DRAFT: COMMENTS INVITED

Financial Crisis Inquiry Commission

Preliminary Staff Report

THE COMMUNITY REINVESTMENT ACT AND THE MORTGAGE CRISIS

APRIL 7, 2010

This preliminary staff report is submitted to the Financial Crisis Inquiry Commission (FCIC) and the public for information, review, and comment. Comments can be submitted through the FCIC's website, www.fcic.gov.

This document has not been approved by the Commission.

The report provides background factual information to the Commission on subject matters that are the focus of the FCIC's public hearings on April 7, 8, and 9, 2010. In particular, this report provides information on the Community Reinvestment Act. Staff will provide investigative findings as well as additional information on these subject matters to the Commission over the course of the FCIC's tenure.

Deadline for Comment: May 15, 2010

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The Community Reinvestment Act and the Mortgage Crisis

The purpose of this preliminary staff report is to provide background on the Community Reinvestment Act (CRA). Section I provides background on the CRA. Section II discusses the evidence on CRA's contribution to an increase in the number of risky mortgages originated.

I. BACKGROUND ON THE COMMUNITY REINVESTMENT ACT

The CRA[1] was enacted in 1977 to encourage depository institutions (or "banks") to lend to their local communities. Chairman Ben Bernanke of the Federal Reserve Board said in a 2007 speech:

> Public and congressional concerns about the deteriorating condition of America's cities, particularly lower-income and minority neighborhoods, led to the enactment of the Community Reinvestment Act. In the view of many, urban decay was partly a consequence of limited credit availability, which encouraged urban flight and inhibited the rehabilitation of declining neighborhoods. Some critics pinned the blame for the lack of credit availability on mainstream financial institutions, which they characterized as willing to accept deposits from households and small businesses in lower-income neighborhoods but unwilling to lend or invest in those same neighborhoods despite the presence of creditworthy borrowers.

Since enactment, the CRA has been amended several times, often in tandem with other changes in housing policy. These changes included: in 1989, agencies were required to issue CRA ratings publicly along with written empirical performance evaluations; in 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act repealed restrictions on interstate banking and listed CRA ratings received by the out-of-state bank as a consideration in evaluating banks' applications to create interstate branches; and in 1995, the CRA was revised with the intent of systematizing its enforcement and reducing its regulatory burden.

Under the CRA, banks are periodically examined to evaluate the extent to which they are adequately serving their communities. Based on the examination, regulators assign each bank one of four CRA performance ratings: outstanding, satisfactory, needs to improve, or substantial noncompliance. CRA ratings are used by banking regulators when considering applications by banks for approval of mergers and acquisitions or other types of applications. Regulators can deny applications based on an applicant's poor CRA rating.[2]

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[1] 12 U.S.C. §§ 2901–2908 (2000).
[2] For example, in 1989 the Federal Reserve Board denied an application by the Continental Bank of Chicago to acquire Grand Canyon State Bank based on Continental Bank's poor record of CRA compliance. Michael Quint, "Fed Blocks Continental Bid to Acquire Bank in Arizona," *New York Times*, Feb. 16, 1989.

For purposes of CRA examinations, each bank defines a geographic "assessment area," in which its practices are evaluated.[3] For retail banking institutions, the assessment area includes the geographic areas in which it takes deposits or originates loans. Regulators use three tests to evaluate each bank's performance of its CRA obligations: an investment test, a service test, and a lending test. The investment test evaluates the bank's investments that have a community development purpose. The service test considers the bank's provision of retail banking services, for example through branches and ATMs, in the assessment area. The lending test, which is the most relevant test for the mortgage market, considers the geographic distribution of the institution's borrowers, as well as the distribution of lending across different types of borrowers.

For residential mortgage loans, regulators consider in particular (a) the proportion of the bank's loans in its assessment area; (b) the geographic dispersion of the bank's loans within the assessment area; (c) the amount of lending done in low-, moderate-, middle-, and high-income geographies in the assessment area; (d) the amount of lending to low-, moderate-, middle-, and upper-income borrowers; and (e) the bank's use of innovative or flexible lending practices in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies.[4] Both originations and purchases of loans count towards a bank's CRA obligations.[5] Importantly, CRA ratings are based on the actual historical performance of the institution and generally may not rely on plans or commitments for future action.[6] The CRA does not require banks to make loans that are inconsistent with safe and sound operations. Institutions "are permitted and encouraged to develop and apply flexible underwriting standards for loans that benefit low- or moderate-income geographies or individuals, only if consistent with safe and sound operations."[7]

II. THE CRA AND THE MORTGAGE CRISIS

In the wake of the foreclosure crisis, when default rates on subprime loans increased sharply, some argued that the CRA contributed to the crisis by encouraging lenders to originate riskier loans.

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[3] 12 CFR 25.41.
[4] 12 CFR 25.22. Low and moderate-income census tracts are tracts with median family income less than 80 percent of the metro area's median family income.
[5] 12 CFR 25.22(a)(2).
[6] *See, e.g.*, Federal Reserve Board Order approving the merger of NationsBank and BankAmerica (1998, p. 63), at http://www.federalreserve.gov/boarddocs/press/BHC/1998/19980817/default.pdf ; Federal Reserve Board Order approving the merger of Bank of America and FleetBoston (2004, pp. 51-52), at http://www.federalreserve.gov/boarddocs/press/orders/2004/20040308/attachment.pdf. CRA regulations do allow banks to establish an optional strategic plan for meeting the credit needs of its assessment area and to be assessed for CRA compliance based on its performance meeting the goals of an approved strategic plan. See 12 CFR 25.27. Only two banks currently have approved strategic plans for CRA. *See* http://www.federalreserve.gov/dcca/cra/stratpln.htm.
[7] 12 CFR 25.21(d).

One challenge in evaluating the CRA's role in encouraging the origination of risky loans is determining which loans were made because of the CRA and would not have been made in the absence of the CRA. The first step in such an analysis is to quantify the flow of loans that helped the originator meet its CRA obligations. Glenn Canner and Neil Bhutta, economists at the Board of Governors of the Federal Reserve System, have collected data that help to answer this question. They estimate the fraction of subprime originations that would have helped the originating bank earn a good CRA rating using the 2006 Home Mortgage Disclosure Act (HMDA) data.[8] Among all mortgages originated in 2006, 28 percent were originated by banks subject to the CRA within their CRA assessment areas. The remaining 72 percent were made by banks outside of their assessment area or were made by mortgage lenders not subject to the CRA. Of all mortgage originations, 10 percent were originated by banking institutions and affiliates subject to the CRA within their CRA assessment areas to low-and moderate-income borrowers or in low- or moderate-income neighborhoods.

This category of mortgages for which banks could have received CRA credit (i.e., mortgages that were made in assessment areas to low-income borrowers or in low-income neighborhoods) includes relatively low-risk loans.[9] To estimate the fraction of *subprime* mortgages that were CRA-related, Canner and Bhutta (2008) use whether the mortgage was "higher-priced" according to the HMDA data as an indicator for whether it was a subprime loan. While this is of course an imperfect measure of whether a loan is subprime, among higher-priced mortgages, only 6 percent of all higher-priced loans were made to low- or moderate income borrowers or in low- or moderate-income neighborhoods by CRA-covered lenders in their assessment areas.

An important caveat to the analysis of Canner and Bhutta (2008) is that it does not include purchases of mortgages by depositories for which they can receive CRA credit. For example, some mortgages originated by independent mortgage companies may be purchased by depository institutions whose assessment area includes the borrower. The HMDA data unfortunately lack sufficient detail to identify such purchases. The HMDA data do report whether each originated loan is sold to a depository institution within the reporting period. In 2006, of the 14 million mortgages originated, 664,204, or 4.8 percent, were sold to a depository institution. Of these 4.8 percent, only a fraction were within the assessment area of the purchaser.[10]

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[8] Canner and Bhutta (2008).

[9] A 2009 report by authors from the Center for Community Lending and Center for Responsible Lending discusses borrower characteristics from a national program in part designed to help lenders covered by CRA meet their CRA obligations. The report states, "3.21 percent of our sample of community lending borrowers were 90-days' delinquent or in foreclosure process in the second quarter of 2008. This was slightly higher than the 2.35 percent delinquency rate on prime loans but well below the 17.8 percent on subprime loans nationwide." http://www.ccc.unc.edu/documents/Risky.Disaggreg.11.09.Final.pdf

[10] *See* 2006 HMDA National Aggregate Table 3-2, at http://www.ffiec.gov/HMDA/online_rpts.htm

In addition, many large mortgage lenders made public commitments to lend to low- and moderate-income and minority households.[11] (This category may include loans that do not meet CRA specifications. For example, CRA exams require that a bank had made qualifying loans to borrowers with prescribed income characteristics within its assessment area. In addition, CRA exams are unrelated to a borrower's race.) In a recent paper, Edward Pinto, a consultant to the mortgage-finance industry, compiled figures on reported lending pursuant to such commitments from five large originators' press releases.[12] He estimates a total of $2.127 trillion in such originations from 2001 to 2008. To calculate the total stock of such mortgages still outstanding in 2008, one needs to know what fraction of each year's originations were paid off by the borrower or defaulted prior to 2008. Using estimates of the prepayment rate of mortgages from Anthony Pennington-Cross and Giang Ho (2006), which focuses on subprime lending,[13] we estimate that approximately $931 billion of these mortgages would still be outstanding as of 2008. About $11 trillion in total mortgage debt was outstanding in 2008, so the originations made pursuant to these commitments from these five lenders amount to about 8.5 percent of the stock of outstanding mortgages in 2008.[14] As a reference point, mortgages to low- and moderate-income and minority households comprise 36 percent of all mortgage originations in 2008.

These summary statistics provide a sense for the scale of CRA-related lending, as well as the scale of lending done to low- and moderate-income and minority households pursuant to public commitments. However, it is possible that much of this lending would have been done even in the absence of the CRA. Stuart Gabriel, an economist at UCLA, and Stuart Rosenthal, an economist at Syracuse University, in a 2009 paper and, separately, Bhutta (2010) attempt to estimate whether CRA caused additional lending. Both papers find little increase in bank mortgage originations due to the CRA. Gabriel and Rosenthal conclude that "on balance, the lack of more compelling evidence of …. CRA effects on mortgage lending … among targeted underserved [census] tracts is striking…" Bhutta similarly concludes that "[o]n average, the CRA appears to have had little impact, including during the mid 2000's when lending to lower-income areas soared."[15]

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[11] These commitments do not contribute to CRA performance ratings as examinations focus only on actual originations. While comments and feedback received from community groups and the public do have some weight in a bank's CRA exam, these comments and feedback are only considered in regard to a bank's CRA lending, which is a subset of the bank activity potentially described in a press release related to commitments.
[12] Pinto (2010, pp. 12-15). The originators included in Pinto's estimates are Bank of America, JP Morgan Chase, Citibank, Washington Mutual, Countrywide, and affiliates thereof.
[13] Specifically, based on data from Pennington-Cross and Ho (2006) that estimates propensity for subprime loans to prepay or default, we assume that 90 percent are outstanding after 1 year, 63 percent after 2, 42 percent after 3, 24 percent after 4, 17 percent after 5, 10 percent after 6, and 3 percent after 7.
[14] To the extent that other large institutions fulfilled commitments to make loans to low- and moderate-income and minority borrowers, 8.5 percent understates the amount of commitment-related mortgages outstanding in mid-2008.
[15] Bhutta (2010, Abstract).

Another study has examined the relative performance of CRA loans. Elizabeth Laderman and Carolina Reid (2009) compare the performance of loans made by CRA-regulated lenders in their assessment areas to those made by independent mortgage companies, which are not subject to the CRA. To be sure, loans made by CRA-regulated lenders to low and moderate-income borrowers in their assessment areas default at a higher rate than loans made to the typical borrower by these same lenders. However, they find that the foreclosure rate of mortgages originated by independent mortgage companies was about twice the foreclosure rate of mortgages originated by CRA-regulated lenders. Moreover, after accounting for the effect of other characteristics of the loans and the borrowers, such as income and credit score, they find that loans made by CRA-regulated lenders in their assessment areas are *less* likely to default than similar loans made by independent mortgage companies.

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