# Cry Wolf Policy Brief: The Community Reinvestment Act & Responsible Lending

*by Philip Ashton*

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## Introduction

The Community Reinvestment Act (CRA) has been critical to the expansion of responsible credit for low- and moderate-income borrowers since its passage in 1977. Designed to address low levels of lending activity in low- and moderate-income neighborhoods, it has helped spur a growing range of successful affordable loan programs that reduce barriers to credit and increase responsible lending. Despite consistent evidence that the Act produces modest increases in access to capital and is an important incentive for bank investments to profitably tap new opportunities in community economic development, it has been a convenient scapegoat for journalists, academic economists, banking industry lobbyists, and their allies in Congress.

Opponents' have shifted their arguments over time, but have consistently associated the Act with a number of doomsday scenarios that accompanied greater regulation of bank lending activity. These have alternated between dry, academic arguments – for instance, that the Act "promotes the concentration of assets in geographically non-diversified locations, encourages banks to make unprofitable and risky investment and product-line decisions, and penalizes banks that seek to reduce costs by consolidating services or closing or relocating branches" (Macey & Miller 1993: 295); and ferocious accounts by journalists and pundits manufacturing stories about "diabolically brilliant" conspiracies to compel banks to loan money (Schweizer 2009). In one recent revisionist history of the Act:

> The solution to their problems, they believed, lay in forcing lending institutions to make risky loans in urban areas and set aside funds for selected socioeconomic or racial groups. Egged on by a media with an appetite for stories about racism, class warfare, and rising income disparities, the activists would increasingly demand a say in how mortgage loans were made. Using fear and intimidation and the megaphone of a sympathetic press, they would begin to chip away at lending standards, weaken underwriting rules, and push banks away from their traditionally conservative practices (Schweizer 2009: 29).

Republican control of Congress after 1994 provided a platform for these critiques. As prominent opponents (including Republican Senators Alphonse D'Amato, Phil Gramm, Connie Mack, and Richard Shelby) tried to roll back key provisions of the Act as part of broader financial reform, they associated the Act with systemic instability – in the words of Richard Shelby (R-Al), "the Community Reinvestment Act is nothing more than a Government-mandated credit allocation, much like the mandated credit allocation in East Asia that has caused the currency crisis, among other things." In the wake of the growing mortgage crisis after 2006, this "cry wolf" strategy gained momentum, as conservative commentators have uniformly pushed the argument that government "mandates" forced banks to load their portfolios with risky loans, exposing the banking sector to heightened losses.

As policymakers and Congress consider not only new regulations for CRA, but also an entirely new architecture for housing finance, this is an important opportunity to review the historical record on CRA's accomplishments and identify the thin grounds for these criticisms of the Act.

## Legislative History

The roots of the Community Reinvestment Act of 1977 (CRA) lie in the civil rights struggles of the 1960s and the enactment of landmark federal legislation outlawing discriminatory treatment in housing and lending (the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1972) and expanding consumer access to information (the Home Mortgage Disclosure Act of 1975) (Immergluck 2004). Complementing those earlier initiatives, CRA addressed problems of poor credit access by low-income borrowers and neighborhoods by affirming the obligation of chartered banks to meet the credit needs of the communities in which they do business. The Act directed federal banking regulators to assess each bank on its "record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution", and permitted sanctions for institutions with weak records.[1]

Initially, the Reagan administration marginalized community reinvestment regulations; the first denial of a bank application on CRA grounds did not come until 1989 (Fishbein 1992). By the latter half of the 1980s, however, there was widespread dissatisfaction with the lack of effective federal enforcement of fair housing and fair lending regulations. Media accounts, including the "Color of Money" series in the *Atlanta Constitution* and the "Race for Money" series in the *Detroit Free Press* (both in 1988), publicized the continuing barriers to credit access for minorities and provided further evidence that housing and lending discrimination persisted. In 1988, a coalition of congressional representatives and the NAACP, ACLU, and AFL-CIO lobbied for the first fair housing bill since the late 1970s, and convoked Senate hearings into the laxity of fair lending enforcement.[2]

The savings and loan crisis marked a turning point. The large public liability arising from the savings and loan bailout in 1989 fractured industry-government relationships and created new openings for housing and consumer advocates to promote more effective community reinvestment regulations. Congressional supporters successfully pressed reforms to CRA and HMDA within the main piece of bailout legislation – the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) – passed in mid-1989.[3] FIRREA contained four main provisions that strengthened CRA. First, it expanded the coverage of the Act to include all federally chartered loan originators with more than $30 million in assets. Second, it required that the four regulatory agencies examining banks for CRA compliance develop unitary guidelines. Third, it made the CRA examination process more rigorous; CRA grades were changed to a descriptive scale to better distinguish "outstanding" or "good" bank records from those that are "poor" or "need improvement." Finally, FIRREA mandated that the results of regulator exams be made public (Macdonald 1995).

[1] These sanctions were limited to the power to deny approval to applications for expansion or merger; unlike the Fair Housing Act or the Equal Credit Opportunity Act, there were no civil or criminal penalties attached to CRA.
[2] These hearings publicized a 75% drop in regulator hours devoted to CRA examinations since the early 1980s, as well as widespread grade inflation (Fishbein 1992). Selected transcripts of the hearings can be found at http://powerreporting.com/color/55.html and http://powerreporting.com/color/63.html.
[3] Key supporters of CRA during FIRREA deliberations included including Sens. Alan Dixon (D-Ill.) and Donald Riegle (D-Mich), and Reps. Henry Gonzalez (D-Texas) and Joseph Kennedy (D-Mass.).

These changes addressed a key concern, namely that regulators blunted CRA's effects through lax examinations and inflated grades. In the wake of FIRREA, the Bush administration began to increase staff hours devoted to CRA examinations, and focused on better training for examining staff. Correspondingly, the failure rate for CRA exams jumped from around 2% in the 1980s to 10% of institutions received failing or "needs improvement" grades by 1992. Between 1989 and 1993, the Federal Reserve Bank refused five applications for expansion on CRA grounds; the Office of Thrift Supervision did the same in 1994 (Macdonald 1995).

The Clinton administration embraced FIRREA's reforms, and codified them in 1995amendments to the regulations governing implementation of CRA.[4] Among other changes, these amendments shifted the emphasis of CRA exams from process (proper record-keeping, setting goals and other good faith efforts) to quantitative assessment of community reinvestment performance and outcomes.[5] Changes to CRA regulations also enabled public opinion through a set of right-to-know provisions; in particular, regulators are supposed to solicit and review public commentary about bank performance when making decisions about applications for charters, FDIC insurance, relocation, merger, acquisition or consolidation.

These reforms moved the CRA exam process out of the margins of the banking system and into the center of the financial transformations of the 1990s. As damaging public criticism during the application process could cause regulators to delay approval of expansions or mergers, "CRA ratings appear to have an impact on the share prices of institutions in the process of merger or takeover, with poor ratings lowering prices" (Macdonald 1995). This pressure and the need for speedy approvals mean that many banks have opted to negotiate with their critics, spurring an estimated $4.2 trillion in bank commitments or agreements aimed at increasing lending and service in historically underserved markets between 1992 and 2005 (NCRC 2007).

As the Act gained additional teeth after 1989, however, and regulators signaled their intent to enforce its provisions through new regulations, a chorus of industry trade groups joined with Congressional opponents to attempt to water down its provisions. In 1991, Rep. Paul Kanjorski (D-Pa) and Sen. Connie Mack (R-Fl) introduced separate bills that would have exempted a significant proportion of lenders from CRA; similar proposals providing "safe harbor" from the regulations for selected groups of banks were advanced by the Bush administration in 1992. These initiatives, though unsuccessful, began a two-decade struggle over the scope and enforcement of the Act.

With Republicans taking control of Congress in 1994, attempts to repeal CRA or roll back significant portions of the Act were periodically surfaced within discussions of broader financial legislation by influential members of the Senate Banking Committee.[6] They successfully pressured the Clinton administration to exempt small banks – those independent banks with assets under $250 million – from

[4] Regulators apply three tests to each bank under examination: (1) a lending test, comparing retail market share in low- and moderate-income loans to its total market share in a community; (2) an investment test, that measured demonstrable impacts of wholesale institutions in low- and moderate-income areas; and (3) a service test, that measures percentages of branches in low- and moderate-income areas (Fishbein 1992; Litan et al. 2000).

[5] These changes were prompted in large part due to pressure from banks to make CRA grades more transparent. As Michael K. Guttau, speaking on behalf of the ABA, noted during 1994 hearings, "'The problem with the Community Reinvestment Act is not its goals but its vagueness and ambiguity that have led to a nightmare of documentation, paperwork and formalized process that diverts bankers' time and bank resources from being utilized to serve our communities… we need to build a system of supervision and enforcement that encourages creativity and substance in community reinvestment lending.'" (as quoted in Eugene Ludwig, "Boost the strength of the CRA", National Mortgage News (May 16, 1994)).

[6] This included Alphonse D'Amato (R-NY), Phil Gramm (R-TX), Connie Mack (R-Fl), and Richard Shelby (R-Al).

expanded examinations under new regulations in 1995, requiring only that they pass a simple lending test. Similar attempts to further water down the bill advanced with consideration of the 1999 Financial Modernization Act, which reduced the frequency of exams for small banks with good records, and created a set of "sunshine provisions" requiring disclosure of any bank-community agreements negotiated pursuant to CRA.[7]

This climate was picked up in the Bush administration, which appointed former Texas and California small bankers to head the Federal Deposit Insurance Corp. and the Office of Thrift Supervision. They spearheaded new CRA regulations in 2005 that changed the definition of "small bank" to any institution with assets less than $1 billion, reducing the number of institutions subject to the full CRA examination process and incentivizing banks to recharter.[8] More importantly, these banks would be considered "small" no matter what the size of the organization or holding company that owns them - "even banks and thrifts that are part of mammoth holding companies would be considered small as long as the bank or thrift itself held less than $1 billion in assets" (Barr 2004). These new regulations sent a signal to the banking community that CRA enforcement was a secondary issue for Bush Administration regulators.

## Crying Wolf: CRA's Supposed Deleterious Effects on the Banking System

Arguments about the inefficiency of CRA have been present since its enactment in the 1970s, as banking industry groups complained about the extra costs of compliance.[9] As the Act gained additional teeth after 1989, and regulators signaled their intent to enforce its provisions through new regulations, a chorus of industry trade groups and academic economists began attacking the theoretical premises of CRA. With Republican control of Congress after 1994, these attacks were taken up within a variety of House and Senate proposals that served to amplify opposition to the Act. Throughout, these attacks have consistently followed three major themes.

<u>CRA is unnecessary due to an efficient banking market</u>. The major academic argument against the Act has emphasized how CRA-induced lending would have happened anyways under efficient market conditions; in other words, there are no market failures justifying CRA-style intervention (Gunther 2000). A predilection to see banking markets as inherently efficient has led some analysts to argue that competition and the profit motive will naturally result in credit being "shipped" from areas of surplus to areas of deficit (Macey & Miller 1993). Correspondingly:

> …in the absence of CRA we would expect banks to make all possible profitable loans, and if our expectation were met, CRA pressures to extend lending would produce unprofitable loans. To the extent that CRA forces banks to engage in activities, it forces losses onto those firms relative to their non-bank competitors (Macey & Miller 1993).

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[7] Attempts to gut CRA as part of Gramm-Leach-Blilely mobilized "a growing bipartisan consensus… concerning the value of CRA…Editorials from the Washington Post, New York Times, Los Angeles Times, Atlanta Constitution and many other newspapers applauded the value of CRA and opposed weakening the law. Big and small banks including National City Bank and Iron and Glass Bank in Pittsburgh have written letters to Congress in favor of CRA and how it has helped them find profitable business opportunities." (US Newswire, "NCRC Says Senate Republicans Deliver Body Blow Against Community Reinvestment Act", May 6, 1999).

[8] Some analyses of the changes estimated that almost 96 percent of FDIC-supervised state nonmember banks would be exempt from full scope CRA review under the new rules, on top of 88 percent of all thrifts (Barr 2004).

[9] Sidney (2003) notes that the cost burdens of compliance accounted for over 2/3 of comments against the Act during Congressional hearings prior to its enactment.

Throughout the late 1990s, academic economists and conservative analysts consistently pointed to the rising subprime mortgage market as evidence that an efficient market could deliver credit to all deserving customers. As nonbank lenders not covered by CRA were leading the expansion of that market, analysts interpreted this as evidence of CRA's redundancy. They also pointed to critical developments such as risk-based pricing, the use of information technology – including automated underwriting and geo-demographic targeting –and the growth in private label securitizations as evidence that banking markets no longer needed the kinds of intervention represented by CRA.

CRA is a "drag" on profitability. Claims of lower profit rates or enhanced operating instability for CRA-covered institutions have persisted since the early 1990s (Gunther 2000). This has been based on several arguments. One argument has focused on regulatory burdens, arguing that the costs imposed by CRA – including extra reporting and paperwork, the need to dedicate staff time to the examination process, or even an imagined requirement that banks "pay out" money to silence community critics – are anti-competitive, amounting to a discriminatory tax that forces differentially high costs onto chartered banks relative to nonbank financial firms not covered by CRA. Industry sponsored studies in the early 1990s identified CRA as "the single most costly regulation" and a major contributor an estimated $10.7 billion in compliance costs in 1990 (as quoted in Macey & Miller 1993: 325).[10] This argument was taken up in 1995 regulatory reforms that aimed to reduce paperwork burdens, when the American Banking Association portrayed reform proposals as a job creation program for bank examiners (Seiberg 1994). Since then, compliance costs are often invoked by critics but rarely quantified, even as bankers themselves have argued that CRA compliance information can be used to identify areas where lending could be profitably increased.

A second argument interprets CRA as a mandate that banks increase their output of "marginal" loans (Gunther, 2000; Lacy & Walter, 2002; Macey & Miller, 1993). According to this interpretation, under efficient market conditions lenders would be making all profitable loans; any new loans spurred by the Act must have a higher probability of loss and a lower margin of profit than lenders would normally make. As banks must then set aside more funds to cover loan losses as a part of risk-based capital rules, CRA also hampers their ability to compete with their non-bank counterparts. The net result, it is argued, is that banks must absorb increased losses and reduced profit margins onto their balance sheet, potentially jeopardizing their viability.

CRA increases systemic risk. In the wake of the subprime mortgage crisis, a broader version of these arguments has attributed systemic effects to CRA. These arguments were primarily confined to academic economists prior to 2007 (Macey & Miller 1993), but have dominated conservative analysis since September 2008. According to these arguments, CRA directs banks into high risk market segments, producing greater financial fragility as the banking system becomes more loaded with risky loans (Wallison 2008). Focusing specifically on loosened underwriting standards, CRA is tied to both the explosion in credit issuance during the mid-2000s, and to the run-up in housing prices during the same period. A typical formulation is as follows:

> Although it is difficult to prove cause and effect, it is highly likely that the lower lending standards required by the CRA influenced what banks and other lenders were willing to offer to borrowers in prime markets. Needless to say, most borrowers would prefer a mortgage with a low down payment requirement, allowing them to buy a larger home for the same initial investment (Wallison 2009).

[10] See also Eliehausen (1998).

As with arguments against Fannie Mae and Freddie Mac, CRA's effect is often portrayed as working indirectly, as "examiners may have given banks 'CRA credit' for their *purchases* of lower-income loans or mortgage-backed securities containing loans to lower-income populations, which could subsequently affect the supply of mortgage credit" (Bhutta & Canner 2009).

## Responding to the Critics: CRA's Role in Building a More Efficient Banking System

Quantitative assessments of CRA have consistently confirmed that the Act produces positive outcomes in the form of increased credit availability for low- and moderate-income borrowers and neighborhoods, even while noting that the marginal effects of CRA were quite small (Apgar & Duda 2003; Ashton, 2008; Bostic & Robinson 2003; Litan et al. 2000; Schwartz 1998). The Joint Center for Housing Studies at Harvard University estimated that in 2000 CRA expanded the supply of mortgage loans to targeted groups by 2.1 percentage points; they noted that, in the context of declining market share for chartered banks, this probably represented the "peak" of CRA's impact. In the wake of the subprime mortgage crisis, a wide range of scholars and advocates have called for CRA's expansion as a means to ensure wider availability of responsible credit (Quercia et al. 2009; Seidman 2009).

Taken as a whole, the existing body of research studying the effects of CRA exposes critics as relying heavily on a mixture of abstract economic assumptions, sloppy data analysis, and ideology when they "cry wolf."

<u>CRA produces a more efficient banking system</u>. CRA's positive impacts can be seen in increased capacity to tapped underserved markets; one measure here has been increased innovations in the way that banks deliver responsible credit to low- and moderate-income markets. A Federal Reserve survey found that 73% of responding banks had at least one initiative to increase lending to historically underserved areas (Avery et al. 2000); common innovations include special loan programs to meet lending targets, community outreach and marketing initiatives, partnerships with community organizations for homeownership counseling and credit remediation, and the creation of special units and affiliates, such as community development departments or bank-owned CDCs (Listokin & Wyly 2000). These help to reduce "process barriers" to credit availability, increasing the overall efficiency of the banking system by tapping opportunities to lend to eligible borrowers in historically underserved areas (Avery et al. 2000; Listokin & Wyly 2000; Quercia 1999). It is on this basis that bankers have consistently voiced their support for the Act:

> "It's not just the right thing to do, it is the smart thing to do in a pluralistic and highly competitive marketplace," said Richard M. Rosenberg, chairman and CEO of BankAmerica Corp. (Cummins 1993).
>
> The CRA has convinced us that when businesses invest in distressed communities, they are much more likely to return to health (Fisk 2007).

<u>CRA does not hamper bank profits</u>. Even as long ago as 1993, when the profitability arguments were gaining ground, banking industry analysts failed to find any connection between CRA and lower profit margins:

> No bank ever failed because of the Community Reinvestment Act. In fact, the act specifically states that any activities should be consistent with the safe and sound operation of the institution. Certainly, if all loans to low-income and moderate-income areas are considered CRA

loans, not all them are risky. After all, 40% of American households are in this income range, and loans to 40% of America can't all be risky (Thomas 1993).

More recent studies have used detailed survey data to arrive at the same conclusions. Studies of bank lending programs by researchers at the Federal Reserve found few differences in return on equity for CRA loans relative to non-CRA loans (Litan et al 2000), and that lending programs developed specifically to improve a CRA rating were almost as profitable for home mortgage lending and more so for home improvement (Avery Bostic & Canner 2005). These findings have been complemented by recent work assessing foreclosure losses, which has found that "loans made by CRA lenders within their assessment areas, which receive the greatest regulatory scrutiny under the CRA, are significantly less likely to be in foreclosure than those made by independent mortgage companies that do not receive the same regulatory oversight" (Laderman & Reid 2009: 122).

A second area where critics turned out to be crying wolf was compliance costs. In contrast to the portrayal of CRA as loading banks with onerous administrative burdens, a staff study by economists at the Federal Reserve found the annual compliance burden in 1999 to be around 600 hours for large banks and about ten hours for small banks – a total of 1.25 million hours and $35.4 million industry-wide; "such a compliance burden would have constituted essentially 0% of the $6 trillion in bank assets and 3 billion hours of total bank employee time, and less than 0.2% of the cost of bank regulation" (Barr 2005: 588). There has never been any proof to justify the claim that CRA enabled community organizations to "extort" money from banks (Duran 2002).

CRA did not promote excessive risk-taking. Here, the evidence is consistent: there is little causal connection between CRA and the subprime mortgage crisis. CRA regulations and enforcement have seen little change since 1995, and the explosion in mortgage lending took place as the Bush administration further diminished the Act's coverage (Bhutta & Canner 2008).

Moreover, data has consistently confirmed that the majority of subprime loans were made by independent mortgage lending companies not covered by CRA (Bhutta & Canner 2008; Laderman & Reid 2009). With the advent of HMDA data on high-interest mortgage from 2004onwards, researchers have determined that, controlling for income, loans made by CRA-covered lenders typically carried lower interest rates than subprime loans and were less likely to end up securitized into the private mortgage-backed security pools that have caused the greatest losses (Traiger & Hinckley 2008). CRA loans (loans by covered institutions within their assessment areas) accounted for only 9% of higher-priced loans to lower-income borrowers and neighborhoods, while independent mortgage companies accounted for over 50% (Park 2008).

Claims that CRA somehow initially spurred an erosion of underwriting standards, or otherwise indirectly spurred irresponsible lending, are hampered by a poor understanding of the history of the subprime market.[11] Research into this question has determined that "less than 2 percent of the mortgage originations sold by independent mortgage companies in 2006 were higher-priced, CRA-credit-eligible, and purchased by CRA-covered banking institutions" (Bhutta & Canner, 2009).This is not to say that there was not excessive risk-taking by CRA-covered institutions; rather, the majority of that lending took place outside of CRA's purview (Ashton 2010). Here, the problem was not CRA's regulations but their

[11] For instance, Wallison (2008) essentially asserts that CRA created a market for risky loans with little evidence to back that claim. In contrast, Chomsisengphet & Pennington-Cross (2006), Immergluck (2009), and Ashton (2009) provide in-depth analyses of the growth of the subprime mortgage market in the 1990s within a distinct institutional framework of nonbank lenders and private secondary mortgage conduits.

lack of extensive coverage across all of a lender's lines of business. High-cost lending by CRA-covered lenders was more prevalent outside of their assessment areas (Laderman & Reid 2009) and amongst mortgage affiliates and subsidiaries – both areas where lenders are not subject to full-scope CRA review (Ashton 2010).

The message that emerges from this body of research is consistent and clear: CRA was a channel for responsible lending, and the mortgage crisis might have turned out differently if its scope had been wider and its enforcement more rigorous (Quercia et al., 2009; Seidman 2009). The primary issue on the table for mortgage market reform is how to modernize the Community Reinvestment Act to better address the growth of the shadow banking system and the growing need for responsible credit.

# Appendix A: Additional Sources

## Organizations

- National Community Reinvestment Coalition. http://www.ncrc.org.
- Center for Responsible Lending. http://www.responsiblelending.org.
- Woodstock Institute. http://www.woodstockinst.com.
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