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The Community Reinvestment Act's Harmful Legacy
How It Hampers Access to Credit

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This paper discusses how depository and lending institutions can best benefit communities by increasing residents' access to credit, and what role, if any, the Community Reinvestment Act of 1977 (CRA) ought to play. It details the background, original justifications, and historical application of the CRA to banks and thrifts as well as credit unions' exemption from it. It also describes how the Act has worked out in practice, and makes the case that the best way to increase access to credit and achieve the stated goals of the Act is by not mandating CRA at all, but rather to deregulate credit unions and make compliance with CRA voluntary for both banks and credit unions. In the short term, the government should limit CRA's reach and level the playing field between banks and credit unions by exempting smaller banks and thrifts from the Act.

How the CRA Works. During the mid 1970s, the notion that banks contributed to the economic decline of inner cities gained popularity among government officials and community activists. Lenders allegedly "redlined" these neighborhoods—drawing a red line, both literally and figuratively, around areas with perceived undesirable characteristics and systematically refusing credit to residents, regardless of individual creditworthiness. Because these neighborhoods were predominantly low- and middle-income (LMI), as well as minority, activists and leaders condemned redlining as unlawful discrimination.[1]

This led to the passage of the Housing and Mortgage Disclosure Act (HMDA) in 1976, which required most lending institutions to publicly disclose lending practices. Analysis of that data, which did show low levels of investment in poorer neighborhoods, resulted in the passage of the Community Reinvestment Act (CRA) the following year.

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The Act requires banks and thrifts to make loans throughout their entire market, operate depository facilities in certain neighborhoods, and collect data about lending habits to be periodically reported to federal supervisory agencies[2]—which use CRA ratings when evaluating applications for mergers and acquisitions.[3]

The Act exempts credit unions (insured by the National Credit Union Administration), which the law's authors assumed had neither the ability nor the incentive to discriminate as banks had—a largely valid assumption at the time. Credit unions, by definition, limit their membership to people who share a "common bond," which historically, has been defined as working, worshipping, or attending school at the same place. Therefore, a credit union could not "disinvest" in the only people to whom it could lend.[4]

The CRA's Effects: Changes in Lending. In the years after CRA's passage, lending to low and middle income neighborhood residents increased dramatically. According to the San Francisco Fed, between 1993 and 1997 home purchase loans to low income borrowers increased by 37 percent and for moderate income borrowers by 29 percent. For residents of LMI neighborhoods, the increase in home-purchase-loan writing was even greater—43 percent for low income neighborhoods and 32 percent for moderate income neighborhoods. By comparison, residents of middle and high income neighborhoods saw lending rise by 23 percent and 17 percent, respectively.[5] CRA proponents cite this as evidence of the Act's success, but the evidence makes it difficult to attribute the results to the CRA alone—lending increased across the board after the Act's passage, and deregulation and new technology may have been an equal or greater contributing factor.

Lending increased among all institutions—including non-bank lenders and credit unions—not just among those subject to CRA. In a study of mortgage lending data during the 1990s, Jeffery Gunther of the Dallas Fed shows that CRA and non-CRA lenders[6] accounted for an almost equal percentage of the loans made in low-income neighborhoods. Moreover, while CRA lenders followed the market trend of increased lending to LMI neighborhood residents, non-CRA lenders increased lending to borrowers in these areas at a faster rate. From 1993 to 1997, non-CRA lenders increased the amount of their portfolios dedicated to home loans in low income communities from 11 to 14.3 percent. Meanwhile, CRA lenders' portfolios' share of home purchase loans to low income neighborhoods was the same in 1997 as in 1993—11.5 percent.[7]

Moreover, the combination of dramatic advances in information technologies and deregulation throughout the 1980s and 1990s created a highly competitive market that virtually guaranteed the availability of credit to anybody who sought it. Three major pieces of legislation that removed regulatory barriers for the banking industry included:

- ***Depository Deregulation and Monetary Control Act of 1980.*** Allowed institutions to charge any interest rates they chose.
- ***Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994.*** Allowed banks to operate across state lines.
- ***Gramm-Leach-Bliley Act of 1999.*** Allowed banks to engage in previously prohibited activities such as lending, depositing, issuing insurance, and financial advising.

In today's highly competitive market, it is unrealistic that a neighborhood could be entirely cut off from access to credit, as any lender choosing to shun an area simply leaves room for competitors to move in.[8]

On Shaky Ground. Before discussing the costs and benefits of expanding the CRA, it is worth looking back at its original justification. A reassessment of that debate suggests that support for the measure rested on significantly flawed data.

While community activists and legislators touted the early data results of the Housing and Mortgage Disclosure Act as statistical proof of redlining, opponents have since argued that the original models used in evaluating the data were significantly flawed.

Clifford Rossi and Fred Phillips-Patrick of the Office of Thrift Supervision maintain that the models used to interpret the data were inconclusive at best and misleading at worst. In their study, the models appear to show lending discrimination along racial lines, but at the same time reacting to creditworthiness. They conclude that the flaws in the statistical data occurred because, "the equations used in evaluating neighborhood credit-flow assumed that demand was exogenous…By estimating [the] equation without estimating simultaneously an equation for the demand for mortgage credit, the model results in inconsistent and biased estimates of the parameters."[9] They note that the "single-model" equations do not tell the entire story about a neighborhood's credit flow because they cannot account for supply and demand within neighborhoods.[10]

Andrew Holmes of Brigham Young University and Paul Horovitz of the University of Houston made a similar study of the Houston lending environment throughout the 1970s. They determined that the racial variable was only significant when risk variables, such as falling home prices, were not included.[11] They criticize the original models used in analyzing the HMDA data, stating that the "results from the single-equation model are not reliable indicators of redlining or its absence." Furthermore, they claim that even sophisticated simultaneous models do not provide uncontestable evidence of discrimination because individual credit histories can explain the results just as well.[12]

Analysis of the original HMDA data may have created the appearance of systematic discrimination when banks were most likely doing what lenders have always done and continue to do: avoid risk.

Furthermore, no statistical analysis has addressed the fact that, until the 1970s, information technology was unsophisticated and not widely available, and gathering information on prospective loan applicants was time consuming and expensive. Therefore, to gauge the riskiness of a given loan, it is reasonable to assume that bankers used residence in a low income area as an indication of other undesirable qualities, which could affect the applicants' creditworthiness and ability to repay the loan.[13]

In addition to lack of knowledge about borrowers, lenders seeking to mitigate risk also faced a lack of knowledge about the value of the properties that LMI borrowers used as collateral. Until the 1970s, appraisals for home values were almost exclusively limited to higher-value homes. Even the value of a home in a LMI neighborhood could be determined, it was still virtually impossible to judge the value of surrounding homes, and bankers may have been unwilling to bet that an area would improve rather than deteriorate. As the Dallas Fed's Gunther notes, homes in a given area have mutually reflexive value—if one house falls into disrepair, it reduces the value of the other homes around it.[14] Thus, until the 1970s, lenders could have appeared to be discriminating simply by using their very limited data, including residence in an LMI neighborhood to decide whether a loan was too risky to make. Rapidly advancing technology and statistical methods have made reliance on such presumptions obsolete.

Further, if the original analysis of the HMDA data was correct and therefore constituted evidence of widespread discrimination in lending, one would expect that as federal agencies began to enforce CRA compliance many cases of discrimination would become apparent. This does not appear to be the case. In 1991, after enactment of the Federal Deposit Insurance Corporation Improvement Act, which required regulatory agencies to refer potential illegal discrimination cases to the Justice Department, a pattern of unjustified discrimination did not appear evident. Of roughly 24,000 institutions surveyed over a period of three years, there were only 48 referrals. Of those, the Department took legal action in only six cases and dismissed nine for lack of evidence.[15] Such a nominal amount of violations calls the original claims of rampant redlining into question.

Negative Results. The Community Reinvestment Act does not appear to have had any positive effect on lending to residents of LMI neighborhoods. In fact, it appears to have had a *negative* effect on CRA lenders and LMI residents alike.

- ***Increased Risk.*** While both CRA- and non-CRA lenders have increased the number of loans to low-income borrowers, the financial soundness of CRA-covered institutions decreases the better they conform to the CRA. Gunther compares certain institutions' CRA ratings to their CAMELS rating—a formula used by bank regulators to assign safety and soundness ratings that takes into account capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks. He found that the better a lender was rated by CRA standards, the worse was its CAMELS rating.[16]
- ***Increased Costs for Small Lenders.*** Apart from the cumulative cost of writing riskier loans, CRA-covered institutions must cope with the direct costs of complying with the Act. The burden is especially heavy on small lenders that might compete directly with credit unions, which are exempt from the Act.[17] A 1992 survey of 445 small banks found that compliance with CRA cost 4.5 percent of their pretax income and, on average, 0.25 percent of their total assets.[18]

The negative effect of CRA on small banks compounds in light of the observation by George Benston of Emory University that larger banks often operate in LMI as a strategic loss, in order to get a satisfactory CRA rating for regulatory approval for mergers and acquisitions.[19] Thus, expecting a loss, large banks charge extremely low rates against which smaller banks cannot compete. This drives out smaller lending institutions. Once large banks fulfill the required compliance with CRA, they often discontinue lending in the area.[20]

The CRA discourages lenders from moving in to replace those lenders that have moved out, because its LMI lending requirements makes closing, or moving branches difficult and more costly for lenders in those neighborhoods, thus adding another layer of risk. Federal regulators take CRA compliance ratings into not only when banks apply for new charters or branches, but also when they apply to move or close a branch. The CRA, then, denies creditworthy borrowers in LMI neighborhoods access to of depository institutions that would have otherwise taken the risk of opening branches in those neighborhoods.[21]

In 1995 regulators, recognizing the burden that the CRA placed on smaller lending institutions, attempted to standardize testing and decrease the regulatory strain. The amended regulations required large banks and thrifts—those institutions with over $250 million in assets—to report data on small business and farm loans, community development loans, and home mortgage lending. Small banks—those with assets under $250 millions—were exempt from investment and service tests and were not required to submit data. Instead, government agencies evaluated small banks' loan-to-deposit ratio, the percentage of loans written in the community, lending to individuals and business with varying income levels, lending across geography, and the banks' response to complaints.[22]

Rent Seeking Opportunity for Activists. In addition to its negative effect on the financial stability of small lenders, the CRA has created opportunities for rent seeking and financial and logistical burdens for all lenders. The Act forces lenders to spend money, time, and resources on documentation, PR, and other compliance costs.[23]

Moreover, the examination process to determine the level at which a bank is meeting its CRA obligations can sometimes take several months.[24] This has become a major point of leverage—and source of funding—for "community" activist groups. Lending institutions, rather than face the increased expense of a slowed deposit facility application due to a CRA challenge, have committed over $7 billion to such groups and $23 billion to community development lending projects since 1977.[25] Some companies seek to mitigate the threat by funding activist groups' projects, instead of reforming their overall approach to community reinvestment, according to Jonathan Macey of Yale Law School.[26]

Groups like the Association of Community Organizations for Reform Now (ACORN), aware that even small delays in approval can result in substantial losses of money for financial institutions, have been exploiting such a strategy for years. For example, Chase Manhattan and J.P. Morgan donated hundred of thousands of dollars to ACORN around the time that they applied for permission to merge.[27]

Many lenders spend large sums of money on PR campaigns that essentially have no benefit to the community or to the lending institution, merely to stave off criticism.[28]

Higher Lending Costs. While the increase in lending to underserved areas in recent years is encouraging, much of it is due to increasing subprime lending—loans made at higher rates to people with lower-than-prime credit. Subprime mortgages are not inherently a bad thing, and in fact are the only means by which some borrowers can access credit, but evidence suggests that many borrowers who received subprime loans would have qualified for loans with better terms and that CRA is partly responsible for their not doing so. The CRA, by encouraging loosening underwriting standards, may have contributed to the massive increase in foreclosure rates.

After nearly a decade of improved lending to underserved markets, Richard A. Williams of the University of Notre Dame, Eileen McConnell of Indiana University-Bloomington, and Reynold Nesiba of Augustana College noticed that lending began to decline in 1995. After further investigation, they concluded that lending was not declining; rather, the source was simply shifting from private to government-backed loans.[29] This raises what they term the "disturbing" possibility that borrowers who otherwise could have achieved better-deal loans were "stolen away" by government-backed lenders. Fannie Mae CEO Franklin Raines admits that half the borrowers in the sub-prime market "could have qualified for lower-cost conventional financing."[30]

From 1993 to 1998, CRA-covered institutions wrote a large percentage of the loans made to residents of LMI neighborhoods. However, CRA-regulated lenders tended to focus on prime lending. Of the vast increase in subprime lending in LMI neighborhoods, CRA-covered institutions only accounted for 15 percent of those loans. According to a study by Kathleen C. Engel of the Cleveland-Marshall College of Law and Patricia McCoy of the University of Connecticut Law School, this shows that CRA fails in one of its original purposes, which was to encourage banks to lend to their whole communities.

Conclusion. The Community Reinvestment Act has not encouraged investment in lower income neighborhoods in a way that would not have happened in its absence. Without even addressing the essential questions about the government's right to tell private banks and thrifts what to do, the nation should seriously consider repealing the Act based on its ineffectiveness alone.

Further, its uneven application to small banks and thrifts is unfair. The American Bankers Association may make a valid point when it says that, "Today, credit unions have the ability to offer complex financial products, just like banks. They have been able to extend their membership…again just like banks"[31]—but that does not justify applying an ineffective regulation to credit unions as well as banks.

Yet some members of Congress want to do just that. House Financial Services Chairman Barney Frank (D-Mass.), in a speech to the National Association of Federal Credit Unions on September 11th, 2007,[32] endorsed legislation loosening restrictions on credit unions' field of membership and net worth standards, but went on to recommend reexamining credit unions' exemption from the CRA.

If anything, LMI neighborhoods have too much access to the *wrong kind* of credit, a problem that the CRA has helped exacerbate. In its analysis of the 2006 Mortgage Disclosure Act data, the Federal Reserve noted a "strong correlation between the number of high-cost loans in a given area and the rate of delinquency."[33]

If regulators wish to encourage and increase the flow of credit to low income communities,[34] a more effective method, rather than adding restrictions by applying CRA to credit unions, would be to allow all credit unions to add "underserved markets" to their field of membership. Also, simultaneously, regulators should exempt small banks from the Act as a way of leveling the playing field between them and credit unions.[35] This would reduce the total regulatory burden on financial services in the United States and, allowing the free market to meet of lower income Americans' financial services needs.

Yet these are only small steps in the right direction. To truly unburden banks, thrifts, and credit unions and open up the flow of credit to communities across the country, the best option would be to make CRA compliance voluntary—if not doing away with the Act entirely. Lending institutions could submit their records to an independent auditor and use the results to attract customers. Similarly, if consumers wish to work exclusively with lending and depository institutions with a good record of CRA compliance, they can consider the ratings of those institutions who voluntarily submit to CRA assessment.

Short of the ideal goal of eliminating it, reducing the scope and strength of the Community Reinvestment Act, as much as possible, is the best politically feasible option to increase the availability of financial services to individuals at all income levels.

Notes

[1] Council of Development Finance Agencies, Community Reinvestment Act (CRA) Fact Sheet, 1 http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b2928b086256efa005c5f78/f133ad718f3081d4862571410077df1d/$FILE/CDFA%20Fact%20Sheet%20-%20CRA.pdf.

[2]Council of Development Finance Agencies, http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b2928b086256efa005c5f78/f133ad718f3081d4862571410077df1d/$FILE/CDFA%20Fact%20Sheet%20-%20CRA.pdf. Regulators include the Federal Reserve, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision.

[3] "A Policy in Lapman's Tradition: The Community Reinvestment Act," remarks by Governor Edward M. Gramlich. June 16, 1999, http://www.federalreserve.gov/boarddocs/speeches/1999/19990616.htm.

[4] For more on credit unions, see, Will McBride, "Let Credit Unions Grow: The Case for Expanding Field of Membership," *OnPoint* No. 124, Competitive Enterprise Institute, November 2, 2007.

5 Federal Reserve Bank of San Francisco Economic Letter number 2004-16, June 25, 2004.

[6] In addition to credit unions, non-CRA lenders include independent mortgage and finance companies.

7 Jeffery W. Gunther, "Should CRA Stand for 'Community Redundancy Act'?" *Regulation*, Cato Institute, Vol. 23, No. 3. p. 58, http://www.cato.org/pubs/regulation/regv23n3/gunther.pdf.

[8] Ibid.

[9] Fred J. Phillips-Patrick and Clifford V. Rossi, 1996. S" "Statistical Evidence of Mortgage Redlining? A Cautionary Tale," *Journal of Real Estate Research*, American Real Estate Society, vol. 11, No. 1, 1996, p. 13, http://cbeweb-1.fullerton.edu/finance/journal/papers/pdf/past/vol11n01/v11p013.pdf.

[10] Ibid. p. 15

[11] Andrew L. Holmes, A. and P. Horvitz," Mortgage Redlining: Race, Risk, and Demand," *Journal of Finance,*

1994, 49, pp. 81–99. Holmes was on the faculty of Sam Houston State University at the time of this article's publication.
[12] Ibid, p. 22
[13] Gunther, p57
[14] Gunther.
[15] George J. Benston, "The Community Reinvestment Act: Looking for Discrimination That Isn't There," *Policy Analysis* No. 354, Cato Institute, October 6. 1999, p. 11, http://www.cato.org/pub_display.php?pub_id=1213.
16 Ibid, 59
[17] Since the Act's passage, the size of the credit union movement—although not its share of the banking economy—has grown and, under new community charters, many credit unions serve state-wide markets. The country's largest credit union—Navy Federal Credit Union—indeed, has grown to the scale of a medium-sized bank with roughly $30 billion in assets and revenues of over $400 million.
18 Benston, *It's Time to Repeal the Community Reinvestment Act,* http://www.cato.org/pub_display.php?pub_id=4976.
[19] Benston, "The Community Reinvestment Act: Looking for Discrimination That Isn't There*,"* p 10.
[20] Ibid.
[21] Ibid.
[22] Richard D. Marisco, The 2004-2005 Amendments to the Community Reinvestment Act Regulations: For Communities , One Step Forward and Three Steps Back, p. 536
Beyond the community reinvestment act 712-713
[24] Jonathan R Macey, "The Community Reinvestment Act: An Economic Analysis," *Virginia Law Review*, Vol. 79, No. 2, March 1993, pp. 291-348
[25] Craig E. Marcus, "Beyond the Boundaries of the Community Reinvestment Act and the Fair Lending Laws: Developing a Market-Based Framework for Generating Low- and Moderate-Income Lending," *Columbia Law Review*, Vol. 96, No. 3, April 1996, pp.712-713.
[26] Macey, p. 335.
[27] Sol Stern, "ACORN's Nutty Regime for Cities," *City Journal*, Spring 2003, http://www.city-journal.org/html/13_2_acorns_nutty_regime.html.
[28] Macey, p. 331.
[29] Richard A Williams, Eileen McConnell, and Reynold Nesiba, "The Effects of the GDEs. CRA, and Institutional Characteristics on Home Mortgage Lending to Underserved Markets," *Cityscape: A Journal of Policy Development and Research*, Volume 5, Number 3, 2001, U.S. Department of Housing and Urban Development, http://www.huduser.org/Periodicals/CITYSCPE/VOL5NUM3/williams.pdf.
[30] Williams, McConnell, and Nesiba, "The Changing Face of Inequality in Home Mortgage Lending," *Social Problems*, Vol. 52, Issue 2, 2005, pp. 181–208, http://www.asu.edu/clas/transborder/documents/diaz_pdfs/SocialProblems2005.pdf.
[31] American Bankers Association. "Credit Unions: A Changing Industry, " Winter 2004, http://www.aba.com/NR/rdonlyres/804662A0-4225-11D4-AAE6-00508B95258D/34880/CreditUnionsAChangingIndustry012705.pdf.
[32] CUNA news, http://www.cuna.org/newsnow/07/wash091107-3.html.
[33] Disparities Among Racial Groups and Delinquency Rates Important to Note In 2006 Fed HMDA Data Report, Says Wolters Klumer Financial Services, Wolters Klumer Financial Services news release, September 19, 2007, http://www.wolterskluwerfs.com/NewsEvents/Press/press091907.html.
[34] Kathleen C Engel and Patricia A McCoy, "The CRA Implications of Predatory Lending," *Fordham Urban Law Journal*, April 1, 2002, http://goliath.ecnext.com/coms2/gi_0199-1862983/The-CRA-implications-of-predatory.html.
[35] Ideally, these two things could be done at the same time, particularly if bankers believe that proposals before Congress (such as the Credit Union Regulatory Improvement Act (H.R. 1537) tilt the field in favor of credit unions at the expense of banks.