

## Issues in CRA Reform

by Mark S. Sniderman

Last July, the Clinton administration urged federal bank and thrift institution regulators to propose new rules for implementing the Community Reinvestment Act (CRA), a law that was enacted in large part to discourage mortgage lenders from redlining disadvantaged communities.<sup>1</sup> In asking for a less burdensome and more objective lender-evaluation process, the President noted that both lenders and community advocates have been dissatisfied with the results of more than 15 years of CRA regulation. The President's request follows a period of intense nationwide examination and debate about housing credit discrimination. This *Economic Commentary* discusses the prevailing CRA environment and reviews some of the related issues that remain to be resolved.

### ■ Background and History

The CRA, enacted in 1977, sprang from the desire of community advocates to see more housing credit and community development lending generated by local depository institutions. The Act encourages federally insured commercial banks and savings associations to help meet the credit needs of all segments of their communities, including low- to moderate-income areas, in a manner consistent with safe and sound banking practices.

Most participants in the CRA process (lenders, regulators, and community groups) have come to interpret the law as imposing an affirmative obligation on lenders to provide credit to residents throughout their business service area. But how is lender performance to be measured? Wary of imposing a credit allocation plan on financial institutions, Congress was deliberately vague on

this issue. Legislation allowed regulators to deny lenders' applications for mergers and acquisitions on the grounds of unacceptable CRA performance, but did not provide for stiffer penalties.

Implementation of the CRA process has been assisted by another law, the Home Mortgage Disclosure Act (HMDA). Enacted in 1975, HMDA originally required depository financial institutions with offices in metropolitan areas to report annually the number and dollar volume of mortgage loans they made in each census tract of their market, and to make these reports publicly available. Through HMDA, Congress compelled selected banks and thrifts to provide information that not only would help regulators and community groups monitor the home lending activities of depository institutions, but would also enable lenders to evaluate their own and their competitors' performance in a comparable format.

From the outset, there were differences of opinion about the adequacy and usefulness of the HMDA data. Some analysts, using a standard based on the population or number of owner-occupied housing units in a region, complained the data showed that minority and low- to moderate-income areas generally were not getting their "fair share" of loan activity. Even when comparisons were made among neighborhoods with apparently similar household incomes, predominantly minority areas seemed to receive notably less housing credit than did predominantly white areas. Lenders argued that these simplistic analyses painted an incomplete picture of housing credit markets because the

The Community Reinvestment Act (CRA) was enacted in 1977 to enhance credit flows to disadvantaged communities. Lenders and community advocates alike have continued to express dissatisfaction with the results of legislative and regulatory responses to this issue. As a result, federal bank and thrift institution regulators are now scrutinizing the Act, hoping to find a less burdensome and more objective lender-evaluation process that will serve society's best interest. This article provides an overview of the prevailing community-lending environment, including a history of CRA implementation, a discussion of related research studies, and some economic considerations that should be kept in mind as policymakers attempt to reform the current process.

HMDA data alone did not reflect differences either in the creditworthiness of the applicants or in credit demand that might exist across neighborhoods.

Lenders contended that if these and other factors could be adequately accounted for, what appeared in the HMDA data to be evidence of geographic racial bias would disappear. But early evidence was not completely supportive of this view. For example, a study published by the Federal Reserve Bank of Cleveland in 1981 examined the distribution of mortgage credit in the Cleveland metropolitan area.<sup>2</sup> The authors supplemented Cleveland HMDA data with county records of actual deed-title transfers, enabling them to approximate more accurately the demand for home mortgage credit in each neighborhood. They found evidence that commercial banks and savings and loans made fewer loans in predominantly minority Cleveland neighborhoods than did other lenders, but that those other lenders (principally mortgage banks) were taking up the slack to the point where credit supply and demand were being equalized in the broader market. The CRA, however, imposes obligations on individual lenders regardless of overall credit availability in a metropolitan area. Consequently, although the Cleveland-area mortgage loan market may have been operating in an *economically efficient* manner, certain lenders may not have been in compliance with their CRA obligations.

Lenders and community groups waged many battles over CRA during the 1980s, some over data interpretations and others related to CRA enforcement criteria. On the first point, lenders continued to insist that neighborhoods differed from one another along dimensions relevant to sound business decisions, including housing stock characteristics and the applicants' default risks. HMDA data were not thought to be equal to the task of distinguishing among applicants on the basis of these factors. On the second point, community groups charged that *process* mattered more to regulators than *results*. When consumer compliance examiners evaluated a bank's CRA

performance during the 1980s, they typically looked at the geographic pattern of home loans, and they also pulled a sample of loan application files to check for lending discrimination. But, at least as far as CRA enforcement was concerned, examiners primarily emphasized such factors as a bank's efforts to assess community credit needs, product development activities, and advertising practices relevant to disadvantaged segments of its service area.

The environment gradually changed during the decade as CRA hostilities intensified and the shortcomings of the HMDA data became obvious to lenders, community groups, and regulators. In 1989, Congress enacted revisions to HMDA that both increased the set of lenders required to report such information (including independent mortgage companies) and expanded the scope of information to be reported by those now covered. For the first time, lenders had to detail certain information about every *application* for home mortgages, home improvement loans, and mortgage refinancings. This information included the applicant's annual income, race, and sex; loan amount requested; property location; and the application's disposition (approval/denial). Armed with this new applicant-level data, analysts were now better able to gauge the neighborhood demand for housing credit faced by individual lenders in the market.

#### ■ The Debate Shifts

The change in reporting also brought a shift in public attention away from redlining — the original concern of CRA — toward discrimination against individual applicants. Of course, lending discrimination against individuals is illegal and is addressed through provisions of other laws such as the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. Before the new HMDA data became commonly available, complaints of individual lending discrimination had been pursued on a case-by-case basis, outside of wide-ranging public scrutiny. Today, anyone can easily see how individual applicants fare in the credit decision process and can tabulate

the percentages of minority or low-income applicants who are denied credit by any covered lender.

With the benefit of hindsight, it is not surprising that lending discrimination, as opposed to redlining, began to receive so much attention from community groups and the news media. The expanded HMDA showed that nationwide, the vast majority of applicants are approved for mortgage credit, although the approval rates vary considerably by race, ethnic status, and income. But stated in terms of denial rates, minorities tend to be turned down about twice as frequently as whites.<sup>3</sup>

Some lenders were quite surprised to discover the magnitude of the differences within their own organizations, and even after considering that not all applicants are equally qualified for credit, wondered if something was amiss in their own lending operations. Public attention to these approval/denial disparities caused a number of lenders to reexamine and modify their entire loan application review systems.

At the same time, it should be clear that some of the same criticisms leveled against discrimination analyses based on the old HMDA data apply to the new data as well. Current HMDA data are not truly suitable for testing individual or neighborhood discrimination because they include few characteristics of an applicant's risk profile. Missing from the HMDA data are such basic indicators of the applicant's creditworthiness as payment-to-income ratios, down payment amount, episodes of slow payment or bankruptcy, and work history. Because previous research indicates that race is correlated with many of these variables, not including them could falsely signal race as an independent factor in the lender's decision. Also absent are details about the property and its appraised value, the credit terms of the loan, and the ability of applicants to obtain private mortgage insurance.

### ■ Federal Reserve Bank of Boston Study

The Federal Reserve Bank of Boston recently conducted a study of mortgage lending in the Boston area.<sup>4</sup> The project was carefully conceived to overcome many of the obstacles researchers would typically face. In an effort to collect the most relevant information used by loan officers, lenders were asked to recommend which factors should be added to the HMDA data they had already reported to their primary regulator. A sample of 131 lenders then voluntarily supplied 38 additional pieces of information for each of their black and Hispanic applicants and for a random sample of their white applicants (selected by the Reserve Bank). The researchers looked for errors and inconsistencies in the data and contacted lenders when data were missing or appeared implausible. The final sample contained about 3,000 applications.

The authors reported that before controlling for relevant economic factors, Boston-area lenders rejected 2.7 minority applicants for each white rejection, but that after taking these factors into account, the rejection ratio declined to 1.6 to 1. This finding supports the position of those who have argued for years that simple denial rates per se dramatically overstate the extent of any racial bias in mortgage lending. At the same time, the authors concluded that an unexplained gap associated with race still existed.

A troublesome issue remains to be confronted, however, and bears directly on how one should interpret the Boston Fed study. In the opinion of the authors, lenders appear to use judgment on "close calls" in ways that favor white applicants. In fact, the authors contend that the process operates so subtly that compliance examiners are unlikely to detect the bias even when looking at the loan files directly. Thus, the authors implicitly argue that even the toughest compliance examiner (or the most well-intentioned lender, for that matter) would find it difficult to detect lending discrimination in the loan files.

To shed light on this issue, the Federal Deposit Insurance Corporation (FDIC) sent teams of examiners to look at the loan files of roughly two dozen lenders who participated in the Boston Fed study. The examiners reviewed the files of denied applicants whose applications had large probabilities of being approved according to the primary model developed for use in the Boston study. The FDIC's report concludes that the lenders were justified in rejecting some applicants for reasons that were not reflected in the data provided to the Reserve Bank.<sup>5</sup> For the remaining rejected applicants, compliance examiners did not find evidence of disparate treatment.

The FDIC report does not attempt to explicitly support or refute the Boston Fed's principal finding of disparate racial treatment. Rather, its author suggests that a careful review of the loan files appears to be a prudent component of any serious study of post-application lender discrimination. This recommendation carries force when one considers that the degree of differential bias found in the Boston study was on the order of six in 100 applicants.

How, then, should one regard the use of purely statistical tests of lending discrimination? Despite the caveats, statistical models can be helpful in identifying particular applications that may have been handled at odds with normal underwriting practices. Being able to spot these applications can help lenders in reviewing how well their actual practices compare with their standards. And, of course, statistical models can assist compliance examiners in their reviews of lender performance. However, these models alone should not be relied on for proof of lending discrimination. Capturing the complex interaction among relevant factors considered by lenders is not easy; the "correct" model is hard to specify. Moreover, regulatory use of statistical models to detect discrimination could limit the amount of credit extended, as lenders attempt to approve only loans that fit the regulator's model.

### ■ Issues of the Moment

In the wake of the Boston study, federal regulatory officials have stepped up their efforts to enforce the CRA, ECOA, and Fair Housing Act. Some agencies have already announced programs to target lenders with high minority denial rates or low minority application rates for closer review. Bank and thrift managers understand the motivation behind these initiatives, but still feel uncertain as to exactly what is expected of their institutions, particularly with regard to the CRA. Many of them feel caught between the public perception of a general industry problem and the lack of any hard proof of wrongdoing at their own institutions. In this regard, the agencies have just released a policy statement on fair lending intended to provide better guidance on what constitutes discrimination.

President Clinton requested changes in CRA implementation in July 1993 to reduce excessive paperwork; to include consumer, small business, and community development lending; and to increase the objectivity of the evaluation system. He asked for more emphasis on results and more certainty regarding evaluation and enforcement. Last December, federal regulators charged with enforcing CRA responded by proposing new rules that would radically alter the scope of coverage, compliance criteria, and enforcement methods.

Under the proposed regulations, covered lenders would now be expected to meet the needs of their entire service areas through a combination of consumer, residential, small business, and community development lending. Certain lenders would have to collect and report information on all of these activities, not just on their housing credit applications. Medium- to large-size retail lenders would be evaluated on how the amounts and geographical distribution of their loans compared with the activity of other covered lenders in the marketplace. Small depository institutions would not be asked to provide this information to their primary regulators, and those that have at least 60 percent of their deposits invested in a "good mix" of loans in the community would

receive streamlined examinations and would be presumed to be meeting their CRA obligations. For all lenders, regulators would consider equity investments in community development corporations as well as the number and location of branch offices in the service area.<sup>6</sup> And, for the first time, enforcement actions could include fines for noncompliance.

Although the proposed regulations are more specific about evaluating results than about assessing efforts, regulators appear loath to impose strict numerical quotas on lenders. Examiners still will be expected to use judgment in evaluating compliance. Experience suggests that regulators have reason to be concerned about such a process, however, since community groups have historically complained that discretion has been used to overlook lender inadequacies.

Similarly, lenders have argued that a flexible system enables regulators to change the rules on them in midstream. Community groups fret that lenders will choose the strategic plan option as a means of evading more stringent discipline. Commercial banks have another concern about the proposal: Selected lenders are to be evaluated only against other selected lenders covered by CRA. This approach means that a lender's performance assessment could depend importantly on which other lenders are in its peer group. Finance and insurance companies would not be covered by the new reporting requirements. Accordingly, covered lenders worry about competing against other lenders that face lower reporting and compliance burdens.

#### ■ Economic Considerations

Quite apart from the parochial concerns of organized lenders and community groups, the general public should expect policymakers to consider which evaluation method is in society's best interest. Reflecting on experience with HMDA, it would seem prudent for Congress and the regulators to weigh carefully the information reporting system they plan to implement. HMDA data are expensive to collect, process,

and distribute. Certain collected items provide only limited benefits, and research using the data suggests that some reporting modifications would be cost-effective. For example, required information could be scaled back to include nothing more than the applicant's income and race, property location, and the application's disposition. Alternatively, lenders could be required to report on factors known to be important determinants of loan disposition, such as down payment, credit and work history, wealth, and other debt obligations. If regulators plan to augment the current data system with information about small business lending and community development investments, they must consider carefully the costs and benefits of each required factor.

Policymakers could also rethink the entire premise of CRA as it has developed. CRA's objective is to improve the flow of credit to disadvantaged communities. Policymakers have proposed that each covered federally insured depository institution be required to meet certain performance levels, regardless of the market's overall performance. In addition to other requirements, the proposed regulations would compare a lender's market share of reportable loans in low- and moderate-income communities within the lender's service area with its market share outside these communities. Though lenders would retain some flexibility in structuring their loan portfolios, regulations would require all covered lenders to specialize in meeting the credit needs of disadvantaged neighborhoods when the expertise and capacity of only a few lenders might be needed. In extreme cases, regulations could compel covered lenders to supply more credit to some neighborhoods than customer demand warrants.

#### ■ A Real-World Analogy

Federal air pollution control requirements present a useful analogy to an alternative approach. Early regulatory efforts to enforce the Clean Air Act in the 1970s rested on the premise that all polluting establishments in a region had equal responsibilities to adopt best practices and minimize undesirable

emissions, regardless of the region's overall air quality and the costs of compliance. Eventually, policymakers recognized that in certain instances, society's objective could be accomplished at a much lower cost by limiting the total amount of emissions a region could sustain, by assigning property rights to individual firms, and then by allowing these firms to allocate the total among themselves. Firms that can innovate most cost-effectively to reduce pollution can sell their allocations to other firms that find it relatively more costly to do so. In this solution, government sets the limit and the market determines the best method of accomplishing the objective.

Adopting a similar posture toward CRA would clearly be a change in methods, but need not require a change in society's objective of enhancing credit flows to disadvantaged neighborhoods. Without developing a specific plan within this alternative framework, the general dimensions seem clear. Consistent with the proposed regulations, lenders could be assigned some quantifiable financial responsibility for contributing to community lending. Firms would then be free to channel all or part of their obligation through other financial intermediaries, presumably those with the greatest expertise in community lending.

CRA implementation along these lines might generate more lending with less paperwork than either the current or proposed systems, but this method requires specific numerical responsibilities to be assigned to covered lenders. In determining quantities, policymakers should recognize that solutions to complex societal problems are likely to require far broader efforts than government-mandated credit programs alone can deliver.

## ■ Footnotes

1. Redlining occurs when lenders refuse to make mortgage loans in predominantly minority and poor neighborhoods.
2. See Robert B. Avery and Thomas M. Buynak, "Mortgage Redlining: Some New Evidence," *Federal Reserve Bank of Cleveland, Economic Review*, Summer 1981, pp. 18-32.
3. See Glenn B. Canner, Wayne Passmore, and Dolores S. Smith, "Residential Lending to Low-Income and Minority Families: Evidence from the 1992 HMDA Data," *Federal Reserve Bulletin*, vol. 80, no. 2 (February 1994), pp. 79-108.
4. See Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M.B. Tooiell, "Mortgage Lending in Boston: Interpreting HMDA Data," *Federal Reserve Bank of Boston, Working Paper No. 92-7*, October 1992.
5. See David K. Horne, "Evaluating the Role of Race in Mortgage Lending," *FDIC Banking Review*, forthcoming 1994.
6. Lenders, in conjunction with community groups, could choose to develop a strategic CRA plan. Under this option, regulators would evaluate lender performance against the plan.

Mark S. Sniderman is vice president and associate director of research at the Federal Reserve Bank of Cleveland. The author thanks Robert B. Avery, Patricia E. Beeson, and Glenn B. Canner for helpful comments.

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## **Related Articles Published by the Federal Reserve Bank of Cleveland**

Listed below are research publications from the past five years that have covered the topics of lending discrimination, community development, and studies relating to the Community Reinvestment Act and the Home Mortgage Disclosure Act. Individual copies of any of these papers are available free of charge from the Corporate Communications and Community Affairs Department of the Federal Reserve Bank of Cleveland. Call 1-800-543-3489, then key in 1-5-3 on your touch-tone phone to reach the publication request option. If you prefer to fax your order, the number is 216-579-2477.

### **Community Lending and Economic Development**

by Jerry L. Jordan  
*Economic Commentary*  
November 15, 1993

In a September 1993 speech at the Federal Reserve Bank of Cleveland's Community Reinvestment Forum in Columbus, Ohio, President Jerry L. Jordan urged lenders to reconsider the problems associated with improving credit access in America's inner cities. According to Jordan, although eliminating lending discrimination clearly deserves a high priority among banking regulators, minority communities also stand to benefit tremendously from public policies that recognize solutions predicated on economic development.

### **Home Mortgage Lending by the Numbers**

by Robert B. Avery, Patricia E. Beeson, and Mark S. Sniderman  
*Economic Commentary*  
February 15, 1993

Home mortgage lenders have recently come under increased scrutiny in the wake of several published studies showing that minority applicants are far more likely than whites to be denied housing credit. This article takes a look at some of the issues associated with those reports and raises the concern that simple comparisons of lenders' denial rates are not sufficient for grasping the complexities surrounding community-oriented lending.

### **Making Judgments about Mortgage Lending Patterns**

by Robert B. Avery  
*Economic Commentary*  
December 15, 1989

Studies examining whether mortgage lenders discriminate against borrowers in minority and lower-income areas have traditionally analyzed the relationship between aggregate annual mortgage lending within a neighborhood and the neighborhood's characteristics. Regulatory-agency compliance examiners make judgments about the mortgage lending procedures adopted by individual lenders. The differences in these two methods of evaluation are not easily reconciled, as argued in this paper.

### **Lender Consistency in Housing Credit Markets**

by Robert B. Avery, Patricia E. Beeson, and Mark S. Sniderman  
Working Paper 9309, December 1993

The authors examine how and why individual financial institutions vary in their propensity to attract and approve mortgage applications from minorities. Using data revealed by the Home Mortgage Disclosure Act, they explore the relationship between various measures of lender-market and financial performance and minority loan originations.

### **Accounting for Racial Differences in Housing Credit Markets**

by Robert B. Avery, Patricia E. Beeson, and Mark S. Sniderman  
Working Paper 9310, December 1993

This paper documents racial and neighborhood differences in home mortgage denial rates using data collected under the Home Mortgage Disclosure Act, exploring the extent to which objective lending criteria are responsible for observed differences. The authors find persistent variations in denial rates between white and minority applicants, but emphasize that the HMDA data do not contain enough relevant information to draw any firm conclusions regarding causation.

### **Cross-Lender Variation in Home Mortgage Lending**

by Robert B. Avery, Patricia E. Beeson, and Mark S. Sniderman  
Working Paper 9219, December 1992

This paper provides a lender-specific analysis of differences in minority and low-income mortgage loan originations using new applicant-level data gathered under the Home Mortgage Disclosure Act. The authors find that the variance across lenders in these loan originations is more the result of variance in application rates to those lenders than of relative differences in the disposition of the applications after they are received.

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