the slowdown in CRA-related activities that the situation requires. As a result, the CRA exam process tends to assign inferior ratings to banks struggling with financial difficulties. That tendency is another manifestation of the conflict between the CRA exam process and safety and soundness considerations.

The relationship between current and past problem ratings provides further evidence of conflict between CRA and safety and soundness. Current safety and soundness problems are associated with managerial shortcomings, as perceived by examiners and reflected in the management rating a bank received in its previous safety and soundness exam. CRA problems are not associated with management problems. More important, current safety and soundness problems are associated with previous safety and soundness problems, as reflected in the composite rating a bank received in its previous safety and soundness exam, but not with previous CRA problems. In contrast, CRA problems are associated with previous CRA and CAMEL problems. The linkage between current CRA problems and previous CAMEL problems further supports the view that financial difficulties can result in substandard CRA ratings by necessitating a retrenchment in CRA-related activity.

The safety and soundness criteria used in assigning

CAMEL ratings and the credit availability objectives of CRA are in opposition. The tension is apparent in the empirical results, especially for small banks. When management quality is held constant, concentrating bank assets in loans tends to help CRA ratings but hurt CAMEL ratings, and banks with financial problems are more likely to receive substandard CRA ratings, even though a shift in resources away from CRA objectives may be necessary to facilitate financial recovery or to contain losses.

CONFLICT RESOLUTION

THE THEORY AND DATA REVIEWED HERE SUGGEST IT IS unlikely that CRA is responsible for recent increases in home-purchase lending in low-income neighborhoods. Instead, deregulation and technology have lowered information costs, heightened competition, and increased access to financial services. These findings raise questions about the degree to which CRA is needed to ensure fair access to credit by all segments of our economy. Fears that low-income neighborhoods would suffer from a lack of credit if not for CRA are unjustified. The available mortgage lending data are consistent with the view that low-income neighborhoods' access to credit does not depend on CRA.

Given the lack of benefits associated with CRA, it becomes all the more important to count its costs. In that regard, the data on CRA and CAMEL ratings point to a supervisory process in pursuit of conflicting goals. And the tension between CRA objectives and safety and soundness standards has been an underappreciated cost of CRA.

As the analysis shows, banks undergoing financial problems are more likely to receive substandard CRA ratings, and in relatively good financial times, such as today, few institutions are downgraded by the CRA exam process. Unfortunately, the conflict between CRA and safety and soundness may not receive the remedial attention it requires until the next round of widespread asset quality problems.

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