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The Community Reinvestment Act at 40

Why Is It Still Necessary to “Lean” on Banks?

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INTRODUCTION

The Community Reinvestment Act of 1977 (CRA) turned 40 a few years ago. Although assessments/evaluations of longstanding programs are always to be welcomed, anniversaries that end with a “5” or a “0” are often a good opportunity/excuse for such assessments. The CRA is no exception.

The increased availability of data – plus the increased sophistication of statistical/econometric techniques – have made quantitative assessments of the effects of the CRA more feasible. That is all to the good.¹

Nevertheless, in order to draw conclusions from these assessments one needs to specify the goals of a program – in quantifiable terms. Related to this specification of the goals is a statement of what problems the program is trying to address – and the specific sources of those problems. Further, data rarely “speak for themselves”. Instead, one needs a model – an organized way of thinking about behavior and relationships – in order to make sense of the data and extract their implications.

The remainder of this commentary will expand on these ideas.

THE GOALS OF THE CRA/THE PROBLEMS TO BE ADDRESSED

The CRA was enacted at a time – 1977 – when banks and savings institutions² were perceived as neglecting to provide financial services – especially loans – to neighborhoods in which the residents were predominantly minority and low/moderate income households. The practice of “red lining” – bank managements’ drawing red lines on maps around such neighborhoods and instructing their loan officers to not make loans to these neighborhoods’ households (e.g., in the form of residential mortgage loans) and small businesses – appeared to be common.³ And to the extent that banks had branches in these neighborhoods, which were accepting the deposits of the residents but not lending in those neighborhoods, the banks were perceived as “draining” the deposits out of those areas.

The CRA’s remedy was to mandate that banks “meet the credit needs of the communities” in which the banks do business. It is thus a geography-based mandate, with bank branches and their surrounding communities being the focus of regulatory attention. The banks are expected to give special attention to low- and moderate-income (LMI) neighborhoods. And the lending should be consistent with safe-and-sound lending practices.

The overall goal – helping the residents of LMI neighborhoods – is definitely worthwhile. However, the specific goal – meeting “credit needs” – is vague and difficult to quantify. In essence, “needs” are inherently subjective; and the “credit needs” of a community are even more so.⁴ In turn, this makes assessments of banks’ performance problematic – both in the day-to-day regulatory sphere as well as for any external assessments.

For the first 20 years or so of the regulatory enforcement of the CRA, the regulators tended to focus on a bank’s *efforts* to serve its community and the documentation of those efforts; after 1995 there was more focus on lending *outcomes* in the community; and most recently there has an expanded awareness that the depository and related services (such as check-cashing and debit cards) have value for community residents (especially when the alternatives – such as store-front check-cashing services – are relatively costly). In essence the regulatory assessments in the earlier period focused more on “inputs”; the regulatory assessments after 1995 have focused more on “outputs”. Although the latter emphasis is definitely preferable to the former, the fundamental problem remains: It is difficult to make assessments when the goal is expressed in terms of “credit needs”.

Further, there has been little effort to explore the sources of the perceived problem: Why does it continue to be necessary – *more than 40 years after the CRA’s enactment* – to expend regulatory efforts to “lean on” on banks to make loans that (apparently) they otherwise do not want to make?⁵

In the discussion that follows, it is worth keeping in mind the basic “business model” of banking: Banks take in deposits and make loans with those deposited funds. Banks make their income on the net “spread” between the interest rate that they charge on the loans and the interest that they pay on deposits, plus any fees that they charge that are related to the loans, deposits, and/or other services that the banks provide. If a borrower doesn’t repay the loan (or doesn’t repay the full amount), this is a loss to the bank; hence, banks are quite interested in the creditworthiness of their potential borrowers: the likelihood that the bank’s loans will be repaid.^{6,7}

Let us now return to the question above: Why is it still necessary for CRA regulation to “lean on” banks to make loans that they otherwise do not want to make? Here are some potential explanations:

1. Discrimination against minorities. It may be the case that bank personnel continue to be biased against lending to otherwise creditworthy households and small businesses and thus are forgoing profitable loans where the borrowers are minorities. In turn, this bias might arise from two potential sources: a) The bank personnel simply prefer not to deal with minorities; or b) The bank personnel systematically (and thus in a biased fashion) underestimate the creditworthiness of potential minority borrowers.

2. Inadequate effort. Bank personnel are simply not making a sufficient effort to ascertain the creditworthiness of potential borrowers; banks make loans only (or largely) to the easy-to-ascertain-creditworthiness potential borrowers. With more effort, the bank personnel would realize that more of their potential borrowers are creditworthy, and thus the bank would make more of these in-actuality-profitable loans.⁸ To the extent that minorities and/or LMI potential borrowers are more likely to be in the harder-to-ascertain-true-creditworthiness category, bank lending to those potential borrowers will be lower than if greater effort were expended.⁹

3. Market power. In some geographic areas, there may be inadequate competition, and thus any incumbent bank in those areas will be able to exercise market power. In turn, this market power will be reflected in: a) higher-than-competitive interest rates that are charged on loans; b) lower-than-competitive interest rates that are paid on deposits; and/or c) higher-than-competitive fees on loans and/or deposits. In turn, these less competitive rates – in addition to generating larger profits for the incumbent bank – will mean fewer customers for those services. To the extent that LMI neighborhoods experience inadequate competition, the residents and small businesses in these neighborhoods will suffer these consequences – which will include being priced out of otherwise affordable loans.

4. Reduced financial sophistication of borrowers. Even where there appears to be adequate competition, the reduced financial sophistication¹⁰ of some potential borrowers may allow the bank to charge above-competitive interest rates and/or fees on loans to those borrowers.¹¹ To the extent that minorities and/or LMI residents more generally are less financially sophisticated than are other borrowers, they are more likely to suffer the consequences – which (again) include being priced out of otherwise affordable loans.

5. Collective action problems. LMI neighborhoods – because of fewer community amenities, higher crime rates, etc. – may be perceived by individual banks as a risky environment for making individual loans. However, if the banks that are within or adjacent to a LMI neighborhood could be collectively assured that all of them would be making loans in the same community, they would likely then perceive their individual loans as less risky and would be more willing to extend credit and on more favorable terms to potential borrowers in that neighborhood. In essence, the collective action would “internalize the externalities” for the individual lending banks.¹²

6. Beneficial spillover effects more generally. To the extent that expanded lending has wider beneficial effects for a LMI community (beyond those that were mentioned in #5 immediately above), an individual bank is likely to

not take them into account in its lending decisions.¹³ Again, loans to potential borrowers in LMI neighborhoods will be lower than if these beneficial spillover effects were somehow taken into account in the lending decision.

BETTER POLICIES.

The listing in the previous section of the possible justifications for the CRA provide the basis for considering first-best policies for addressing these problems.¹⁴ In short:

- If the problem is persistent discrimination in lending decisions by bank personnel, then more vigorous enforcement of the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974 should be pursued.¹⁵
- If the problem is inadequate effort and/or inadequate competition in bank lending, then expanded chartering of banks – especially of those that are likely to serve LMI communities – should be pursued. In this regard, one important beneficial direction would be to allow non-financial firms that have a good track record of serving LMI communities to acquire bank charters.¹⁶ In the same spirit, credit unions (which have a strong “serve their membership” ethos) should be encouraged to expand into LMI neighborhoods through loosened membership restrictions.
- If the problem is one of inadequate collective action, then bank regulators should strongly encourage bank consortia that would jointly undertake lending programs in LMI neighborhoods. Although this kind of encouragement currently occurs within the CRA, it need not require the overall superstructure of the CRA to be pursued by bank regulators.
- If the problem is that of generally beneficial spillovers from lending, then this kind of general social benefit should not be expected to be forthcoming from private profit-oriented financial institutions. Instead, such loans should be specifically targeted with subsidies from the public fisc. In addition, the expansion of Community Development Financial Institutions (CDFIs) – which already function as specially chartered lending institutions that are intended to be focused on such lending – should be further encouraged and their funding expanded (again, from the public fisc).¹⁷ To expect that banks should be making such loans as part of a bank’s CRA efforts is to expect that the bank should be making loans that it will find to be unprofitable (or at least less profitable than the alternatives that are otherwise open to it). In turn, this will relegate such loans to a second-class status within the bank and encourage (at best) shirking and reluctance on the part of the bank.
- If more than one of the problems that were listed above provide the justification for the CRA, then (of course) more than one of these first-best policies should be pursued.

In sum, there are better ways of addressing the problems that the CRA is supposed to address. Because the requirement of “meet the credit needs...” is so vague and also because the CRA is so specifically linked to the geography of a bank (and its branches), the CRA is a distinctly second-best way of addressing those problems.

Even within the context of the CRA and its geographic focus, there is a better way: The (currently vague) annual lending obligation of each bank should be explicitly quantified. These obligations could then be traded among banks, so that a system could arise that is similar to the “cap-and-trade” arrangements that have successfully encouraged greater efficiency and lower costs in dealing with environmental problems.¹⁸ In essence, such a quantified-tradable-obligation arrangement would greatly reduce the current ambiguity in a bank’s CRA obligations and would also encourage greater efficiency and innovation, since it would allow banks (or other lending institutions) with greater expertise at making such loans to be able to take over such obligations. Again, the CRA in its current form is distinctly second-best.

Finally, it is worth noting an important potential drawback of the CRA even to the LMI communities that it is intended to help: The CRA lending obligations that are linked to the specific geographic locations of



a bank's branches and/or the added regulatory burden that a bank might endure in its efforts to close a LMI neighborhood branch could well discourage the establishment of *new* branches in or adjacent to LMI neighborhoods.¹⁹ The LMI neighborhoods are thereby deprived of the lower-cost financial services that these branches could otherwise bring.

CONCLUSION.

The 40th anniversary of the CRA provides a welcome opportunity to re-assess this important program. Any assessment, however, should be clear about the specific problems (and their causes) that the CRA is supposed to address.

Recent advances in data availability and in econometric techniques indicate that the CRA is having a net positive effect on lending in LMI neighborhoods. But the discussion above argues that the CRA may not be the best way of achieving those results. Better alternatives should be considered.

NOTES

1. Some of these recent quantitative assessments can be found in, e.g., Bostic and Lee (2017); Ding and Nakamura (2017); Ringo (2017); and Ding et al. (2018). A more extensive review and assessment can be found in Ding and Reid (2019), which also provides an assessment of the CRA's effect on bank branching patterns during the years that followed the Great Recession of 2007-2009. An earlier review can be found in Barr (2005).
2. For the remainder of this commentary, unless otherwise indicated, I will use “banks” to refer to this wider group of depository institutions. It is immediately worth noting that credit unions – the other main category of depository institution – were not (and continue to be not) covered by the CRA.
3. Such line-drawing appears to have begun at least as early as the 1930s and was encouraged by federal agencies.
4. Economists often distinguish between individuals’ “needs” or “wants” – which (beyond bare biological sustenance needs) are subjective – and their actual purchasing behaviors. Assessing the “credit needs” of an individual (or of a business) has that same level of subjectivity. Bringing the “community” into the picture adds an additional layer of ambiguity: whose needs?
5. The recent quantitative evidence (see the studies that are referenced in footnote 1) that banks expand their lending when a neighborhood is newly designated as CRA-eligible and contract their lending when a neighborhood is newly designated as not CRA-eligible (e.g., because household incomes have increased) – although showing that CRA does have an effect – is also consistent with this “leaning-on” characterization.
6. And, in turn, this is why banks collect information from prospective borrowers, such as their credit scores, their credit histories, their current and recent employment records, and (for small businesses) their business plans and recent tax records. It is also why banks often look for collateral as security for a loan (e.g., the residential property itself as collateral for a mortgage loan) and/or ask for guarantors (e.g., “co-signors”, or governments as guarantors) for the repayment of the loan.
7. The above description of basic banking is over-simplified – especially for an era in which many kinds of consumer-oriented loans (e.g., residential mortgages, auto loans, credit-card loans) can be securitized: bundled into securities that can be sold in the capital markets. But the issue of the creditworthiness of the borrowers remains, since the investors in such securities will generally want to know about the creditworthiness of the borrowers of the loans that are the underlying components of the securities. In turn, the originating bank will need to offer representations, warranties, and indemnifications that are related to the creditworthiness of the underlying borrowers.
8. This is a version of what Leibenstein (1966) termed “X-inefficiency”.
9. This explanation could also be considered to be a variant of #1b above.
10. This can include inadequate understanding/appreciation of the terms of a loan and/or inadequate “shopping around” to other potential lenders by a potential borrower.
11. Such excessive fees push such services into the category of “abusive lending” – which would not satisfy the criterion of “meeting the credit needs” of the borrower.
12. Barr (2005) makes a similar point with respect to the “thicker” stock of information about the creditworthiness of a community's residents and businesses that arises when more lenders make more loans in a community.



13. For some evidence in this regard, see, e.g., Guttentag & Wachter (1980) and Ling & Wachter (1998). Again, these kinds of issues are also covered in Barr (2005).

14. By “first-best”, we mean a policy that addresses a problem in the most-direct (targeted) and least-cost fashion. A “second-best” policy would do so less directly and/or at greater cost.

15. For some recent articles that address this issue, see, e.g., Courchane & Ross (2019) and O’Regan (2019).

16. See White (2009b) for the argument that Walmart – which unsuccessfully sought to enter U.S. banking during the 1990s and 2000s – would be this kind of beneficial entrant into providing banking services for LMI households.

17. And, again, the expansion of credit unions into LMI neighborhoods would be in the same spirit.

18. See Klausner (1995) and Richardson (2002).

19. “Barriers to exit are barriers to entry” is a well-understood concept in the industrial organization area of economics.

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