

Ben S Bernanke: The Community Reinvestment Act - its evolution and new challenges

Remarks by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Community Affairs Research Conference, Washington DC, 30 March 2007.

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This year marks the thirtieth anniversary of the Community Reinvestment Act (CRA). Enacted in 1977, the CRA affirmed the obligation of federally insured depository institutions to help meet the credit needs of communities in which they are chartered, consistent with safe and sound operations. The act also charged the federal bank regulatory agencies, including the Federal Reserve, with implementing the CRA through regulations and with examining banks and thrifts to determine whether they meet their CRA obligations.

The CRA presents an interesting case study of a regulatory regime that has evolved to adjust to changes in the economic, financial, and social environment. Since the CRA's enactment, the implementing regulations have been substantially amended three times--in 1989, 1995, and 2005. In each case, changes to the regulations reflected both experience gained in the implementation of the law as well as ongoing developments in financial markets and the economy. In my remarks today, I will survey some milestones in the evolution of the CRA, beginning with a description of the economic and social concerns that prompted the passage of the act. With this brief history as background, I will comment on the challenges we face in ensuring that the CRA remains effective and relevant in the future.

The origins of the Community Reinvestment Act

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.

Several social and economic factors help explain why credit to lower-income neighborhoods was limited at that time. First, racial discrimination in lending undoubtedly adversely affected local communities. Discriminatory lending practices had deep historical roots. The term "redlining," which refers to the practice of designating certain lower-income or minority neighborhoods as ineligible for credit, appears to have originated in 1935, when the Federal Home Loan Bank Board asked the Home Owners' Loan Corporation to create "residential security maps" for 239 cities that would indicate the level of security for real estate investments in each surveyed city.¹ The resulting maps designated four categories of lending and investment risk, each with a letter and color designation. Type "D" areas, those considered to be the riskiest for lending and which included many neighborhoods with predominantly African-American populations, were color-coded red on the maps--hence the term "redlining" (Federal Home Loan Bank Board, 1937). Private lenders reportedly constructed similar maps that were used to determine credit availability and terms. The 1961 Report on Housing by the U.S. Commission on Civil Rights reported practices that included requiring high down payments and rapid amortization schedules for African-American borrowers as well as blanket refusals to lend in particular areas.

¹ The Home Owners' Loan Corporation (HOLC) was a New Deal agency established in 1933 to help stabilize real estate that had depreciated during the Depression and to refinance mortgage debt of economically distressed homeowners. It granted fifteen-year mortgage loans at 5 percent interest to some 1 million homeowners between August 1933 and June 1936, the period it was authorized to originate new loans (Hiller, 2003).

Besides discrimination a variety of economic and institutional factors help to explain the relative unavailability of credit in lower-income neighborhoods.² Thirty years ago, the secondary market for mortgages was rudimentary at best, which limited local loan originators' access to capital and reduced their ability to diversify credit risks geographically.³ Informational problems also inhibited lending in some urban areas. For example, relative to higher-income neighborhoods, lower-income areas tend to have fewer home sales and more-diverse housing structures, making accurate appraisal more difficult⁴. Similarly, credit evaluations tend to be more costly for lower-income borrowers, who are relatively more likely to have short or irregular credit histories.⁵ Informational barriers to lending were heightened by the absence of uniform national depositories of information on the credit experiences of consumers; at the time, the credit-reporting system consisted of hundreds of local credit bureaus, each of which maintained limited information on local residents.⁶ The high costs of gathering information, together with the difficulty of keeping information proprietary, may have created a "first-mover" problem, in which each financial institution has an incentive to let one of its competitors be the first to enter an underserved market. Without some coordination, the first-mover problem may result in no institution choosing to incur the costs of entry (Lang and Nakamura, 1993; Barr, 2005; and Ling, 1998).

The regulatory environment of the period was yet another factor limiting broad access to credit. State and federal rules prohibited interstate branching or acquisitions and in some cases restricted even intrastate branching, reducing competition and the ability of lenders to diversify geographic risk.⁷ Also, interest rate ceilings on mortgages in some locations effectively blocked lending to potential borrowers judged to pose higher risks, and interest rate ceilings on deposits (notably, the infamous Regulation Q) led to periodic episodes of disintermediation and reduced availability of mortgage credit (Chomsisengphet and Pennington-Cross, 2006; and McNeil and Rechter, 1980).

Taken together, these social, economic, and regulatory factors contributed to the perception that banking institutions were failing to adequately serve the credit needs of some residents of their communities, a concern that led the Congress to enact the CRA. The CRA reaffirmed the long-standing principle that financial institutions must serve "the convenience and needs," including credit needs, of the communities in which they are chartered. The obligation of financial institutions to serve their communities was seen as a *quid pro quo* for privileges such as the protection afforded by federal deposit insurance and access to the Federal Reserve's discount window (FFIEC, 1992). Indeed, the Bank Holding Company Act, passed in 1956, had already required the Federal Reserve Board, when ruling on proposed acquisitions by banks or bank holding companies, to evaluate how well the institutions involved were meeting community needs, consistent with the requirements of safety and soundness.

The CRA was only one of a series of laws passed during the 1970s intended to reduce credit-related discrimination, expand access to credit, and shed light on lending patterns. The CRA itself focused on the provision of credit to low- and moderate-income communities rather than on discrimination by race, sex, or other personal characteristics. Legislation that addressed discrimination in lending explicitly included the Equal Credit Opportunity Act and the Fair Housing Act. The Home Mortgage Disclosure Act was enacted to increase transparency in the mortgage lending market and to support public and

² Debate continues on the relative importance of racial bias and economic factors for explaining redlining and similar practices (see Lacker, 1995).

³ The Federal Reserve's Flow of Funds accounts did not even record private securitization activity until the early 1980s, and purchases by federal housing agencies, which were focused on government-backed loans and lower-risk conventional loans, represented less than 1 percent of total outstanding home mortgage debt in the years preceding enactment of the CRA.

⁴ Analysis of decennial census and Home Mortgage Disclosure Act data indicates that lower-income areas have about half the number of owner-occupied homes and home purchase loans in a given year than do higher-income areas.

⁵ Although information from the period before the CRA is not available, a review of credit records from one of the national credit-reporting agencies today supports this conjecture, as it finds that individuals in lower-income areas have, on average, substantially shorter credit histories and only about half as many credit accounts. Also, nearly 40 percent of the individuals in lower-income census tracts cannot be scored, a proportion nearly three times that found in higher-income areas. This information comes from analysis by staff members of the Federal Reserve Board in conjunction with a report to the Congress (Board of Governors of the Federal Reserve System, forthcoming).

⁶ The low-cost summary measures of credit history that have gained widespread market acceptance today did not emerge until 1989, when Fair Isaac and Company developed the FICO score.

⁷ For a listing of these rules, see Amel and Keane (1986).

private investment activity. From an economic perspective, the CRA can be interpreted as an attempt to rectify market failures--for example, by inducing banks to invest in building the knowledge and expertise necessary to lend profitably in lower-income neighborhoods. Similarly, to the extent that the CRA encouraged coordinated or simultaneous efforts by banks to lend in underserved areas, it had the potential to reduce the first-mover problem.

The debate surrounding the passage of the CRA was contentious, with critics charging that the law would distort credit markets, create unnecessary regulatory burden, and lead to unsound lending. Partly in response to these concerns, the Congress included little prescriptive detail in the law. Instead, the CRA simply directs the banking regulatory agencies to ensure that banks serve the credit needs of their local communities in a safe and sound manner. In effect, the agencies were left with considerable discretion and flexibility to modify the rules in light of changes in the economy and in financial markets (Garwood and Smith, 1993). At times, this discretion has been the source of some uncertainty on the part of regulated institutions concerned with compliance. However, the flexibility has proved valuable in allowing the CRA to remain relevant despite rapid economic and financial change and widely differing economic circumstances among neighborhoods.

The evolution of the CRA

For more than a decade after its enactment, the CRA was a rather low-profile banking regulation, one that set minimal compliance requirements for depository institutions and attracted limited supervisory attention from the bank regulatory agencies.⁸ By the late 1980s, however, the issues surrounding access to credit were attracting renewed interest. In response to this interest, the Congress included in the Financial Institution Reform and Recovery Act of 1989 (FIRREA) an amendment to the CRA statute to require public disclosure of institutions' ratings and performance evaluations. FIRREA also expanded data collection and made public certain data reported under the HMDA. With the requisite data becoming available, advocacy groups, researchers, and other analysts began to perform more-sophisticated, quantitative analyses of banks' records in meeting the credit needs of their communities.

Further attention to CRA was generated by the surge in bank merger and acquisition activities that followed the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. As public scrutiny of bank merger and acquisition activity escalated, advocacy groups increasingly used the public comment process to protest bank applications on CRA grounds. In instances of highly contested applications, the Federal Reserve Board and other agencies held public meetings to allow the public and the applicants to comment on the lending records of the banks in question. In response to these new pressures, banks began to devote more resources to their CRA programs. Many institutions established separate business units and subsidiary community development corporations to facilitate lending that would be given favorable consideration in CRA examinations. Local and regional public-private partnerships and multibank loan consortia also gained more prominence as banks developed strategies for expanding and managing CRA-related activities.

Even as these developments were occurring, extensive change was taking place in the financial services sector. During the 1980s and 1990s, technological progress significantly improved data collection and information processing, which led to the development and widespread use of credit-scoring models and the availability of generic credit history scores. Deregulation also contributed to the changes in the marketplace. Notably, the lifting of prohibitions against interstate banking was followed by an increased pace of industry consolidation. Also, the preemption of usury laws on home loans created more scope for risk-based pricing of mortgages. Securitization of affordable housing loans expanded, as did the secondary market for those loans, in part reflecting a 1992 law that required the government-sponsored enterprises, Fannie Mae and Freddie Mac, to devote a percentage of their activities to meeting affordable housing goals (HUD, 2006). A generally strong economy and lower interest rates also helped improved access to credit by lower-income households.

Bankers were also gaining experience in underwriting and managing the risk of lending in lower-income communities. After years of experimentation, the managers of financial institutions found that

⁸ Examinations were conducted to evaluate an institution's compliance in five performance areas, comprising twelve assessment factors. The examination culminated in the assignment of a rating (Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance) and a written report that became part of the supervisory record for the institution.

these loan portfolios, if properly underwritten and managed, could be profitable. In fact, a Federal Reserve study found that, generally, CRA-related lending activity was at least somewhat profitable and usually did not involve disproportionately higher levels of default (Avery, Bostic, and Canner, 2000; see also Board of Governors, 1993). Moreover, community groups and nonprofit organizations began to take a more businesslike, market-oriented approach to local economic development, leading them to establish more-formalized and more-productive partnerships with banks. Community groups provided information to financial institutions on the needs of lower-income communities for credit and services, offered financial education and counseling services to community members, and referred "bankable" customers to partner banks. Specialized community development banks and financial institutions with the mission of providing financial services and credit to lower-income communities and families emerged and grew.

Policy developments bolstered the infrastructure and funding of community development lending organizations. Notably, the passage of the Community Development Financial Institutions (CDFI) Act of 1994 created the CDFI Fund at the Department of Treasury. The expansion of CDFIs provided banks with access to new opportunities to finance community economic development. Other initiatives, such as the federal Low Income Housing Tax Credit and New Markets Tax Credit programs provided vehicles for investing in affordable housing development and economic revitalization in distressed communities.

Even as CRA-related lending became more extensive and more market-based, concerns were expressed about the implementation of the law. Financial institutions complained about compliance costs (Elliehausen, 1998). Both bankers and community groups criticized the CRA examination procedures as emphasizing process over results, arguing that the examination criteria were too subjective and that a more-quantitative system for evaluating institutions' CRA performance should be developed. In response to these criticisms, President Clinton in 1993 directed the agencies that implement CRA to review and revise the regulations, with the goals of clarifying performance standards, making examinations and evaluations more consistent, and reducing the compliance burden.

The CRA regulations adopted in 1995 established for large institutions a three-pronged test based on performance in the areas of lending, investments, and services. While the regulations placed the greatest emphasis on lending, they encouraged innovative approaches to addressing community development credit needs. Several provisions were included to reduce compliance costs, among them a new rule that allowed small banks to meet their requirements by means of a streamlined examination focused on lending activities.⁹

When the new regulations were adopted, the agencies committed themselves to reviewing the regulations in 2002 to assess their effectiveness. The promised review made use of extensive public comment and scholarly research on the efficacy of CRA programs. In their comments on the proposed revisions to the rules, bankers and community organizations generally agreed that the fundamental elements of the regulations were sound and that the agencies should maintain the overall structure of the 1995 regulations, although each group raised a number of specific issues. Findings from the research by Board staff members, in combination with the public comments, led the agencies to propose new definitions for "small" banks, which would be subject only to a lending test to assess compliance with the CRA, and for "intermediate small" banks, which would be subject to a lending test as well as a new and more-flexible community development test (Avery, Canner, Mok, and Sokolov, 2005). In addition, the research underscored the benefit of expanding the definition of "community development" to include activities benefiting middle-income communities in distressed rural areas and in disaster areas. The final rule was adopted in July 2005.

In each of the major regulatory revisions, the goal of the regulators has been to increase the effectiveness of the CRA in promoting the economic development of lower-income communities while reducing the associated compliance burden. Again, making progress toward achieving these goals has been made easier by the flexibility of the original statute, which has allowed the regulators to

⁹ The agencies sought to offer banks some flexibility in choosing an examination strategy that suited their business models. The 1995 regulations gave banks the option to submit a strategic plan for complying with CRA in lieu of the standard approach to examination. A community development test was offered to wholesale and limited-purpose banks as a standard for their compliance. The agencies also required that examiners evaluate a bank's CRA record within a performance context that considered socioeconomic factors and market conditions within the institution's service area.

adapt the rules to changing market and economic circumstances and to give financial institutions the latitude to meet their CRA obligations in diverse and cost-effective ways.

Has the CRA achieved its objectives? Research on the CRA has tended to find positive net effects, but the results are not uniform. A paper by Board staff members compared census tracts just above and below the low- and moderate-income threshold, finding that the tracts below the threshold had higher homeownership rates, higher growth in owner-occupied units, and lower vacancy rates than would have otherwise been predicted (Avery, Calem, and Canner, 2003). An analysis by Harvard's Joint Center for Housing Studies concluded that the CRA has expanded access to residential mortgages for lower-income borrowers, but that research also finds that the CRA's effect is diminishing as mortgage lending by nonbank institutions expands (Apgar and Duda, 2003). Yet another review concludes that the CRA has been effective in helping to overcome market failures and reduce discrimination at a relatively low cost, precisely because the CRA sets forth a flexible standard rather than a rule (Barr, 2005). However, some critical studies have argued that the CRA has been ineffective in addressing discrimination and market failures and that its social costs outweigh its benefits (see, for example, Hylton, 2006, and Barr, 2005).

The CRA is clearly far from perfect. Although its objectives are broad and ambitious, its net effects on lower-income neighborhoods are difficult to measure with precision.¹⁰ Addressing CRA responsibilities also imposes costs on financial institutions. It appears that, at least in some instances, the CRA has served as a catalyst, inducing banks to enter underserved markets that they might otherwise have ignored. At its most successful, the CRA may have had a multiplier effect, supplementing its direct impact by stimulating new market-based, profit-driven economic activity in lower-income neighborhoods.

The future of the CRA

As we look forward, the CRA will have to continue evolving to reflect the ongoing changes in financial markets and in the economy more generally. I will conclude by flagging just a few of the issues that will remain important for the implementation and the effect of CRA.

First, for some institutions the concept of the "local community" is no longer as clear as it was when the CRA was enacted. Today, some institutions are not identified with a particular community but are regional or national in scope, which inevitably makes the definition of the relevant assessment areas somewhat difficult. Moreover, to an increasing extent, banks use nontraditional avenues--the Internet, for example--to interact with customers, in some cases avoiding a bricks-and-mortar presence altogether. To date, defining "local community" for the purposes of CRA assessment has been manageable as most banks still lend in local communities where they have deposit-taking facilities or branches. However, if these trends continue, defining a "local community" may become increasingly difficult, and the concept eventually may require reconsideration by regulators or even the Congress.

Second, changes in the structure of the financial industry have resulted in many financial transactions that fell under the CRA umbrella in 1977 having become increasingly the province of nondepositaries not subject to CRA, including companies owned by banks or bank holding companies. Holding companies' nonbank affiliates, for instance, can be included in the CRA assessment of the banking institution at the discretion of the bank but need not be. Most mortgages are now packaged by brokers, and nearly two in three mortgages are originated by nondepositaries not covered by the CRA.¹¹ Nonbank institutions, such as payday lenders, check cashers, and remittance agents, are important sources of financial services in low- and moderate-income communities. In some cases, nonbank service providers offer convenience to customers but at prices that have raised concerns (Carr and Schuetz, 2001, and Barr, 2004).

¹⁰ Distinguishing with certainty the effects that the CRA had on "CRA-type" activity from the effects of simultaneous regulatory and market changes over this period has not been possible. It is highly likely that these factors have interacted with one another to affect consumers.

¹¹ The [National Association of Mortgage Brokers](#) reports that 68 percent of home loan originations involve mortgage brokers. In 2005, 63 percent of mortgages were originated by mortgage companies. (Of the mortgage companies, 70 percent were independent; the rest were affiliated with depository institutions.) The remaining 37 percent were originated by depositories directly: 21.6 percent by commercial banks, 12.9 percent by savings institutions, and 2.5 percent by credit unions (see Avery, Brevoort, and Canner, 2006).

Some observers have suggested extending the CRA to nonbank providers, but this proposal neglects a fundamental premise of the CRA legislation--that banks incur special obligations in exchange for the advantages conferred by their charters, such as deposit insurance. Of course, the CRA is not the only tool for addressing such issues, should it be determined that consumers are not adequately protected in their dealings with nonbanks. The CRA may nevertheless have some role to play; for example, a possible question to consider is whether increasing the focus on services by banking institutions might encourage them to compete more actively with nonbank providers in lower-income neighborhoods.

Third, access to credit in lower-income communities is obviously much greater today than when the CRA was enacted. This greater access has had tangible benefits, such as the increase in homeownership rates (Joint Center for Housing Studies, 2006). However, recent problems in mortgage markets illustrate that an underlying assumption of the CRA--that *more* lending equals *better* outcomes for local communities may not always hold.¹² Whether, and if so, how to try to differentiate "good" from "bad" lending in the CRA context is an issue that is likely to challenge us for some time. One possible strategy is to place more weight in CRA examinations on factors such as whether an institution provides services complementary to lending--for example, counseling and financial education.

The CRA was created to help ensure lower-income communities have access to credit and financial services. When it passed the legislation, the Congress could not have foreseen the extensive changes in financial markets and the economy that have occurred over the past thirty years; thus, the decision to write the statute broadly and with considerable flexibility appears wise in retrospect. In implementing the law, the banking agencies have tried to learn from market developments, from research, and from the comments of financial institutions, consumers, and other interested parties. The regulations have thus changed over time in response to the changing financial landscape and as we have learned more about what works and what doesn't. We do not know how the economy and the financial system will change in coming decades, but it is safe to assume that change will be rapid. Considerable creativity and flexibility will thus be necessary to ensure that the CRA continues to assist community economic development without placing an undue burden on financial institutions.

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¹² These concerns are reflected in the [Interagency Guidance on Nontraditional Mortgage Product Risks](#) (Office of the Controller of the Currency and others, 2006), as well as recently issued requests for public comment on the expansion of that guidance. For further discussion of the emergence of the subprime mortgage market, see Gramlich, 2007.

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