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Costly Information and the CRA

The Community Reinvestment Act (CRA), passed in 1977, requires banks and other depository institutions to make an effort to meet the credit needs of *all* the communities in which they are located, including the low- and moderate-income neighborhoods. In recent years, banks' community reinvestment activities have come under increasing scrutiny, and CRA enforcement has become more stringent. In this *Letter*, we investigate some of the factors that led to the passage of the law, and the impact of stricter enforcement standards on commercial banks' mortgage lending and profitability.

Information, risk, and lending

Whenever a bank makes a loan, it faces the risk that the loan may not be fully repaid. Thus, its *expected* return is lower than the contractual rate on the loan. To account for this risk, a bank might choose to vary its loan rates according to the credit-worthiness and collateral of the individual borrower, with higher rates for the borrowers that appear to pose the greatest risk. In the case of mortgage loans, however, banks tend not to vary their loan rates significantly across borrowers. Instead, they attempt to offer loans to only the most credit-worthy borrowers.

Identifying credit-worthy borrowers requires the bank to "invest" in information about potential borrowers. (Typically, the kinds of information banks seek include applicants' income and credit background and the stability of applicants' employment and residence history.) Presumably, the more information the bank obtains, the more effectively it will be able to gauge credit-worthiness. Thus, by investing in information that enables it to screen applicants better, a lender may be able to raise the expected return to mortgage lending.

Obtaining this information and screening applicants is costly. Moreover, these costs may vary across individuals and neighborhoods. One factor that may influence these costs is the bank's presence in a given neighborhood. A bank with little lending experience in the neighborhood is likely to have very limited information about the credit-worthiness of the residents, and the cost of evaluating applicants from this area may turn out to be higher than in other neighborhoods where the bank has more lending experience.

When the costs of finding profitable opportunities differ sharply across neighborhoods, banks may find it difficult to make profitable loans in certain neighborhoods, even though some good projects may exist in these neighborhoods. Thus, it is possible that bank lending patterns will differ across neighborhoods even if other conditions are similar.

Inasmuch as household income prospects and trends in real estate values may be loosely associated with the ethnic characteristics of neighborhoods, bank lending patterns may appear to be correlated with these ethnic characteristics. Many have asserted that these correlations provide evidence that banks have engaged in discriminatory lending behavior. This perception led to the enactment of laws such as the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the CRA.

CRA enforcement

Under the CRA, banks are required to solicit loans in low-income areas. They are not required to lend to bad credit risks, but they must make an effort to find good lending opportunities in those areas. As part of their compliance with CRA-related regulations, banks must have a community reinvestment plan, and must demonstrate a concerted effort to market bank loan and deposit products to all neighborhoods in their defined market area.

One important tool available to bank regulators in enforcing CRA is the power to deny banks' proposed mergers and acquisitions. Although this power has not been used widely in the past, there is a clear trend toward greater attention to CRA compliance in evaluating such applications.

Regulators sometimes have made approval of the application contingent on the bank's willingness to revise its policies to meet CRA guidelines.

In addition, community groups and neighborhood organizations are permitted to file formal protests against merger and acquisition applications on the ground that applicant banks are not meeting their obligations under the CRA. In many instances, these groups have succeeded in delaying proposed mergers and, in some cases, obtaining promises of increased lending or other concessions by banks. Finally, because CRA compliance ratings assigned by the regulatory agencies after July 1, 1990, will be disclosed to the public, heightened public scrutiny will be brought to bear on depository institutions.

Effects on lending patterns

To determine how CRA affects banks' behavior, we developed a model of bank lending that takes into account the possibility that perceived credit risks may vary across neighborhoods. These perceptions about risk are formed, in part, on the basis of the bank's information about borrowers in the area. As the bank increases its presence in the area, its costs of screening applicants may fall, making lending in the area more attractive. In this framework, the bank balances the expected gain from information (lowering default risk through better screening) with the cost of obtaining that information (devoting more resources to assessing loans in the neighborhood).

Our results suggest that information effects can hinder lending to low-income neighborhoods. If past experience has not uncovered a large pool of qualified borrowers in an area, a bank may maintain only a minimal presence in that neighborhood. With few branches and/or loan officers in the area, it may be hard to identify new, profitable lending opportunities. Expected returns to lending (net of search costs) are thus likely to be lower in those areas where the bank has little or no presence. This, in turn, makes it less likely that the bank will increase lending in these areas.

CRA, in this framework, can influence a bank's lending to residents of low-income neighborhoods by encouraging the bank to search harder for good borrowers. Because the benefits of additional search under CRA include avoiding regulatory penalties, the bank may find it worthwhile to increase its presence in low-income neighborhoods, and in the process, may uncover more qualified borrowers. (For a full description of this model, see the Summer 1990 issue of the Federal Reserve Bank of San Francisco's *Economic Review*.)

New institutions

Thus, our model suggests that as a bank obtains additional information about a given neighborhood, it may find profitable lending opportunities that can partially offset the costs of complying with the CRA. Nonetheless, the cost of obtaining information in neighborhoods targeted by the CRA still may be relatively high, giving banks an incentive to find ways to reduce these costs. One way banks in a number of states have attempted to reduce costs is to form a multi-bank consortium to find and make loans in disadvantaged neighborhoods. These institutions, such as the California Community Reinvestment Corporation, provide a pool of loan funds from several banks. The consortium serves the purposes of lowering the per-bank costs of obtaining information about low-income neighborhoods as well as spreading loan risk among several lenders.

Another way banks have sought to reduce information costs is to work directly with nonprofit community groups, allowing these groups to perform the initial applicant screening for CRA-related loans. This approach lowers the cost of information for the lender by shifting part of the search and monitoring costs to the community groups. It also increases community group sensitivity to the credit risk problems faced by banks when lending in certain areas.

Effort vs. results

Although the CRA is expressed in terms of effort, recent events may suggest a shift in emphasis. Community groups cite a lack of lending *volume* in low-income neighborhoods as a reason to protest mergers and acquisitions, rather than evidence of insufficient efforts to find good loans. This shift is understandable, given that it may be easier to measure results than effort.

Critics of a results-oriented focus maintain, however, that such an approach could lead to higher risk. To the extent that credit-worthy borrowers cannot be found, they argue, a results-oriented approach to CRA would force banks

to lower their credit standards, which, in turn, could lead to higher default rates. Thus, one implication of a results-oriented approach is that bank income could be lower under CRA than otherwise.

While credit-worthy borrowers exist in CRA-targeted neighborhoods, the relevant issue involves the cost of finding these borrowers. The critics of a results-oriented approach argue that since banks did not lend in these neighborhoods previously, the *expected* return (not necessarily the actual return) net of the cost of finding good borrowers was too low to make these loans profitable. Community groups, on the other hand, maintain that banks have significantly overestimated the cost of finding credit-worthy borrowers in low-income neighborhoods and that as banks become more involved in these neighborhoods, as the CRA requires, they will find profitable lending opportunities.

Social vs. private costs

One important conclusion drawn from our theoretical model is that below-desired lending to low-income neighborhoods may arise, in part, because of a lack of information about opportunities. High costs of gathering the needed information may keep banks from voluntarily seeking credit-worthy borrowers in these areas.

CRA represents one mechanism to pressure banks to address the problems created by costly information. The law imposes a penalty on banks if they fail to exert sufficient effort searching for good loans in low-income areas. In essence, CRA imposes a tax on banks (in the form of regulatory penalties) to achieve the social goal of increased lending to disadvantaged neighborhoods.

The incidence of this tax, however, is an important public policy issue. If there is evidence that the apparent lack of lending in low-income areas is due to banks' inaccurate appraisals of the costs of finding credit-worthy borrowers, then it may be appropriate to tax banks to achieve the desired social goal. The recent results-oriented interpretation of CRA seems to be predicated on the assumption that banks persistently are overestimating the costs of lending in low-income areas. The evidence on this point is inconclusive, though. Redlining studies generally have failed to demonstrate conclusively the existence of neighborhood lending differentials after controlling for relevant demand and supply factors in housing markets.

To the extent that the cost of obtaining information about lending opportunities to low-income neighborhoods is indeed high, banks may find the costs of complying with CRA prohibitive, and may be induced to close branches in CRA-sensitive neighborhoods in order to change their defined market to exclude those areas. (Such closings are difficult, however.) In those cases, bank customers in those neighborhoods would bear some of the cost of CRA through reduced services.

The magnitude of this potential cost is not yet known. CRA proponents, both inside and outside banks, argue that CRA loans have performed as well as other loans. This suggests that banks may have overestimated the risks of lending to low-income borrowers. In those cases, the costs of CRA compliance may be negligible and the bank may profit from the activity.

However, it is still not clear how costly it will be to find profitable opportunities as the scale of CRA lending increases. If these costs rise, the adverse effect on bank competitiveness will become important. A policy that requires private banks to bear the social cost of increasing low-income lending could put them at a competitive disadvantage with respect to other institutions that do not face CRA responsibilities.

Sticks vs. carrots

Our research indicates that information costs can make it more difficult for banks to lend to borrowers in low-income neighborhoods. CRA uses a "stick" to pressure banks to search for additional qualified borrowers in these neighborhoods. In the process, banks bear the cost of this social policy. If the costs of compliance become large, it may be necessary to consider alternative ways to surmount information problems without putting banks at a competitive disadvantage. For example, banks could be rewarded for good CRA performance (perhaps through expanded powers). Alternatively, loan guarantee programs could be used to encourage a more even geographic distribution of lending.

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