

SPRING 2010
Volume 1 Number 2

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



A Proposal: Using the CRA to Fight Vacancy and Abandonment

INSIDE:

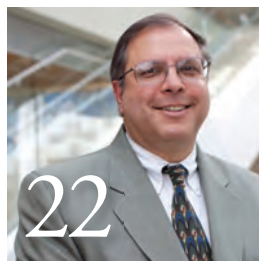
Credit for
Small Businesses

Systemic Risk

Q&A with
Economist
Anil Kashyap

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Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387
forefront@clev.frb.org
clevelandfed.org/forefront

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President and CEO: Sandra Pianalto

Editor-In-Chief: Mark Sniderman,
Executive Vice President and Chief Policy Officer

Managing Editor: Robin Ratliff

Editor: Doug Campbell

Associate Editors: Amy Koehnen, Michele Lachman

Art Director: Michael Galka

Designer: Natalie Bashkin

Web Managers: Stephen Gracey, David Toth

Contributors:

O. Emre Ergungor

Kyle Fee

Thomas Fitzpatrick

Lou Marich

Todd Morgano

Lisa Nelson

Anne O'Shaughnessy

AnnMarie Wiersch

Editorial Board:

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The CRA and the Economics of Lending in Lower-Income Neighborhoods



O. Emre Ergungor
Senior Research Economist

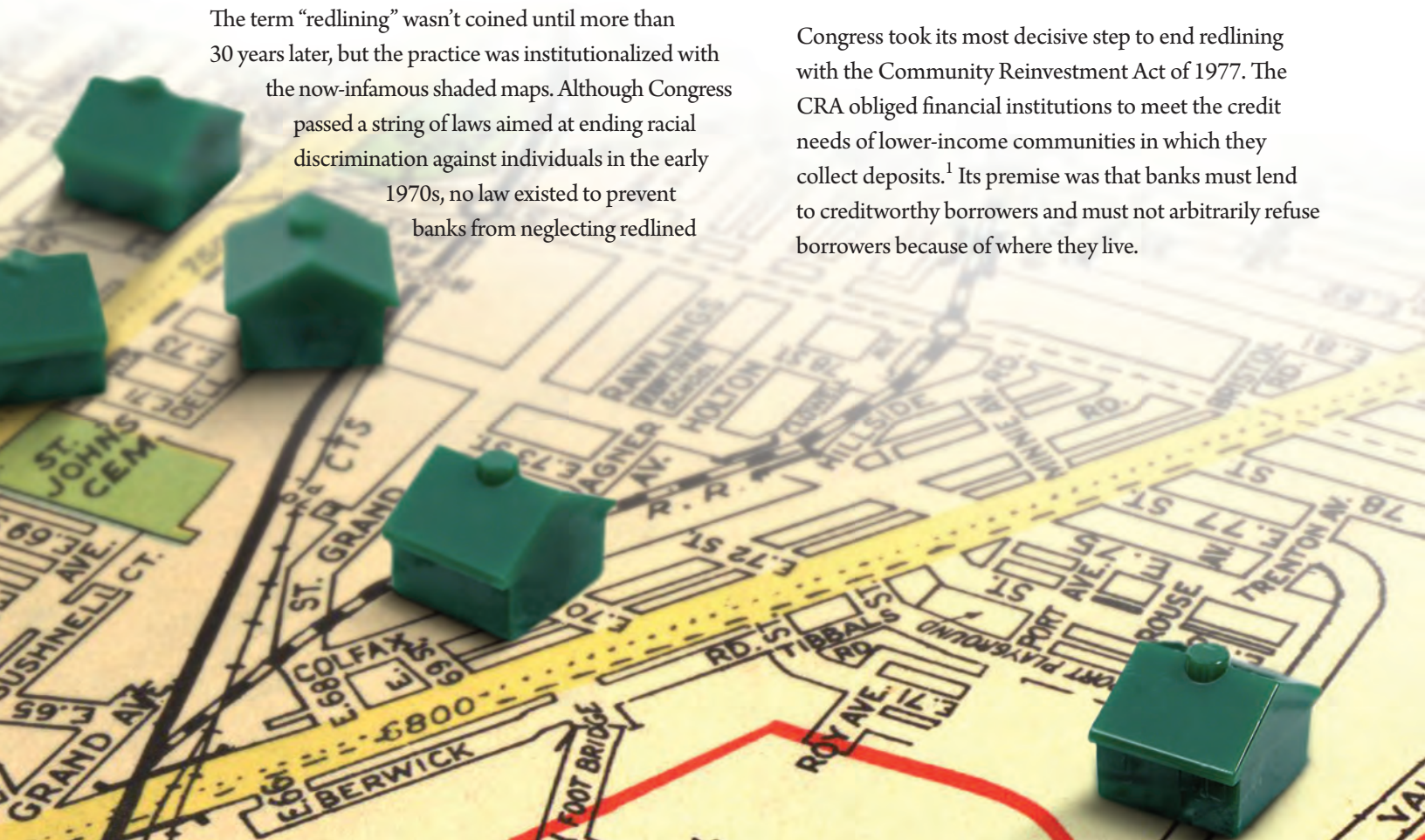
In 1935, a team inside the Home Owners Loan Corporation embarked on an ambitious project. Staffers of the federal agency, whose mission was to help Depression-slammed families avert foreclosure, began to color-code neighborhoods in 239 cities by real-estate risk level. The resulting maps classified residential areas on a scale of one (lowest risk) to four (highest risk). The riskiest neighborhoods were populated by low-income people, who were more often than not African-Americans. These were assigned the color red.

The term “redlining” wasn’t coined until more than 30 years later, but the practice was institutionalized with the now-infamous shaded maps. Although Congress passed a string of laws aimed at ending racial discrimination against individuals in the early 1970s, no law existed to prevent banks from neglecting redlined

neighborhoods in their entirety. Over time, these primarily minority and lower-income communities were caught in a vicious spiral of decline with rising crime and waning economic prospects.

The way many saw it, banks were contributing to these communities’ decline by stifling the flow of credit. They were collecting residents’ savings as deposits and investing them outside the community, even though there were creditworthy borrowers and profitable investment opportunities inside it.

Congress took its most decisive step to end redlining with the Community Reinvestment Act of 1977. The CRA obliged financial institutions to meet the credit needs of lower-income communities in which they collect deposits.¹ Its premise was that banks must lend to creditworthy borrowers and must not arbitrarily refuse borrowers because of where they live.



Thirty-three years later, there is a new financial order, and it may be time to reconsider whether the CRA needs a twenty-first-century overhaul.

The Economics of Lending in Lower-Income Areas

The very existence of redlining implies that financial institutions refuse loans to people who deserve credit; that is, profitable lending opportunities are left on the table. Why would that happen? At least three plausible explanations exist: prejudice, imperfect information, and unprofitability.

Prejudice against certain groups of people is an obvious though unfortunate reality. But unless every lender in the country is prejudiced, some should theoretically be willing to move in and cherry-pick profitable loans in underserved neighborhoods.

However, in the 1970s, banks were hamstrung in their ability to move around in search of good customers because branching across state lines (and often within states) was prohibited. In 1977, there were about 18,000 insured thrifts and commercial banks, and 54 percent of them had just one office. There were also caps on how much interest lenders could charge on loans, effectively preventing them from competing for high-risk borrowers.

These restrictions significantly reduced competition and turned banks into sheltered institutions, which had no incentive to try new products or business models to compete for low- and moderate-income customers.

In the intervening years, there was a revolution in financial services. Banks were given the ability to branch across state lines, making it possible for anyone to do business in lower-income communities. This weakened the case for institutionalized prejudice as a culprit in disinvestment. As a result, in 2010, the reasons why credit wouldn't be available in lower-income communities may have changed. Disinvestment can result from prejudice only if unprejudiced lenders are prevented from doing business in these neighborhoods.

1. This article uses "lower-income" instead of the more technical term "low- and moderate-income," which is used to define borrowers and their neighborhoods under the Community Reinvestment Act. Under current federal rules, a low-income household has income of less than 50 percent of the median family income for the area, and a moderate-income household has income of less than 80 percent, with both adjusted for household size by the Department of Housing and Urban Development.

Imperfect information is a second possible hindrance to banks in evaluating borrowers' creditworthiness. Especially in lower-income communities, where employment histories can be spotty and credit histories nonexistent, it might be prohibitively expensive or practically impossible for a loan officer to determine whether an applicant is a good risk. Such information problems are often at the root of malfunctioning credit markets and contraction of credit.

The CRA has brought credit and investment to lower-income communities. For example, the number and dollar amount of mortgage loans to lower-income borrowers have grown dramatically since the CRA passed, and research shows that this growth did not come in the form of poorly underwritten subprime loans.

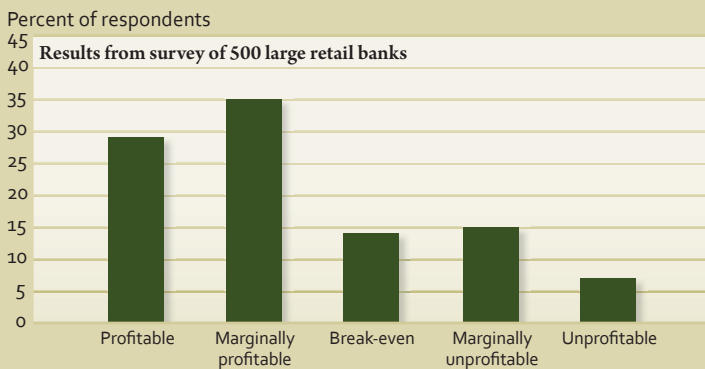
Why is information so important? Consider a hypothetical and highly simplified world with only two kinds of mortgage applicants. One kind will do everything in their power to make timely loan payments. The other would rather not make any payments; they want to live rent-free for up to a year, until the bank forecloses and the sheriff serves them with an eviction notice. In this world, neither sort of applicant makes a down payment, and the lender cannot determine who is creditworthy by looking at the limited financial information they can provide.

In a world of perfect information, diligent applicants would get loans, and the others would be denied. But in the absence of information, if the lender charges a low interest rate on mortgages to make them affordable to creditworthy applicants, it loses money because other applicants will get the same rate and default. On the other hand, if the interest rate is high enough to compensate the lender for a possible loss, the loan becomes unaffordable to the creditworthy applicants, and only the opportunistic applicants benefit. Thus, the lender is in a bind: Whatever the interest rate, creditworthy borrowers cannot get credit. Economists refer to this problem as *adverse selection*.

Unprofitability is a third factor in making business decisions in lower-income areas. Even in the absence of adverse selection, there may be so few creditworthy customers in such areas that setting up a branch or marketing products there does not make business sense.

In a survey of bankers in 2000, 64 percent of respondents reported that their CRA special mortgage programs were at least marginally profitable, though less profitable than their other business lines. Among large banks (those with more than \$30 billion in assets), about 60 percent said such programs were not profitable. (Also, a “marginally profitable” loan could still mean a loss for the bank if that loan takes resources away from more profitable investments.)

Profitability of CRA Programs



Source: Avery, Bostic, and Canner.

What did CRA accomplish?

The CRA has brought credit and investment to lower-income communities. For example, the number and dollar amount of mortgage loans to lower-income borrowers have grown dramatically since the CRA passed, and research shows that this growth did not come in the form of poorly underwritten subprime loans. Institutions covered by CRA were more likely than non-CRA lenders to originate prime loans to lower-income individuals. Recipients of CRA prime loans, in turn, were less likely to default and be foreclosed upon. Evidence also suggests that CRA contributed to increased homeownership and fewer vacancies in lower-income areas. [See related article, “Little Evidence that CRA Caused the Financial Crisis.”]

This is a remarkable success for a blunt tool like CRA. After all, CRA does not try to make markets more competitive (that problem was addressed in later years through other legislation) or to deal with the adverse selection problem. It only directs financial institutions to find a way to attain certain lending goals without compromising safe and sound banking practices.

To their credit, depository institutions have shown the creativity necessary to make CRA work. They compensated for their lack of information by building partnerships with local governments and nonprofits to sort out loan applicants’ creditworthiness. Using the same connections, banks also became better at identifying the need for various financial services and developing the products to meet those needs. Individual development accounts, a type of savings account, and low-cost alternatives to payday loans are two examples of such products.

Federal and local governments provide a multitude of incentives to promote investment and growth in lower-income neighborhoods. Because a single incentive is rarely enough to make investments feasible, banks had to learn how to pool their tax credits and subsidized funding sources. CRA seems to have helped banks overcome their inertia by making community investment a routine activity.

What are CRA’s shortcomings?

Despite its many successes, the CRA has some inherent weaknesses. For example, many large financial institutions view complying with CRA as akin to paying a regulatory tax. Such a tax may be justified only if the regulation’s social benefits (more stable neighborhoods, lower crime, and so forth) exceed the private cost to the lenders.

But taxes also have unintended consequences. To maintain their good standing, financial institutions sign agreements, usually with local governments in their assessment areas, committing themselves to specified lending and investment quotas. But research suggests that some of those institutions try to meet their perceived quotas even if there are not enough profitable lending or investment opportunities; that is, they may view any loss associated with such activity as the cost of maintaining their good standing. For them, the benefits of being in good standing may outweigh a small loss from a loan.²

So what’s the problem? Trying to meet perceived quotas may hurt small local lenders that cannot compete with larger lenders, which may be pricing their loans at less-than-profitable levels. Researchers found that small banks reduce their lending activities if a large bank is implementing a

(continues on page 14)

2. Banks do not face lending or investment quotas in CRA exams.



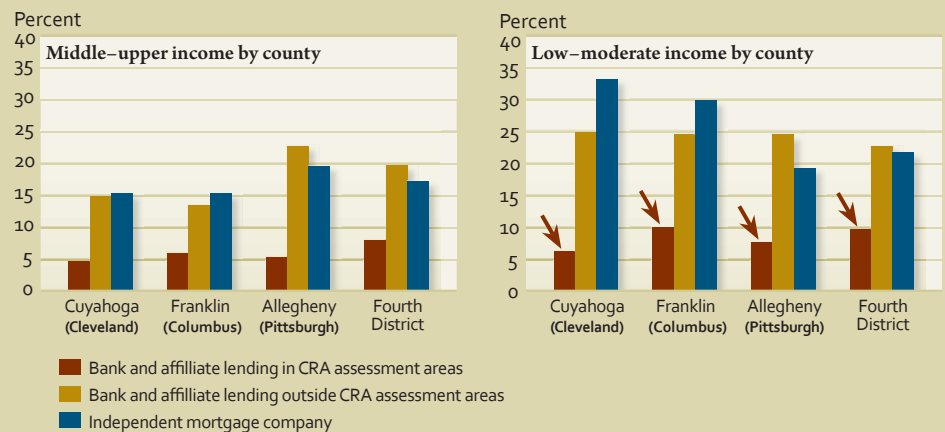
Lisa Nelson
Senior Policy Analyst

Little Evidence that CRA Caused the Financial Crisis

The CRA has come under scrutiny as a suspected contributor to the financial crisis. Under the CRA, insured depository institutions are evaluated on the lending they do in low- and moderate-income (LMI) neighborhoods and to LMI borrowers within the banks' assessment areas. Critics of the CRA suggest that banks were forced by the legislation's requirements to lower lending standards and provide loans to LMI borrowers, regardless of creditworthiness.

Our analysis of CRA lending in the Fourth Federal Reserve District, like analyses at the national level, found little evidence to support this claim.¹ CRA-regulated institutions provided a relatively small share of all loans within the District, and an even smaller percentage of the riskier high-cost loans. The figure shows the distribution of high-cost lending by lender type and borrowers' income group.

High-cost lending by income and lender type, 2006



What immediately stands out is the large percentage of high-cost loans being originated by independent mortgage companies in LMI areas and to LMI borrowers, particularly in Cuyahoga County, Ohio. More than 33 percent of all high-cost loans in Cuyahoga County were originated by independent mortgage companies to LMI borrowers or areas.

Our analysis also reveals that the small percentage of high-cost loans were originated by CRA-regulated banks in LMI areas or to LMI borrowers in their assessment areas. This is true across the three counties and in the Fourth District overall. (See arrows in figure).

Even in the middle- and upper-income areas, CRA-regulated institutions are doing very little of the high-cost lending in their assessment areas. In both Allegheny County, Pennsylvania, and in the Fourth District as a whole, a larger share of the high-cost lending is done by banks and affiliates outside their assessment areas compared to Cuyahoga and Franklin counties, where independent mortgage companies are more dominant.

1. Analysis prepared by Neil Bhutta and Glenn Canner at the Board of Governors of the Federal Reserve System: http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf

CRA agreement in their market. However, large banks do not maintain their level of CRA activities after their agreements expire. The small banks that scaled down their lending when the larger ones moved into their market may have lost their relationships with the community. So when the larger lenders cut back on their activities after their CRA agreement expires, there may not be enough providers to fill the gap.

Of course, any legislation may have unintended consequences, but there are strong signs that CRA has not kept up with changing times.

But if profitable business opportunities exist, why don't lenders move in to fill the gap after a CRA agreement expires? First, new entrants lack the community relationships that old lenders had. At the outset, this lack of connection could exacerbate the adverse selection problem. Second, as CRA's opponents argue, lenders may avoid opening new branches in lower-income communities, where they would come under the purview of CRA and incur the associated regulatory obligations. Thus, the argument goes, a policy to bring banking services to lower-income communities may actually discourage new banks from entering these communities.³

Of course, any legislation may have unintended consequences, but there are strong signs that CRA has not kept up with changing times. For example, assessment areas are now defined around banks' branches, a practice that fails to capture the realities of the current banking market. If a group of banks from across the nation form a partnership to fund low-income housing projects using housing tax credits, they will get CRA consideration only if the project is built in their assessment area. A bank that participates in a housing development will not get CRA credit unless it has a branch nearby. The CRA fails to motivate such interstate collaborations because it was designed at a time when banking was strictly local and banks were constructions of bricks and mortar. And it was designed at a time when banks provided almost all of people's important financial services, from checking and savings accounts to mortgage loans, because banks were the only show in town.

A further problem with assessment areas is the scrutiny they receive during a compliance exam. A bank is expected to provide more products and services in the areas where it collects most of its deposits. However, over the past 30 years, it has become increasingly difficult to track a deposit's location. For example, a large, multistate bank may take a deposit in Ohio but report it at its New York headquarters. As a result, the assessment area in New York must provide more CRA-related products to its community because that is where the deposits are counted for regulatory purposes.

Questions for the future

The goals set in CRA are worth pursuing. However, three big issues need to be addressed.

First, how can we know a community is being served if we cannot measure its needs? As noted in the earlier discussion of CRA agreements, banks may have an incentive to overinvest in some neighborhoods if they do not discover a community's needs and regulators' expectations during the compliance exam. In fact, many banks complain that the statute is vague and that they don't know exactly what level of lending and investment would satisfy the community and the regulators.

This concern is a sign that lenders are not necessarily driven by the profitability of their CRA activities but by their desire to meet some undefined quota in each assessment area. This brings us to the second question: **How profitable are CRA products?** Hard evidence is scarce. CRA loans and investments are treated no differently than a lender's non-CRA activities. These loans do not carry a CRA "flag" that would help researchers identify and evaluate them. The cost of these loans is practically impossible to calculate, because many of these products are cross-subsidized. For example, when the bank advertises its checking account product, a lower-income customer who opens an account may also take out a loan. So it is not all that clear how a lender should allocate advertising costs among product lines. Still, some bank surveys have indicated that CRA business is profitable, though not always as profitable as non-CRA activities. Tying up the bank's capital in less profitable endeavors is admittedly a loss to bank shareholders. More work remains to be done in this area.

3. See Macey and Miller.

The third issue concerns the very premise of CRA. **If there is a social benefit in bringing loans and investments to lower-income neighborhoods, why should the bank's shareholders bear the entire cost?**

In 1977, CRA's champions justified it with the argument that banks received some unique benefits from taxpayers. For example, bank deposits are insured by the Federal Deposit Insurance Corporation, and banks have access to the Federal Reserve's discount window, which provides emergency funds if they cannot raise funds in the market. If banks receive these benefits from taxpayers, the argument goes, they should pay for services to lower-income communities. This line of reasoning made sense at the time because competition in banking markets was limited and any benefits provided to banks accrued to shareholders. However, in today's competitive banking markets, where financial institutions cut their rates and fees to the bone to stay competitive, benefits provided to banks actually accrue to the end users of their products, that is, consumers and businesses. As a result, banks may not have the surplus they need to cushion potential losses from CRA activities.

If the quid pro quo argument is no longer valid, who should pick up the tab? Of all the questions surrounding CRA, this is the most urgent. ■

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- Avery, Robert B., Raphael W. Bostic, and Glenn B. Canner. 2000. "CRA Special Lending Programs." *Federal Reserve Bulletin* 86: 711–31.
- Macey, Jonathan R., and Geoffrey P. Miller. 1993. "The Community Reinvestment Act: An Economic Analysis." *Virginia Law Review* 79: 291–348.

Recommended Readings



Find more academic resources about the Community Reinvestment Act.
www.clevelandfed.org/forefront



Profitability of CRA Programs

Learn more about the economics of lending in low- to moderate-income communities.

www.clevelandfed.org/forefront
