

“An Analysis of the Community Reinvestment Act.”

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Pledge: On my honor I have neither given nor received any unacknowledged aid on this paper. Casidhe Horan

I. Introduction

When the housing market bubble burst in 2007, and the country's economy started its downward spiral on the backs of defaulted subprime loans and devalued mortgage-backed securities, the search was on to find someone or something to blame. One of the suspects that quickly surfaced was the Community Reinvestment Act (CRA) of 1977. The law was intended to curb redlining, or the practice of refusing to lend to entire low-income and minority neighborhoods because the risk is too high, by requiring a bank to lend to residents of the community where the bank is located. Since its inception, controversy has surrounded the CRA regarding its strengths and weaknesses as a policy and its interventionist role in the housing market. Yet the most recent iteration of the debate – defining the role of the CRA in the 2008 financial crisis – has become particularly heated.

On the one hand, critics of the CRA pinpoint the act as the root of the crisis, claiming it was the sole reason for the proliferation of the faulty loans.¹ Essentially, the story goes, the CRA and an army of community advocate enforcers put pressure on banks to lend to low-income and minority communities to whom they would have not made loans under traditional circumstances; i.e., members of these communities lacked the income, creditworthiness, and assets to merit a loan. But banks were hesitant to loosen lending standards too much and to take on too many of these riskier loans, called subprime loans. As such, Fannie Mae and Freddie Mac were directed to purchase these loans from the banks. Now able to originate loans but offload the risk onto Fannie Mae and Freddie Mac, banks began to make more and more subprime loans. A key link to the crisis here is that non-CRA lending institutions such as independent mortgage lenders could offer subprime loans and sell them to Fannie Mae and Freddie Mac as well. Meanwhile, Fannie and Freddie started to securitize the loans and sell them in the secondary mortgage

¹ See Williams (2008), Sowell (2009), Kurtz (2008)

market to Wall Street firms such as Bear Stearns and Citibank, laying the foundation for the crisis to come.

But defendants of the CRA claim it wasn't pressure from the act that pushed banks into riskier subprime lending, but the greed of mortgage brokers, bank officials, etc., along with the deregulation of the financial system beginning in 1999, that led to the mess.² They argue that the CRA never had a quota system for the number of loans to minorities or low-income residents a bank needed to make, and banks were always instructed to maintain sound operations. Furthermore, they ask how a bill passed in 1977 could cause a financial crisis thirty years later.

Determining the anatomy of the financial collapse is crucial to prevent repeating the same mistakes in the long run, but thus far, only a small handful of those on either side of the CRA debate have delved deeply enough into the issue to understand the history and facts of the CRA that would allow them to have a more thoroughly considered opinion on the matter. Unfortunately, because the subprime crisis occurred so recently, there is no definitive study that allows us to deliver a verdict on whether or not the Community Reinvestment Act caused the increase in subprime loans that eventually defaulted and triggered the crisis. What we can do, however, is (1) create a better context for studying the CRA by piecing together the history of events that culminated in the Community Reinvestment Act in 1977, (2) understand how the CRA evolved over the next thirty years, and (3) look at trends in CRA lending and subprime lending in the past fifteen years to make educated inferences about the link between the CRA and the subprime crises. The goal of this paper is to do just that, while also remembering that people remain at the heart of this issue. As I explain in the next section, the ultimate purpose of the CRA was to improve the quality of housing and general well-being for moderate- and low-

² See Gordon (2008), Pressman (2008), Barr 2008.

income individuals, and the ultimate question we need to answer is whether or not the CRA is an effective tool to fulfill that goal.

This paper by no means provides an exhaustive answer, but it does lay out a framework for making the decision. It summarizes the modern history of government involvement in the housing market (Section II), discusses in detail the provision of the CRA and how it has changed over the years (Section III), presents the results of the CRA and its impact on lending (Section IV), draws conclusions about the role of the CRA in the financial crisis based on the historical background and results of the CRA (Section V), and finally, concludes with remarks on the future of the CRA. The analysis presented in this paper is limited to home mortgage loans unless otherwise indicated, since it was subprime home mortgage loans that caused the financial crisis.

II. Historical Background

To fully understand and then analyze the CRA, we first need to develop a context for it by examining the conditions and events that led to its enactment. Here I outline the housing problem that CRA attempted to address.

The CRA's relatively narrow goal of improving credit access for residents of low- and moderate-income neighborhoods was derived from a larger set of goals aimed at improving urban housing and, ultimately, repairing America's broken central cities. In the 1960's and 1970's, white flight, poverty, high and rising crime levels, and overstretched budgets that could not sufficiently fund crucial improvements in urban education or transportation were crippling America's "declining central cities." By 1977, these cities had become the focal point of social policy debate. But the most visible marker of the urban predicament was poor housing for low-income individuals, an issue which the government had been struggling to resolve since the

1930's. In fact, forty-five years of housing policy and debate preceded the CRA's passage in 1977. Moreover, the racial segregation and redlining that the CRA was meant to fix became more systemic and institutionalized during this period.³

The government's first foray into the housing field was the creation of the Reconstruction Finance Corporation (RFC) under the Emergency Relief and Construction Act of 1932. While slums were by no means new to the American city landscape in the 1930's, the Great Depression's exacerbating toll on the poor and their living conditions had drawn public attention to urban housing and prompted the government to intervene. The RFC offered loans to private banks and financial institutions that provided housing to low-income individuals, with the intent to both prevent these banks from failing due to mass foreclosures and encourage them to continue to make mortgage loans. Yet the RFC had little direct influence on large down payments, the increasing incidence of second mortgages, high interest rates, or any other issues on the individual borrower level. Hence, Congress passed the National Housing Act of 1934, establishing the Federal Housing Authority (FHA). The FHA was given authority to release private credit into the hands of the banks and other lending institutions for home repairs and construction, and it was also charged with developing mortgage insurance to further improve liquidity in the market. The FHA created and launched a secondary market for mortgages, the Federal National Mortgage Association (Fannie Mae), in 1937.⁴

Another attempt to directly aid victims of the Great Depression was the creation of the Home Owners' Loan Corporation (HOLC), established in 1933. HOLC serviced urban housing and economic needs; for example, it provided financial assistance to city residents so that they could either retain or purchase new homes. HOLC also developed the long-term, self-amortizing

³ Gorham, William. *The Urban Predicament*. Washington, D.C.: The Urban Institute. (1976)

⁴ Ibid.

mortgage, making purchasing a home more affordable. Together with the FHA and the RFC, HOLC spurred housing construction and kept many from losing their homes, but the government's intervention strategy still faced two key flaws with no easy solutions.⁵

First, it failed to address the most pressing problem: the disastrous housing conditions of the poor. The poorest of the poor could not purchase homes, regardless of lower prices or that they were federally insured, and their concern was not finding a new house but instead simply finding a decent place to sleep. The National Housing Act of 1937 directly tackled the issue for the first time by introducing federally funded public housing. Under this act, the United States Public Housing Authority authorized loans to local public housing authorities for low-rent public housing construction expenses. Unfortunately, the initial model of public housing – the mid- and high-rise apartment buildings that concentrated low-income residents in dense geographical areas – proved to be little better than the slums they were meant to replace, and the debate over how best to provide affordable housing continues on today⁶. But this act in 1937 marked the first time government recognized the negative social consequences of insufficient affordable housing and committed to directly improving housing options for the poor.⁷

The second flaw turned out to be particularly pernicious. Although HOLC and the FHA did have positive influences on urban housing markets, from their inception through 1960 they were largely responsible for the institutionalization of systemic racial segregation practices such as redlining, which led to sharply segregated neighborhoods and contributed to the decline of the American city. First, consider HOLC, which provided financial assistance to city residents, enabling them to retain or purchase homes. In its appraisals of real estate and neighborhoods,

⁵ From Redlining to Reinvestment: Community Responses to Urban Disinvestment. Ed: Gregory Squires. Philadelphia: Temple University Press (1992).

⁶ Gorham(1976).

⁷ From Redlining to Reinvestment (1992)

HOLC consistently undervalued dense, racially mixed, or aging neighborhoods. Furthermore, racially homogeneous neighborhoods were not valued equally. In one evaluation of a St. Louis County neighborhood, HOLC appraisers noted that real estate values had significantly depreciated to the point where they had “little or no value today, having suffered a tremendous decline in values due to the colored element now controlling the district,” (Jackson 1985: 200). By undervaluing such neighborhoods, HOLC discouraged investment by other banks, financial institutions, or even retail stores who equate weaker economic opportunities with low real estate values. Some even attribute the origination of redlining to HOLC’s appraisal practices.⁸

The FHA, underwriter of federally insured mortgages, was also guilty of encouraging discrimination in housing. The 1938 FHA Underwriting Manual stated:

Areas surrounding a location are to be investigated to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups.

If a neighborhood is to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally contributes to instability and a decline in values.

(U.S. Federal Housing Administration 1938: par 937)⁹

In other words, FHA underwriters were advised to finance home purchases that perpetuated racially segregated neighborhoods. The FHA also “endorsed racially restrictive covenants that prohibited property from being sold to racial minorities,” until 1948 when the U.S. Supreme Court declared those covenants unenforceable by federal courts.¹⁰

⁸ Ibid.

⁹ Ibid

¹⁰ Ibid.

These actions of HOLC and the FHA reinforced, if not validated, the general practices of the real estate industry as a whole during this time period. The following statement was included from 1924 to 1950 in the National Association of Real Estate Boards's national code of ethics:

A realtor should never be instrumental in introducing into a neighborhood a character of property or occupancy, members of any race or nationality, or any individual whose presence will clearly be detrimental to property values in the neighborhood. (Judd 1984: 284)

Even when the statement was removed in 1951, the attitude was not openly challenged until the 1960's.¹¹

In sum, the FHA, HOLC, and the real estate industry sharpened neighborhood racial lines, facilitated redlining, and restricted opportunities for low-income or minority groups to move to better neighborhoods. Urban renewal efforts that began in 1949, which involved clearing slums for new, more profitable economic development, further clustered the poor and minorities in concentrated areas. At the same time, the introduction of federally insured, self-amortizing mortgages (plus a host of other factors such as the construction of the nation's highway system) made homeownership more attractive and drew those with higher incomes (mostly whites) out of cities to the suburbs, taking with them their capital. This quickly became a self-reinforcing cycle, where strapped-for-capital cities had trouble maintaining affordable housing, which decreased real estate values even further, and induced anyone with enough cash to leave.¹²

Things markedly changed in the 1960's. As the Civil Rights movement and the War on Poverty gained force, the eradication of segregation and discrimination in public life, including housing, was catapulted to the forefront of national issues. This began with President John F.

¹¹ Ibid.

¹² Ibid.

Kennedy's 1962 Executive Order no. 11063 which prohibited discrimination in all housing that received federal financial support. Title VI of the Civil Rights Act of 1964 strengthened the Order by banning discrimination in any program or activity receiving financial assistance, which included public housing. Four years later, Title VIII of the Civil Rights Act of 1968 (the Fair Housing Act) prohibited discrimination by race, color, religion, sex, or national origin in the sale or rental of housing units, terms and conditions of housing transactions, advertising, and other practices related to the availability of housing. The Equal Credit Opportunity Act of 1974 prohibited lending discrimination, including mortgage lending by race, color, national origin, age, sex, marital status, religion, receipt of public assistance, or exercise of rights granted by consumer protection statutes. Meanwhile, the FHA itself made an about-face, now actively looking to make federally insured mortgages available to moderate- and low-income urban residents of all races and ethnicities.¹³

Yet lack of enforcement was an inherent weakness of this collection of new legislation that obstructed its effectiveness. One reason for the lack of enforcement was the lack of information. Without data to analyze, there was no way for regulators of lending institutions, which included the Federal Reserve Board, the Office of the Comptroller, and the Federal Deposit Insurance Corporation (FDIC), to monitor banks' lending activities. Thus, the Home Mortgage Disclosure Act (HMDA) of 1975 was passed, requiring federally regulated banks, savings and loans, and credit unions to report the number and dollar amount of mortgage loans they made by census tract in all metropolitan areas.¹⁴

By the mid-1970's, however, policy makers' focus had shifted beyond simply eradicating discrimination and segregation for its own sake. Instead, there was growing concern over the

¹³ "History of Fair Housing." HUD. 21 Aug 2007 <http://www.hud.gov/offices/fheo/aboutfheo/history.cfm> Accessed 3 Mar 2008

¹⁴ Ibid.

deteriorating American city. As alluded to earlier, white flight and the growth of suburbia had stripped cities of capital, crime had been increasing for the past decade, and education, still reeling from desegregation mandates, was in a state of flux with high school achievement declining in urban school systems. Moreover, despite the good intentions of the Fair Housing Act, the low-income and minority neighborhoods that resulted from the previous residential segregation practices stubbornly grew into racially and socioeconomically homogeneous ghettos where these urban maladies festered and living conditions continued to devolve.¹⁵ While policy makers and social scientists alike could well-understand the problem, an easy or optimal solution was decidedly more difficult to pinpoint. A prevailing strategy of attack emerged to try once again to improve urban housing.

The reasoning behind this approach was two-fold. First, the housing conditions in many poor neighborhoods of cities remained deplorable and human beings should not be subject to such a low standard of living. Second, poor housing was not only a symptom of poverty and crime but also a cause. They claimed that low-quality housing reduced real estate values of an entire neighborhood, which in turn reduced residents' net worth as well as incentives for economic development. Additionally, the current layout of many neighborhoods and housing complexes was conducive to the violent, toxic culture, also bringing down real estate values.¹⁶

To fix the problem, policy makers knew that they needed to change how they structured public housing developments. But another key aspect of the problem was brought to their attention by members of the growing community economic development movement, which evolved as a complement to the War on Poverty and Great Society programs and emphasized the development of housing, jobs, and business opportunities within low-income communities for

¹⁵ Gorham (1976).

¹⁶ Ibid.

their low-income residents through both public and private ventures. Community advocates, who ranged from community organizers to nonprofit directors to local government officials to local ministers, recognized that there were residents of the current low-income and minority neighborhoods, perhaps of moderate-income levels, who could actually afford to own their own homes. The logic was that if they could get these residents to purchase houses in the neighborhood, the residents would have more incentive to police their own communities and to take good care of their own houses, which would raise real estate values. They would also simultaneously increase the availability of government-subsidized housing for truly low-income residents by relinquishing their spots.¹⁷

But lending institutions were continuing to ignore the credit needs of entire neighborhoods based on racial and income composition (redlining). Regulators of lending institutions still felt no real push to enforce lending standards pertaining to racial discrimination. Plus, the original HMDA of 1975 did not require banks to document the racial composition of their loan portfolios, making it nearly impossible for regulators to enforce the standards, even if their attempts were more aggressive. A call for an affirmative approach to eliminating discrimination in lending, which would require banks to actively lend to minorities and low-income individuals in their communities, arose in opposition to the current laws that only prohibited discrimination against minorities. The answer was the Community Reinvestment Act.

III. The Community Reinvestment Act

The First Decade

President Jimmy Carter signed the Community Reinvestment Act (CRA) on October 12, 1977. Its stated purpose was two-fold:

¹⁷ Ibid.

- i) To require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions
- ii) To encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions (12 U.S.C. 2901).¹⁸

In other words, given that regulated financial institutions are required by law “to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business,” and that the convenience and needs of the communities “include the need for credit services as well as deposit services,” Congress declared federally insured depository institutions obligated to meet the credit needs of their local communities (12 U.S.C. 2901).¹⁹

Congress allocated regulatory authority to three federal financial supervisory agencies. First, the Office of the Comptroller of the Currency (OCC) oversees national banks, such as Bank of America or Citibank, which by definition are all chartered, regulated, and supervised by the OCC. Second, the Board of Governors of the Federal Reserve System is responsible for state-chartered banks that are members of the Federal Reserve System and bank holding companies. Third, Congress directed the Federal Deposit Insurance Corporation (FDIC) to monitor the state-chartered banks whose deposits are insured by the FDIC but are not members of the Federal Reserve System. However, oversight of savings banks whose deposits are insured

¹⁸ "Community Reinvestment - 12 USC Chapter 30". FDIC. 3 Aug 1999.
<http://www.fdic.gov/regulations/community/community/12c30.html>

¹⁹ Ibid.

by FDIC and savings association holding companies was delegated to the Office of Thrift Supervision.²⁰

Each agency's responsibility was to incorporate into its usual examination of a financial institution the institution's record of meeting the credit needs of its entire community. Evaluations that occurred between 1977 and 1989 consisted of twelve assessment factors. These factors included determining the credit needs of the community, how the bank markets its credit options, the types of credit the bank offers, the geographic distribution of the loans, the record of opening and closing branches, the bank's service record, the bank's record of involvement in local community projects, and the financial and legal capability of the institution. The regulations were intentionally vague in an effort to promote bank creativity. No specific type of lending or other credit product was mandated, nor was a certain volume of lending prescribed. All institutions covered by the regulating agencies were subject to the same set of regulations and assessment factors, regardless of size or location. The results and conclusions from these evaluations culminated in one numerical rating of CRA compliance.²¹

The federal financial supervisory agencies were then required to take this rating into account when evaluating the institution's application for a depository facility, and the agencies also considered the results when reviewing applications to become a financial holding company. Hence, the sole leverage to enforce the CRA held by the Comptroller, the Board, and the FDIC over their respective financial institutions was the power to deny banks' requests to expand operations through branching or mergers and acquisitions if their CRA ratings were not sufficiently high.

²⁰ Ibid.

²¹ Braunstein, Sandra. "The Community Reinvestment Act." Federal Reserve Board. 13 Feb 2008
<http://www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm>

The original 1977 bill, however, was largely unsatisfactory according to many community advocates. First of all, its provisions for regulation were notably weak. The CRA provided little guidance to bank regulators as to how they should evaluate a bank's CRA compliance, nor did it specify how often a bank should be evaluated. Also, the power to deny banks' requests to expand operations – the only direct enforcement authority held by regulators – was weakened by the fact that during this time there was only very limited bank consolidation. Passive regulators, who gave 97% of examined institutions one of the two highest CRA ratings, compounded the problem.

Aside from the regulatory issues, community advocates argued that the CRA failed to sufficiently prohibit redlining and racial discrimination.²² This was the result of a fundamental disconnect between the vision of community advocates and the vision of Congress for the CRA. Both had the ultimate goal of improving housing for low-income urban residents. Community advocates, however, generally saw redlining as the major issue, requiring increases in loans to the poor and to minorities as measures of success, while Congress had focused on improving communities and ensuring that deposits put into local banks were reinvested within those communities in a beneficial, but safe and profitable, manner.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) as a bailout measure for the savings and loan crisis. But in response to reports presented to Congress on the persistence of redlining, FIRREA included amendments to the CRA that strengthened it in three ways. First, the CRA's five-point numeric rating scale was replaced with a four-tiered descriptive rating system, where a bank was assigned one of the four following ratings:

²² Ibid.

- i) “Outstanding record of meeting community credit needs,”
- ii) “Satisfactory record of meeting community credit needs,”
- iii) “Needs to improve meeting community credit needs,” or
- iv) “Substantial noncompliance in meeting community credit needs.”²³

Second, FIRREA required regulating agencies to compile a written evaluation of each financial institution’s CRA record. And third, FIRREA mandated public disclosure of each institution’s CRA rating and performance evaluation. FIRREA further bolstered the CRA by also amending the Home Mortgage Disclosure Act requirements to include the race, ethnicity, gender, and income of loan applicants. Together, these amendments created much more transparency in banks’ lending activities.²⁴

These legal changes coincided with a shift in bank regulators’ attitudes towards CRA compliance. The Federal Reserve denied a merger request on the grounds of low CRA performance for the first time in 1989, sending a wake-up call to the banking world. On the very same day as that decision, the Federal Reserve also released a policy statement announcing its more aggressive approach towards CRA enforcement, which included a checklist of items regulators should consider before approving a merger request, and a statement emphasizing the importance of public hearings and community input in the decision-making process. True to their word, in the next two years, 11% of the lenders rated by federal regulators failed compared with 2.5% failure rate from 1986-1989.²⁵

Under increased scrutiny from both regulators and community advocates, banks now felt compelled to be more aware of their CRA compliance. As former president of Local Initiatives

²³ "Community Reinvestment - 12 USC Chapter 30". FDIC. 3 Aug 1999.
<http://www.fdic.gov/regulations/community/community/12c30.html>

²⁴ *Ibid.*

²⁵ Fishbein, Allen. "The Community Reinvestment Act After Fifteen Years: It Works, but Strengthened Enforcement is Necessary." The Fordham Urban Law Journal. (20), 2. Jan 1993. Pp. 293-310.

Support Corporation Paul Grogan said, “The banks are clearly under pressure. They are actually competing to lend in poor neighborhoods.”²⁶ Even banks who were not concerned about pending mergers or acquisitions took care to meticulously document their compliance. With the CRA ratings now public and available to relentless community advocates, a poor rating could harm a bank’s standing and prestige in a community, something banks value highly²⁷. For example, the American Bar Association encouraged members to bank only with lending institutions that had good CRA ratings. In a survey conducted by the *American Banker*, the trade daily reported that one-third of banking customers – and one-half of minorities said they would switch their accounts from lending institutions with a poor CRA rating.²⁸

Banks responded by setting up community development offices and creating agreements with local community development organizations to finance projects; they would commit to finance affordable housing and other development projects conducted by local community organizations. Other banks made unilateral commitments, without a partnership with a community organization. For example, Chase Manhattan Bank set up the Chase Community Development Corporation and committed \$200 million toward affordable housing and other development projects over a five-year period.²⁹ Bank of America committed \$12 billion over a ten year period for loans to targeted low-income census tracts, the expansion of special mortgage products for low-income and minority borrowers, small business loan programs, and consumer loan programs.³⁰

²⁶ Lueck, Thomas. “Lenders Feel New Pressures to Aid Poor Neighborhoods.” *New York Times*. 19 Aug 1990 <http://www.nytimes.com/1990/08/19/realestate/lenders-feel-new-pressures-to-aid-poor-neighborhoods.html?sec=&spon=&pagewanted=all> Accessed 3 Mar 2008

²⁷ Ibid.

²⁸ Fishbein (1993).

²⁹ Lueck (1990)

³⁰ Fishbein (1993)

The combination of a renewed commitment to CRA enforcement, an open door for community involvement, the release of public information on whose loan applications banks were accepting and rejecting, and movement in the banking industry toward consolidation, had finally given the CRA “teeth” and got CRA compliance on bank presidents’ agendas. Yet a major complaint of community advocates, that CRA evaluations were still based heavily on efforts to meet the credit needs of their community rather than results remained unresolved. They were also unsatisfied with the translation from banks’ huge community development “commitments” to the actual implementation. The push to grade banks based on the quantity and composition of loans actually made in their communities rather than their promises to “try” to meet lending needs led to more changes to the CRA in the 1990’s.³¹

The 1995 Regulatory Changes

When former President Bill Clinton came to office in 1992, homeownership was one of his priorities. In 1994, Clinton and HUD Secretary Henry Cisneros formed a coalition of 56 partners including realtors, homebuilders, mortgage bankers, Fannie Mae, Freddie Mac, Habitat for Humanity, and low-income housing advocates to create the National Homeownership Strategy. They set a goal of reaching a 67.5% homeownership rate – the highest ever – by the year 2000, and to do it they laid out 100 specific actions, which included making the CRA more effective.³² Clinton want to strengthen the CRA’s influence on banks’ lending activities by streamlining the CRA examination process, shifting the focus from process to results, and cutting the costs of compliance for banks. Federal regulators finally responded in 1995, and the first change was to tailor examination approaches to an institution’s size and business operations. The CRA examination of depository institutions with \$250 million or more in assets, or those

³¹ Braunstein (2008).

³² Urban Policy Brief, Number 2. Aug 1995. <http://www.huduser.org/publications/txt/hdbrf2.txt>

belonging to a holding company with \$1 billion or more in assets, are now subject to three tests: lending, investment, and service.³³

The lending test, comprised of a both quantitative and qualitative factors, carries the most weight – fifty percent of the overall CRA rating. No institution can get a passing rating of “satisfactory” or above if it does not receive a minimum rating of “low-satisfactory” on its lending test, regardless of how well it performs on the other tests. On the other hand, any institution that receives a rating of “outstanding” on its lending test is guaranteed at least a “satisfactory” overall rating, regardless of how poorly it performs on the other tests. Community advocates are most concerned with banks’ performances on this test, and scrutinize the results with extra rigor.³⁴

The investment and service tests each makes up twenty-five percent of the overall CRA rating. Under these tests, examiners evaluate investments benefiting low- and moderate-income individuals and neighborhoods or distressed and underserved rural areas, as well as the services a bank provides to an entire community, such as ATM machines or financial education courses. Examiners also consider the innovativeness of banks’ approaches to increase lending, investment, and service to the low- and moderate-income individuals in their communities. Banks with under \$250 million in assets are not subject to the investment and service test; their evaluation is based primarily on their lending activities.³⁵

The second change to the CRA in 1995 was an increase in public involvement. An examiner now interviews local businesspeople, government officials, housing and consumer advocates, realtors, trade association representatives, and others in the bank’s community about

³³ Apgar, William and Mark Duda. "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." *FRBNY Review*. (9) 2, Jun 2003. Pp 169-191.

³⁴ Ibid.

³⁵ Ibid.

the general credit needs of the community, the availability or lack of availability of credit, and how the bank and other institutions respond to those credit needs. The examiner includes this information in his evaluation. Examiners also consider the bank's public comment file, which documents comments from members of the community on the institution's CRA performance. Finally, in concurrence with the CRA review, a fair lending review is also held to determine any patterns of discriminatory lending. These results are incorporated to the institution's CRA rating, although an inadvertent or isolated violation is often insufficient to warrant a ratings downgrade.³⁶

Two other features of the 1995 changes deserve note. First, a different testing system for "wholesale" and "limited" purpose banks, which do not offer home loans, was created which considered only community development lending, investment, and services. Second, any financial institution that expects to receive a failing grade on CRA performance can opt to devise a strategic plan to improve its CRA activities, subject to approval from the appropriate federal regulating agency. If approved, the institution can receive a passing CRA rating.³⁷

Since 1995, the appropriate federal regulating agencies have conducted CRA examinations of large banks (banks with over \$250 million in assets) every one to three years depending upon the agency and how well the institution under evaluation performed on the last test. For example, the Federal Reserve examines its institutions every two years unless the institution received a CRA-rating of "substantial noncompliance" or less, in which case it will review the institution annually until the institution receives a passing grade. Meanwhile, the

³⁶ Ibid.

³⁷ Ibid.

OCC examines its large institutions every three years, but also reserves the right to increase the frequency in light of a poor rating.³⁸

The Gramm-Leach-Bliley Financial Modernization Act of 1999

The Community Reinvestment Act was once again revised in 1999 by way of the Gramm-Leach-Bliley Financial Modernization Act, the brainchild of Senator Phil Gramm that mainly cleared the way for the creation of financial “supermarkets,” but also included amendments to the CRA. First, a “sunshine” amendment requires full public disclosure of all of a bank’s CRA agreements with community organizations or other entities. Both the bank and the non-bank party to the agreement must produce an annual public report on how the money and other resources involved in the agreement have been used.³⁹

Second, regulatory relief is provided for small banks (under \$250 million in assets). Those who have a CRA rating of “outstanding” must be re-examined only once every five years. Small banks who have a CRA rating of “satisfactory” need to be re-examined only once every four years. Small banks who receive a CRA rating of less than “satisfactory” should be re-examined annually until they achieve at least a “satisfactory” rating. Finally, the Federal Reserve must deny a company’s request to form a financial holding company if any of its banks or other financial institutions has less than a “satisfactory” rating. Furthermore, any bank or financial holding company may not take advantage of any of the new activities permitted under the Gramm-Leach-Bliley Act if the bank or financial holding company did not receive at least a “satisfactory” rating on its last CRA evaluation.⁴⁰

The 2005 Regulatory Change

³⁸ Ibid.

³⁹ "Community Reinvestment Act Amendments in the Gramm-Leach-Bliley Act" Financial Services Modernization Act, Nov 1999 <http://banking.senate.gov/conf/craamd.htm> Accessed 3 Mar 2008

⁴⁰ Ibid.

In the most recent regulatory change to the CRA, a third bank size category was coined. In response to a 2002 interagency review of the effectiveness of the 1995 regulatory changes, the intermediate small institution is now defined as an institution that holds assets of at least \$250 million and less than \$1 billion. They are subject to the same lending tests as large banks, but their community development test, which does consider of community-development lending, investment, and services, has much more flexible targets than those of large banks. In fact, an intermediate bank, like a small bank, could pass a CRA examination without satisfactory community investment or services. Many community advocates felt this weakened the CRA, but those in support of the change claimed it further reduced an unnecessary regulatory burden on banks.⁴¹

IV. Recent Results

The impact the CRA had on lending in the 1990's and into the twenty-first century is not completely clear. It is difficult to parse out changes in lending caused by the CRA from those changes that would have happened on their own, especially given the expanding economy, and falling unemployment that marked the period 1993-1999.⁴² Steady real home price appreciation, secondary mortgage market expansion, strong income growth, and technological advances in financial innovation also benefited both CRA-regulated and non-CRA-regulated lenders.⁴³ This section highlights what we do know.

During the period 1993-1999, depository institutions covered by the CRA and their affiliates⁴⁴ made over \$800 billion in home mortgage, small business, and community

⁴¹ Braunstein (2008)

⁴² Litan, Robert, et al. "The Community Reinvestment Act After Financial Modernization: A Final Report." *U.S. Treasury Department, 2001.* " <https://treas.gov/press/releases/reports/finalrpt.pdf>.

⁴³ Ibid.

⁴⁴ "CRA-lender and its affiliates" is defined as a depository institution and any other branches or offices that it supervises. For example, many CRA-lenders were purchasing independent mortgage lenders during this time period;

development loans to low- and moderate-income communities; these lending activities are collectively referred to as “LMI lending.”⁴⁵ Specifically regarding home purchase loans, the CRA-eligible origination shares of CRA-regulated lenders and their affiliates, meaning the share of total home purchase originations issued by CRA-regulated lenders and their affiliates that is eligible for CRA credit, grew from 31.5% in 1993 to 35.0% in 1999, and the similar CRA-eligible origination share for refinancing loans grew from 20.8% to 33.4%. The combined increase for home purchase loans and refinancing loans, together called mortgage loans, was 40%, which translates to a 55% increase in the number of mortgage loans, with home purchase loans increasing 93.7%. These percentages represent total increases in LMI lending, but minority lending also increased from 21% of CRA-eligible borrowers in 1993 to 28% in 1999. Notably, CRA-regulated lenders increased their home purchase lending at a faster rate than non-CRA lenders, controlling for types of mortgage products sold.⁴⁶

An important dimension of the increase in LMI lending was a shift in composition of that lending from prime to subprime lending.⁴⁷ A subprime loan is an option for borrowers who have poor credit, cannot afford the full downpayment, or have insufficient income or wealth required to qualify for a prime loan. In exchange for the higher risk, lenders charge a higher interest rate. Poor credit history, the lack of a downpayment, and lack of income are in fact three common obstacles to homeownership for low-income individuals; thus they rely on subprime loans to meet their credit needs. It is also important to note that the increases in subprime lending described here were concentrated in minority communities, particularly in refinancing. Only

after the acquisition, the independent mortgage lender would be considered an “affiliate” of the CRA-lender. CRA-lenders had the option of choosing whether or not to include their affiliates in CRA rating evaluations.

⁴⁵ Barr, Michael S. “The Community Reinvestment Act: Thirty Years of Accomplishments but Challenges Remain.” *Testimony before the Committee on Financial Services, U.S. House of Representatives*. 13 Feb 2008. <http://financialservices.house.gov/hearing110/barr021308.pdf>.

⁴⁶ Litan (2001).

⁴⁷ By subprime lending, I always refer to subprime home mortgage lending.

12% of all refinance lending was conducted by subprime specialists, but they made approximately 42% of all refinance loans in predominantly minority neighborhoods.⁴⁸

In 1993, 100% of CRA-eligible home purchase loans originated by CRA-regulated lenders were prime loans. From 1994-1997 the percentage dipped to 99%, reaching 97% in 1998, and dropping to 93% in 1999. This shift in composition of loans was driven not by the decision of CRA-regulated lenders to start making subprime loans themselves, but instead by the purchase of independent subprime specialists. Larger CRA-regulated lenders brought on these subprime specialists as affiliates as those subprime specialists began to take over a significant portion of the home mortgage market. The CRA-regulated lenders could then profit from the subprime loans made by the specialists, although these subprime loans did not necessarily count towards CRA accreditation; they could have been subprime loans made to upper-class borrowers, for instance. Overall, the market share of subprime and manufactured housing loans increased 23.5% for CRA-lenders and their affiliates. But CRA-eligible home mortgage loans made by CRA-regulated lenders and their affiliates remained much more likely than non-CRA lenders to be prime loans. CRA-regulated lenders actually expanded their market share of prime loans by 4.6%.⁴⁹

In sum, lending to moderate- and low-income communities significantly increased between 1993 and 1999, driven mostly by CRA-lenders. Unfortunately, a comparable study has not been completed for more recent years, but we do know that subprime lending continued to mushroom through 2006, reaching \$625 billion 2005 – a full one-fifth of total mortgage originations in that year – although not all of these subprime loans were necessarily to moderate- and low-income communities. We also know that in 2005, about 20% of all subprime loans

⁴⁸ Ibid.

⁴⁹ Ibid.

were originated by banks and thrifts subject to the most stringent federal regulation, the category in which CRA-lenders would fall. Bank affiliates and holding companies, subject to less strict regulation and evaluated less often, originated 30% of the loans, and 50% of the loans were originated by state-chartered mortgage companies that were not federally supervised.⁵⁰

V. CRA & the Crisis

Where does this leave us in the hunt for a greater understanding of the possible link between the Community Reinvestment Act and the subprime crisis? Recall the debate described at the beginning of this paper. The CRA critics claim that the Community Reinvestment Act sparked an unprecedented proliferation of subprime loans, which eventually defaulted, as banking institutions lowered their lending standards in an effort to meet CRA requirements. The CRA supporters argue that the increase in subprime loans was not caused by the CRA but by other factors such as greed or deregulation. The results presented in the section above do not have any bearing on the role of greed or deregulation, but they do provide insight into the relationship between the CRA and subprime lending.

From the results in the previous section, we can gather that from 1993-1999, CRA-regulated depository institutions,

- Increased lending to low- and moderate-income communities by CRA-regulated depository institutions as a share of their total lending activities;
- Increased the number of home mortgage loans;
- Increased their lending to minorities;
- Did not lead the trend of increasing subprime loans and instead joined in the subprime activity a couple years later.

⁵⁰ Gramliches, Edward M. "Booms and Busts: The Case of Subprime Mortgages." http://www.kc.frb.org/publicat/sympos/2007/pdf/Gramlich_0415.pdf

We also know the following:

- After 1999, subprime lending continued to grow exponentially through 2006;
- Bank affiliates and holding companies, such as Bear Stearns or Citibank, originated 30% of the loans. These institutions, while federally regulated, were subject to very lax regulation, and they were evaluated less often than other CRA-regulated institutions;
- State-chartered mortgage companies that were not federally supervised and therefore not subject to CRA regulations originated a full 50% of the loans;
- Subprime loans created by CRA-regulated lenders were at most 20% of all subprime loans in 2006;⁵¹
- CRA subprime loans had the lowest default rate in 2007.⁵²
- CRA-regulated lenders were significantly less likely to engage in the types of risky loan behavior that led to the foreclosure crisis.⁵³

Thus, we can conclude that while CRA-regulated lenders increased their subprime lending activity in the 1990's and into the 2000's, their loans made up at most one-fifth of the total subprime loans in 2006. Furthermore, subprime loans made in 2006 were the loans that defaulted in 2007,⁵⁴ triggering the crisis, but CRA loans had the lowest default rate of all subprime loans in 2007.⁵⁵ Therefore, the evidence does not support the claim that CRA subprime loans were directly responsible for the subprime crisis.

However, the CRA critics' argument is more nuanced than assessing direct blame for the economic collapse to loans made by CRA-lenders. The argument instead is that as the CRA put pressure on lenders to engage in lending to low- and moderate-income communities, it

⁵¹ Traiger & Hinckley, LLP. "The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis." 7 Jan 2008. http://traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf. See also Traiger & Hinckley, LLP. "The Community Reinvestment Act of 1977: Not Guilty." 26 Jan 2009 http://traigerlaw.com/publications/The_community_reinvestment_act_of_1977-not_guilty_1-26-09.pdf.

⁵² Ibid.

⁵³ Ibid.

⁵⁴ Demyanyk, Yuliva and Otto Van Hemer. "Understanding the Subprime Mortgage Crisis." NYU Stern School of Business. 29 Feb 2008. <http://w4.stern.nyu.edu/finance/docs/WP/2008/pdf/wpa08002.pdf> Access 16 Mar 2009

⁵⁵ Traiger (2008)

encouraged lenders to create new and innovative mortgage products so that low-income individuals might qualify, such as lowering or nixing down payments, or designing loans that begin with a low interest rate and small monthly payments in the first two years, after which the interest rate jumps up, significantly increasing the monthly payment. In order to entice lenders to engage in riskier loans, the government instructed Fannie Mae and Freddie Mac to purchase the loans from the CRA-lenders. These lower underwriting standards and the guarantee of Fannie and Freddie on the loans then spread to non CRA-lenders, where the lack of supervision and regulation allowed subprime loans and predatory lending to develop into the financially dangerous products they became.⁵⁶

Yet this story does not hold well under scrutiny either. If true, then subprime lending would have originated in CRA-lending institutions and spread to non-CRA lenders. However, when subprime lending among CRA-lenders began to increase after 1993, it grew not because of a decision to start specializing in subprime loans, but instead because CRA-lenders recognized that non-CRA mortgage companies were gaining a sizeable share of the housing market through subprime loans and wanted to capture those profits for themselves.⁵⁷ Thus, CRA-lenders bought subprime specialists and made them affiliates of the banks. There must have been some trigger other than the CRA to induce the growth of the independent mortgage companies and their subprime specializations. Finding that trigger requires further research.⁵⁸

VII. CRA and the Future

Although there is no decisive evidence in favor of the CRA having a primary role in the foreclosure crisis which led to the financial crisis, as we look forward, it is still the center of

⁵⁶ See Williams (2008); Sowell (2009); Kurtz (2008).

⁵⁷ Litan (2001)..

⁵⁸ See Appendix.

another debate: is it relevant? In the past thirty years, the evidence demonstrates that that LMI lending has expanded, yielding increased access to credit for communities once systematically shutout from the lending world. Yet recent studies have shown that lending to low-income areas has not improved significantly more so than lending in higher-income areas, meaning that overall bank lending and trends have changed such that LMI lending would have increased regardless of the CRA.⁵⁹

In accordance with those results, others argue that the issues that the CRA was intended to address are now irrelevant. For example, the informational asymmetries that made it difficult for lenders to determine the real income, wealth, and credit history of low-income borrowers, and thereby once provided a profit-motivated incentive to engage in redlining, are now largely solved with the advent of the internet, online banking, and FICO credit scores. More significantly, some argue that the basic premise of the CRA, that institutions that take deposits from communities have an obligation to offer credit to those communities, is anachronistic. The CRA was passed in 1977, when banking was still a very localized operation. But in the thirty years since, the repeal of laws prohibiting interstate banking has delocalized the system. It is now considered a virtue of the banking system that the deposits from one side of the country can be used to fulfill a credit need on the other side of the country. Plus, the internet has even stimulated the creation of online mortgage companies and online banking that have no geographical base. Finally, some contend that now that loans to low- and moderate-income communities have proven profitable, the market forces of competition, which did not exist when

⁵⁹ Avery, Robert B. et al. "The Effects of the Community Reinvestment Act on Local Communities." Division of Research and Statistics, Board of Governors of the Federal Reserve System. 20 Mar 2003.

the banking system was localized in the 1970's, should induce banks to continue to lend to those communities without the enforcement of the CRA.⁶⁰

These hypotheses may be incorrect. The CRA may still be crucial to expanding credit access for low-income communities. As such, the debate over the direction of the CRA that had already begun prior to the financial crisis, will surely resume once the economy has stabilized. When it does, familiar questions will be raised. Is redlining still a problem? Should banks be obligated to ensure credit to those from whom they take deposits? How strongly should banks be pressured to make loans to low- and moderate-income neighborhoods? Is there a way to loan to low-income individuals other than through subprime loans? These require rigorous and thoughtful research.

But even before we tackle those questions, we must first ask ourselves deeper questions about housing, affordability, and the government. Is our goal to simply ensure quality housing or to promote homeownership? Recall the 1960's and the 1970's when the CRA was first enacted. The original impetus behind that goal has been to improve neighborhoods through housing. Have neighborhoods improved as a result of the CRA? Can well-kempt affordable rental housing preserve a neighborhood? If so, is that enough, or do we require homeownership? Perhaps a clean neighborhood of low-income individuals paying an affordable rent is better than a neighborhood of low-income homeowners whose budgets are so stretched by their mortgages they must choose between taking a child to the doctor and fixing the proverbial broken window. These are the considerations we must keep in mind in the debate about the CRA, and questions that we need to investigate in the coming years.

⁶⁰ White, Lawrence J. Prepared testimony for U.S. House of Representatives Hearing on "The Community Reinvestment Act: Thirty years of accomplishments but Challenges Remain."

Appendix: A Missing Link?

The trend towards subprime loans in the mortgage industry started to take off around 1994-1996, and as we have seen here, there is no strong evidence that the CRA triggered the increase in subprime lending. But while the CRA is technically cleared for now, it is still crucially important to determine why subprime loans exploded. As I have stated previously, CRA supporters claim that the increase in subprime loans was largely driven by the greed of profit-minded mortgage lenders. If true, why did it take lenders until 1994 to realize the profit opportunities of subprime lending?

A major recommendation that arose from the research undertaken for this paper is to look more closely at the *National Homeownership Strategy: Partners in the American Dream*, commissioned by former President Bill Clinton. The document was released on May 2, 1995, and listed 100 recommended actions for homebuilders, realtors, lenders, non-profits, and other members of the housing industry to take in order to reach the goal of a 67.5% U.S. homeownership rate by the year 2000. Former Secretary of Housing and Urban Development, Henry Cisneros, spearheaded the joint effort of over fifty partners ranging from the National Association of Realtors to the American Bankers Association to Fannie Mae and Freddie Mac to the National Association of Home Builders.⁶¹

The action list includes many good recommendations such as increasing home-buying counseling for first-time home-buyers who may not understand the process, and encouraging technological innovations that allow the home-buying process to be streamlined. However, one of its goals is specifically to reduce downpayment and mortgage costs. It encourages realtors and lenders to “explore creative means of providing low-downpayment financing to potential

⁶¹ The National Homeownership Strategy: Partnership in the American Dream. Washington, D.C.: U.S. Department of Housing and Urban Development, (1995).

homebuyers.”⁶² To support the reduction in downpayment and mortgage costs, it also encourages mortgage underwriters in the secondary market, specifically Fannie Mae and Freddie Mac, to loosen their underwriting standards. Finally, in its recommendations to expand minority homeownership, along with supporting flexible mortgage underwriting standards and lower downpayments, it suggests that “setting performance targets that will serve as benchmarks.”⁶³

I do not claim that the root cause of the subprime crisis should now be transferred to the National Homeownership Strategy, but whereas the CRA is marked by vagueness and ambiguity, this Strategy contains 100 specific actions that speak more directly to the complaints that lower standards and minority-lending performance targets brought on the influx of subprime lending. Thus, it at least merits further investigation.

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⁶² Ibid, pp. 4-8

⁶³ Ibid, pp. 6-7

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