

The Community Reinvestment Act: Past, Present and Future

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The Community Reinvestment Act (CRA) was passed in 1977 to combat the effects of discriminatory lending practices and disinvestment in low- and moderate income communities. It focuses on improving access for underserved communities, rather than underserved individuals. This spatial focus has drawn criticism since its passage, and changes in the lending industry and urban real estate markets call into question its relevance today. This paper will discuss the mechanics of the CRA, its effectiveness, and its relationship with two timely urban issues: gentrification and predatory lending.

The US Congress passed the Community Reinvestment Act (CRA) in 1977 to encourage investment in low- and moderate-income (LMI) neighborhoods where redlining, white flight and suburban migration had weakened the commercial and housing markets. The CRA was meant to act in concert with the Home Mortgage Disclosure Act (HMDA) and the Equal Credit Opportunity Act (ECOA) to combat racial discrimination within the lending industry and expand access to credit for targeted areas. Since its passage, a debate has raged about its effectiveness, appropriateness, and cost-benefit ratio. Criticism comes from both sides, with community groups charging that the Act is too lenient and that CRA scores are artificially inflated, while members of the banking industry point to its costs and allege that community groups use the CRA for unfair “rent-seeking” (Barr 2005). This criticism, combined with recent changes in the lending industry and urban real estate markets, warrants a reevaluation of the efficacy and relevance of the CRA.

The banking industry has undergone many changes in the past two decades with deregulation, the exponential growth of technology, and the globalization of many banking services. These changes have inevitably had a major impact on the effectiveness of the CRA, which was designed in a very different banking era. Moreover, the changing market conditions of inner-city neighborhoods raise concerns about the wisdom of a spatially-focused strategy to improve credit access to LMI borrowers. The CRA may reward banks for lending to gentrifiers while still denying good credit to LMI applicants. Subprime, or even predatory credit, may be all that is available to LMI borrowers in CRA-designated areas. Because of regulatory gaps, banks may actually receive CRA credit for engaging in predatory loans that harm borrowers and fuel blight and

abandonment. These changes beg the question of whether the CRA now contributes to precisely the detrimental effects it was originally designed to address.

This paper will outline the major features of the CRA and its enforcement, evaluate its effectiveness, both historically and contemporaneously, and conclude by examining its relationship with two timely concerns: gentrification and predatory lending.

CRA Evaluation and Enforcement

The CRA was passed in 1977 as a proactive measure to undo the harm caused by years of redlining and disinvestment in urban, LMI, largely minority neighborhoods. The law is based on the idea that federally-insured banks have an obligation to meet the needs of all members of the communities in which they are located. Since banks receive special privileges from the government and raise capital in those areas, they owe this service both to the larger public and to their specific communities. The law targets community needs in three areas: access to credit, investment, and access to depository and other banking services—all critical pieces of improving the quality of life in LMI neighborhoods (Engel and McCoy 2002).

To counter the effects of geographic discrimination, the CRA focuses on the community rather than the individual. As Johnson, Kemp, and Nguyen (2002) write, “Geographic discriminatory policies are rooted in the lender’s opinion that collateral in certain communities are likely to lose value, resulting in a loss to the lender. As a consequence, lending decisions are made without paying attention to the credentials of the particular applicant or the applicant’s specific collateral” (91). Lenders make

assumptions about applicants and their property based on location alone, failing to consider the credit-worthiness of the individual. Regulatory agencies, therefore, measure how well institutions comply with the *community's* needs, not the needs of individual applicants. Clearly, a community is made up of individuals, but the law focuses on neighborhood-level effects. Ideologically, this focus is admirable and refreshing in a society that focuses so much on the individual. In practical terms, however, potential problems exist, especially in relation to the increasing phenomena of gentrification and predatory lending.

Three tests are used to measure a bank's performance in three areas: providing credit, investing, and serving an area's deposit needs. First, the lending test, which counts for half of the CRA score, evaluates whether an institution provides equitable and adequate credit within its CRA area (Barr 2005). The five performance criteria are lending activity, geographic distribution, borrower characteristics, community development lending, and the degree to which the bank's lending practices are innovative and flexible (Johnson, Kemp, and Nguyen 2002). Second,

the investment test determines the extent to which the institution has invested in the community, whether it fills gaps left by the market, and how well it responds to community needs (Barr 2005). Last, the service test, which accounts for one quarter of the overall score (Stegman, Cochran, and Faris 2002), focuses on whether the institution adequately meets the community's deposit and service needs (Barr 2005). The service test is the broadest and least emphasized of the three. Its weakness has drawn criticism from those who argue that access to depository services is critical to financial health (Stegman, Cochran, and Faris 2002). Individuals unable to open a bank account may resort to check-cashing services that charge significant premiums and payday loans that can quickly destroy a borrower's credit.

Based on these three tests, the regulatory agency assigns a numerical score that falls into one of four ranges: outstanding, satisfactory, needs improvement, and substantial noncompliance. The agency also issues a report explaining the reasoning behind the score (Marisco 2003). In 1990, the law was changed to make these reports publicly available (Litan et al 2000, 11). If unfavorable, they can create a public relations debacle for the financial institution.

One innovative feature of the CRA is its diffuse allocation of enforcement capacity. When a bank applies for a merger or acquisition or wants to open or close a bank branch, community groups, competitors, and supervisory agencies have the opportunity to protest the application on the grounds that the bank has failed to meet CRA requirements (Johnson and Sarkar 1996). Putting power in the hands of community groups meets the ideological challenge of Lyndon Johnson's Great Society: a more equitable distribution of both *wealth* and *power*. Through the protest process, the CRA forces major financial institutions to stop and take notice of community demands.

Protests, however, can interfere with the efficiency of the banking industry, eating into its profits and creating incentives to pass costs on to consumers. Critics argue that the CRA actually hurts consumers, including the LMI group that it is designed to benefit, by raising operational costs. The more time banks spend embroiled in the regulatory process, the more overhead costs accumulate. While this may be true to some



Heidelberg Neighborhood, Detroit Michigan. Photo: Heather Smirl.

degree, these critics fail to note that many of the LMI customers that the CRA “harms” in this manner, would not be customers in the first place without the Act.

Most protests do not result in action by supervisory authorities. From 1977 to 1990, the Federal Reserve rejected only one of 182 protested applications (Johnson and Sarkar 1996, 786). The threat of protest and its attendant costs, however, make banks more open to both formal and informal agreements with community groups unhappy with their performance (Bostic and Robinson 2004). CRA agreements benefit both parties: the financial institution lowers the cost of CRA compliance by reducing the risk of protest, and the community group receives concessions without too great a fight (Johnson and Sarkar 1996).

The cost and effectiveness of the CRA may vary depending on the size and scope of the bank. Researchers Bostic and Robinson (2004) hypothesize that larger banks have a greater incentive to comply with CRA regulations than smaller banks because the opportunity for protest occurs when an institution attempts to acquire or merge with another bank, an endeavor that small community banks are less likely to undergo. On the other hand, larger banks depend less on their local reputation: their brands are national, even global, and can sustain the ire of one community. Small banks rely more heavily on their relationship with the community in which they are located and would have a difficult time weathering the criticism of local community groups.

Redlining and Past Disinvestment

Policy-makers designed the CRA to address the discrimination of the past and complement laws aimed at eradicating current discriminatory lending. Until the 1970s, redlining entire neighborhoods and choking off the flow of credit and investment to these areas was common. Institutions justified this practice by citing the perceived risk associated with these areas: they could not be expected to make unsound investments.

Johnson and Sarkar (1996) identify two types of redlining—rational and irrational. Rational redlining occurs when a bank refuses to lend in an area based on justifiable differences in risk and profitability. Some of these extra costs include the lack of information about the creditworthiness of customers, low financial literacy that requires extra time and attention by loan agents, and poor credit histories that make lending a riskier prospect. Irrational redlining occurs when a bank refuses to lend despite the potential for profit. This type of redlining might occur as a result of outright discrimination or simply habit.

The CRA focuses on addressing the latter form of redlining, and, in doing so, could be a boon to both the banking industry and the population the law targets. Some argue that the CRA opened markets previously neglected because of years of systematic, irrational redlining. In a 1996 survey, 98 percent of large residential mortgage lenders found CRA loans profitable, and 24 percent found them *at least as* profitable as other loans (Federal Reserve Board 1999, 4). A bank pioneering alone through previously unexplored markets faces potential risks because of a lack of information about borrowers in these areas, but when all banks are required to provide credit to consumers, the risk is diffused across all lenders and the information needed to make good lending choices to residents of these areas grows. Thus access to credit has a snowballing effect: once a bank enters a market and gathers information, the community becomes a more favorable environment for other investors as the market becomes more liquid (Barr 2001).

Effectiveness

The value of the CRA hinges on one question: does the act improve access to credit and other banking services for LMI communities? Most research has found positive results. Reports indicate that the CRA attacks market failures by encouraging banks to meet the credit needs of their communities (Barr 2005). Because the CRA awards points based on the innovativeness of the lending products and strategies employed by an institution, it has spurred a variety of creative solutions to the difficulties of entering new markets and lending in LMI communities. For instance, banks have banded together to form Community Development Corporations (CDCs), invested in credit counseling programs and created specialized branches within their institutions to administer the CRA process (Barr 2006). These trends are all positive.

Unfortunately, there is no control case. It is possible, as some in the banking industry assert, that these trends would occur even without the CRA, as the lending markets for middle- and upper-income populations become saturated and institutions seek out new markets. However, one study that sought to isolate the effects of the CRA compared each bank’s CRA-eligible lending to the non-CRA-eligible lending. It found that between 1993 and 1998, CRA-eligible mortgages increased by 39 percent, whereas non-CRA-eligible mortgages increased by only 17 percent (Barr 2006). Given these positive signs and the history of past disinvestment, upholding a strong CRA continues to be justified.

Changes in the Lending Industry

At one time, lending was primarily a local activity. Changes in the banking industry have made capital largely aspatial, no longer fixed to a local community but diffused around the globe and online. Have these changes made the CRA irrelevant and ineffective? For instance, how should an institution's CRA assessment area be defined when its capital is spread across nations?

These changes undermine one of the primary justifications for the CRA: the idea that a lending institution owes something to the community from whom its capital is raised. But when capital is raised everywhere and nowhere, how much does a bank owe to the community in which it is located only in the strictest, bricks-and-mortar fashion? Another justification for the CRA, however, still holds

true: banks receive special privileges and charters from the government. Therefore, the government can expect banks to offer these services.

Technological innovations may create further imbalances in access to credit and other financial services. As more lenders move their services online, credit opportunities wither for those without regular computer access. The "digital divide" could erase some of the progress made in the past quarter-century by the CRA and other fair lending laws. Online banking presents an ideal solution to financial institutions looking to circumvent not only the CRA itself but the whole spirit of the law. As Johnson, Kemp, and Nguyen (2002) write, "What could be a more attractive customer base, since those persons who can afford a computer and Internet service are essentially the well-to-do?" (102)



Lombard Street, San Francisco. Photo: Scott Curry

While some worry that the Internet will become “a more efficient avenue for discriminatory lending practices” (101), the main concern is that these services are not currently regulated by the CRA. Extending CRA coverage to these services would come up against two roadblocks. First, these institutions accept deposits well beyond the scope of their physical community (Johnson, Kemp and Nguyen 2002). Defining the CRA assessment area, therefore, would present significant challenges and might be attacked by critics as arbitrary and outdated. Second, because of its controversial nature, any expansion to the CRA will meet significant political opposition. These challenges stand in the way of maintaining the effectiveness of the CRA.

The CRA and Gentrification

Ironically, the lack of access to credit in LMI communities may be what keeps them affordable. Redlining starved access to credit for *all* residents of an area, failing to distinguish between those deemed creditworthy and those deemed uncreditworthy. Today’s system, which mandates fair lending across all communities, combined with sophisticated systems to determine the risk of lending to a particular applicant, may actually increase the vulnerability of LMI households in neighborhoods that lie in the path of gentrification. As Wyly et al (2001) write, “When affluent professionals begin to search for relatively affordable homes in the inner city, LMI residents are threatened with rising housing costs and city-wide reductions in the supply of low-cost housing” (89).

The CRA may fuel gentrification since outsiders looking to purchase cheap real estate may have their loans approved, while current residents may still be unable to access credit. In the era of gentrification, “the traditional dichotomy of urban investment (loan approved or denied) has been complicated by much greater stratification among those who do receive credit” (Wyly and Hammel 2004, 8). Meanwhile, greater market demand for real estate in inner-city neighborhoods increases values along with costs, potentially forcing displacement of current residents. Wyly and Hammel (2004) write, “Working-class and racially marginalized people and places fare poorly in this process—facing either exploitive credit terms nurtured by predatory brokers and loan officers backed by Wall Street investors and global capital, or outright exclusion as displacement and housing market inflation remake cities for the elite professional classes” (3).

In this new era, the CRA may be counterproductive since “[s]patially-defined policy goals often provide CRA credits to banks for making loans to upper-middle class gentrifiers in the inner city” (8). It depends on how one defines success. If one focuses on neighborhood-level

change, then the CRA has done its job: real estate values in the neighborhood have gone up, most likely along with maintenance of the properties and general upkeep of the area. However, if one looks to the individual level, the LMI households living in the neighborhood may have had to relocate to another depressed neighborhood because of increased costs. LMI renters, of course, would benefit the least because they would be forced to move with no attendant increase in wealth. LMI homeowners, on the other hand, may be forced to move but will at least benefit from increased values when they sell their homes.

The CRA and Predatory Lending

No consensus exists about the connection between the CRA and predatory lending. The prevalence of predatory lenders in LMI communities may demonstrate the failure of the CRA to encourage sufficient lending. Predatory lenders may fill the gap created by the absence of traditional lending institutions. If the CRA were working as its designers intended, there would be no lending vacuum for predatory lenders to exploit. Perhaps it is too soon to fully assess the law’s effectiveness. Only 30 years have elapsed since the passage of the CRA, and much evidence exists that lending has moved in the right direction. If nothing else, the CRA encouraged banks to take a second look at previously excluded communities and understand that there are profitable ways to lend within them.

Some of this lending takes the form of subprime loans, a complicated and controversial topic. Not all subprime loans are exploitive; some are simply the best credit that borrowers can access because of low credit scores. When it comes to counting subprime loans toward a bank’s CRA credit, however, regulators should be cautious. As Richard Marisco writes, “A bank that is engaged in subprime lending, which by definition is more costly to the borrower than prime lending, may be failing to ‘meet’ the credit needs of the community; while it may be originating a large number of loans, these loans may not be on the best terms for and affordable to the borrower” (Marisco 2003, 742). Predatory loans comprise a subset of the subprime market; they are the loans that have exploitive and detrimental terms. These loans cause more harm than good by trapping borrowers in a cycle of debt from which they might never extricate themselves.

Recently, great attention has been paid to the effects of subprime loans on mortgage foreclosures. These foreclosures have had a disproportionate impact on LMI, largely minority areas where mortgage originations increased by 40 percent from 1993 to 1997, compared to a nationwide increase of only 20 percent (Wyly et al 2004, 8). The effects of widespread foreclosure have been especially

pronounced in LMI neighborhoods, not only because residents are less likely to have access to low-cost credit but also because LMI borrowers will find it harder to weather fluctuations in the economy given their precarious financial position. Since many LMI communities have suffered decades of disinvestment, the effect of a single foreclosure is much greater than in a neighborhood that is stronger economically. As Immergluck and Smith (2005) observe, “in middle- and upper-income areas...foreclosures are less likely to lead to abandoned buildings and neighborhood blight” (368). In these areas, the stronger real estate market restricts foreclosure to the level of a personal tragedy: someone has lost her home, but it will simply pass on to a new owner.

Most parties agree that predatory loans should not earn banks CRA credit. If they are considered at all, they should detract from the institution’s overall CRA score. In a note issued by federal banking agencies in 2001, questions were raised about the extent to which predatory lending is monitored. The note stated, “Some are concerned that the regulations generally seem to provide consideration of loans without regard to whether the lending activities are appropriate” (CRA Regulations, quoted in Marisco 2003, 743). It went on to suggest that, “a CRA examination also should include consideration of whether certain loans contain harmful or abusive terms and, therefore, do not help meet community credit needs” (CRA Regulations, quoted in Marisco 2003, 743). It then asks, “Does the lending test effectively assess an institution’s record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?” (CRA Regulations, quoted in Marisco 2003, 743). If this exchange is any indication, it would seem that no system is in place for evaluating predatory loans within the CRA regulatory system. Predatory loans can be counted along with legitimate subprime and prime loans to help a bank earn an “outstanding” or “satisfactory” rating.

Engel and McCoy (2002) assert that “both origination and brokerage activities may qualify for CRA credit even when they involve predatory loans” (1575). Predatory loans do not add value to a community; they drain that value away, strip equity from homes, and leave borrowers in desperate circumstances. An influx of predatory loans will leave a community in worse straits than if it had no access to credit at all. As Engel and McCoy (2002) write, “If the CRA is creating incentives for banks to engage in predatory lending, the CRA is actually defeating one of its stated goals” (1577-78).

Banks can be involved with predatory loans indirectly by purchasing loans on the secondary market or financing subprime lenders. Engel and McCoy (2002) write, “These bank activities raise CRA implications because some of the activities receive explicit federal guarantees while others may benefit more generally from federal subsidies” (1585).

Another way that CRA-regulated banks can benefit from the subprime and predatory lending industries is by acquiring non-bank affiliates that are not regulated by the CRA. “Large national prime banks have established specialized subsidiaries focused on particular types of loans, marketed to targeted groups and/or neighborhoods, to reap lucrative profits without tarnishing brand-name reputations” (Wyly and Hammel 2004, 8-9). In 2000, non-bank entities owned by bank holding companies accounted for eight of the ten largest subprime lenders. These non-bank affiliates are exempt from CRA scrutiny unless they volunteer for it, and since there are no incentives to do so, they remain unregulated and free to engage in detrimental lending practices (Engel and McCoy 2002).

Engel and McCoy (2002) argue that “if non-bank affiliates and subsidiaries benefit from federal subsidies, we need to consider whether banks should be penalized for using

Vancouver, Canada Waterfront. Photo: Scott Curry



subsidies to finance predatory lending” (1588). The profits from these abusive lending practices still indirectly accrue to CRA-regulated agencies so that defining banks’ operations too narrowly can allow them to delegate their abusive (and profitable) lending practices to affiliates outside the scope of the CRA, thereby rendering the law less effective.

Conclusion

The CRA made significant progress in accomplishing what Congress intended. Lending and investment in LMI neighborhoods has increased in the years since its passage. Though it is still relevant and effective, significant challenges to the CRA have emerged in the past two decades. Regulatory agencies must step in to monitor the effects of predatory lending and online banking to ensure that the CRA remains effective in this new lending era. The effects of gentrification are beyond the scope of current CRA regulations, but Congress could consider adding a provision that takes the income of borrowers into account on an institution’s CRA evaluation and excludes those above a certain range. This adjustment would target those most in need of access to credit and not give CRA credit to banks for fueling the gentrification of inner-city neighborhoods. Moreover, predatory lending seems to be a loophole in the CRA that the federal government should work aggressively to close. Under no circumstances should CRA-regulated lending institutions receive credit for making loans that have abusive terms and that will undermine the credit health of individuals and the integrity of communities.

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