

Community Reinvestment Act lending: Is it profitable?

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Introduction

In 1977, Congress passed the Community Reinvestment Act (CRA) to encourage federally insured depository institutions to lend in low- to moderate-income neighborhoods and to low- to moderate-income people. Since then, the profitability of the many special lending programs designed to achieve these goals has been questioned on both theoretical and practical grounds.¹ Arguments range from “if the business was profitable you wouldn’t have to pressure institutions to do it” to “we found new markets and new profits through CRA lending.” While CRA requires banks and thrifts to “help meet the credit needs of communities in which they are chartered,” it further cautions that these efforts should be “consistent with safe and sound operations of such institutions.”

Despite the “safe and sound” caution, questions about the risk and overall profitability of CRA lending persist. Many perceive CRA lending to be risky business, with higher losses and lower profits. Anecdotal evidence, on the other hand, suggests that losses on CRA loans may not be appreciably different than for non-CRA loans, and some institutions report their CRA lending is profitable.

Being profitable by simply avoiding losses, however, is not enough. The returns on CRA loans must be as great as those received on other products if lenders are to have a business incentive to extend these loans. Without such returns, institutions will be reluctant to make CRA loans and will be at a competitive disadvantage with lending institutions not subject to CRA.

In this study, our goals were to determine if some lenders have been able to undertake CRA lending in a way that is competitively profitable with their conventional lending and, if so, describe how they did it. We focused on home mortgage lending, which is a relatively standardized, high-volume business, where lenders are likely to have become proficient. What we learned about home mortgage lending likely has implications for other types of CRA lending and the longer-run profitability of CRA lending in general. Our findings also have implications for other frequent parties to CRA lending including government, community organizations and regulators.

To conduct the study, we surveyed large home mortgage lenders. We asked about credit risk, loan terms, processing costs, and overall profitability of single-family

¹ For example, see Glenn Canner and Wayne Passmore, “The Relative Profitability of Commercial Banks Active in Lending in Lower-Income Neighborhoods and to Lower-Income Borrowers,” *Proceedings of the 31st Annual Conference on Bank Structure*, May 1996 (Federal Reserve Bank of Chicago, forthcoming).

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² FIRREA made CRA ratings and performance evaluations public information. See the companion article in this issue for more details on these changes and other events that have shaped CRA and its implementation.

³ Jonathan R. Macey and Geoffrey P. Miller, "The Community Reinvestment Act: An Economic Analysis,"

Virginia Law Review, 79, Number 2 (March 1993), pp. 300-301.

⁴ Kathryn Tholin, et al., **Sound Loans for Communities: An Analysis of the Performance of Community Reinvestment Loans**, Woodstock Institute, October 1993, p. 3. Griffith L. Garwood and Dolores S. Smith, "Community Reinvestment Act: Evolution and Current Issues," **Federal Reserve Bulletin**, Board of Governors of the Federal Reserve System, April 1993, p. 262. Keith Rolland, ed., **Community Reinvestment Advocates**, Federal Reserve Bank of Philadelphia, July 1993, pp. 3-40. "Affordable Home Loan Programs Seem to Be Having an Impact," **American Banker**, Thursday, August 10, 1995, p. 13.

⁵ Olaf de Senerpont Domis, "Truth-in-Lending, CRA Makes '10 Worst Rules' List," **American Banker**, January 31, 1995, p. 3.

⁶ Because there is a lot of publicly available information on mortgage lending by

residential CRA loans and comparable conventional loans. This information permitted a comparison of strategies among institutions that found single-family residential CRA lending competitively profitable with conventional lending and those that did not.

Background

Several pieces of legislation have helped shape lending to low- and moderate-income individuals and neighborhoods. CRA set out to eliminate the practice of "redlining" and encourage insured depository institutions to reinvest in their communities. The Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provided for greater public disclosure of lending to low- and moderate-income borrowers,² hastening the development of affordable housing lending programs,³ and increasing credit available to low-income borrowers.⁴ Finally, the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 added further support for CRA lending by requiring the Department of Housing and Urban Development (HUD) to set purchasing goals for mortgage loans to low- and moderate-income families by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), thereby strengthening the secondary markets for these loans.

These advances in CRA lending, however, have not been without controversy. In the early 1990s, a U.S. Senate task force ranked CRA tenth on a "Ten Worst Regulations List."⁵ Surveys of bankers have often indicated that CRA is one of the most costly regulations to comply with. Some have argued that CRA has forced banks to make loans they would not otherwise make, subjecting them to increased credit risk and lower profitability.

Data on loan losses and profitability of CRA loans, although spotty and largely anecdotal, generally do not show these

loans to be riskier or less profitable than conventional loans. However, some studies have shown that delinquency rates, but not default rates, tend to be higher on CRA loans.⁶ Various surveys on overall profitability indicate some lenders sacrifice profitability to subsidize their CRA loans, while other lenders make money, expect to make money, or break even on their CRA loans.⁷

Information on mortgage lending gathered from round table discussions across the country with bankers, community groups, and others are consistent with these findings.⁸ For example:

Reviewing the components of profitability—transactions costs, delinquencies and defaults, and revenues—participants generally agreed that, for low-income neighborhoods, the costs are higher, delinquencies (but not necessarily defaults) are more common, and revenues are similar to those experienced in other neighborhoods. There are no signs that the profitability of lending in low-income neighborhoods is high.⁹

On subsidized mortgage lending programs where the borrower and lender rely on some form of private or public assistance or guarantees, round table participants noted that low-income, subsidized mortgage markets "yield little return to private equity, and they would be smaller in scope if not for subsidies and a need to meet CRA requirements."¹⁰

Factors hindering profitability were higher paperwork costs, the need for staff with specialized knowledge about subsidy programs, and screening and monitoring costs required by some programs. Also important in the profitability equation were limitations in subsidy programs that discouraged or prevented lenders from pricing for risk.

An interesting observation from round table participants was that smaller community banks may have transactions cost and

risk management advantages over larger institutions in extending CRA loans. These potential advantages resulted from smaller lenders knowing their community residents better and developing stronger borrower relationships over time. This close tie between borrower and lender allowed more personal monitoring of loans, something that was apparently difficult to replicate on a larger scale.

Large lenders, on the other hand, tended to rely on standardized risk measures and processes to handle their higher loan volume and to keep costs down. Since CRA loans often don't fit a standard mold, the need to handle these loans individually may result in higher processing costs. Less direct contact with borrowers may also result in greater credit risks at larger institutions.

The model

To evaluate the profitability of single-family residential CRA lending, we asked lenders questions structured around a standard accounting model for analyzing the profitability of a loan product:

<p>LOAN PROFIT ACCOUNTING MODEL</p> <ul style="list-style-type: none"> Interest income - <u>Interest expense</u> Net interest income - Provision for loan losses - Overhead expenses + <u>Other income</u> Net income
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Questions focused on the overall profitability of CRA lending (net income) as well as its component factors, thus providing an opportunity to explore how some lenders achieved more profitable CRA lending.

The survey

The survey was designed to accommodate a lack of cost accounting information on CRA lending at institutions. In particular,

we asked respondents for their judgments on the profitability of CRA lending relative to conventional lending at their institutions.

The survey focused on single-family residential lending. The high volume and relatively standardized terms and underwriting criteria for this lending contributed both to lender expertise in making these loans and to enough consistent data being generated for meaningful observations.

We knew many institutions would have more than one CRA home mortgage lending program. Where this was the case, we asked respondents to provide information about their organization's most important program or the program that most typified their experience with CRA lending.

Our survey asked respondents for general information about their organizations, their economic environment, and their CRA lending profitability.¹¹ Information about the organizations and their environment centered on the local economy, areas served, institution type, annual volume of CRA and conventional loan originations, and ways CRA lending was approached. The questions pertaining to CRA lending profitability focused on credit risk, transactions costs, loan fees and terms, and profitability. We also asked for comments about other matters that might affect these factors.

The respondents

The intent of the study was to evaluate the relative profitability of seasoned CRA programs, describe possible reasons for profitability differences, and offer insights for improving profitability. Since information on the maturity of CRA programs was not readily available, we surveyed institutions that had total assets of \$100 million or more, assuming their size would correlate with CRA lending experience. To lessen the effects of location, we only surveyed institutions located in metropolitan areas. Further, we only sent questionnaires to institutions that had

*institutions, most studies on CRA lending focus on single-family residential lending. For example see, Fritz Elmendorf and Karin C. Brough, **Affordable Mortgage Program Study: A Survey of Bank Mortgage Programs as of June 30, 1994**, Consumer Bankers Association, (Arlington, Virginia: 1994), p. 9. Also see Rolland, *Community Reinvestment*, p. V. and Tholin, et. al., **Sound Loans**, pp. 9-15.*

⁷ Jaret Seiberg, "CRA Lending is Profitable For Bank, Study Finds," **American Banker**, August 26, 1994, p. 1. Also see Elmendorf and Brough, p. 5.

⁸ These discussions were jointly held as a precursor to the revision of CRA supervision by the three federal banking agencies and the Office of Thrift Supervision.

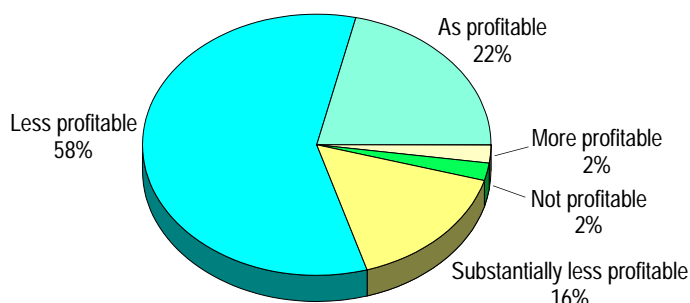
⁹ **Report to Congress on Community Development Lending by Depository Institutions**, Board of Governors of the Federal Reserve System, October 1993, p. 34.

¹⁰ *Ibid*, p. 35.

¹¹ A copy of the survey form can be obtained by contacting the Public Affairs Department, Federal Reserve Bank of Kansas City.

Figure 1

CRA lending profitability



5 percent or more of their loans in single-family residential loans. This was to ensure they did enough of this type of lending to have expertise in making single-family residential loans.

After screening for size, location, and mortgage volume, we sent surveys to 600 institutions across the nation, including 217 banks, 165 savings and loan institutions, and 218 bank holding companies with mortgage banking subsidiaries. No organization was represented in the survey more than once. For example, if a bank and a mortgage banking company of a bank holding company were both in our survey sample, the bank holding company was sent one survey and we left it to the company to forward it to the most appropriate respondent.

Ninety-seven organizations (16 percent) responded to the survey, including 52 banks, 21 savings and loans, 9 mortgage banking subsidiaries of bank holding companies, and 15 bank holding companies, savings and loan holding companies, or savings banks. These institutions operated in 38 states. Ninety-two percent of them reported average to strong

economic and housing conditions in their markets.

All but one respondent made CRA loans directly. Many respondents had relatively new CRA home mortgage programs, with approximately 50 percent being started after 1989.¹²

It is important to note that some of our survey questions addressed areas that respondents did not track separately, and some respondents did not answer all questions. Because of this, the discussion and analysis of survey results include information on the number of responses to questions as well as percentage information. Where the number of responses is small, the data should be interpreted with caution.

Survey results

In the following sections we explore different aspects of CRA lending profitability to determine what strategies and practices made it more profitable at some institutions than others. We start by reviewing overall profitability of CRA and conventional lending then explore individual revenue and expense factors affecting that profitability. Care should be exercised, however, in generalizing our profitability findings to all institutions making CRA loans since our data sample was not randomly drawn. Nevertheless, our results corroborate many findings of other studies and, consequently, may represent CRA profit experiences beyond those who responded to the survey.

Profitability

Ninety-eight percent of survey respondents said their CRA lending was “profitable” (see Figure 1).¹³ Within this 98 percent, there were substantial differences in degrees of profitability. Twenty-four percent said their CRA lending was as profitable or more profitable than their conventional lending. The remainder

¹² Seventy-three respondents provided origination dates for their CRA programs.

¹³ Profitable in this context means the institution did not lose money on their CRA lending.

concluded it was “less profitable” or “substantially less profitable” than their conventional lending.

As noted earlier, many CRA lending programs were put in place after 1989 and, as a consequence, their current profitability may not reflect their long-term profitability. Looking to the future, approximately 31 percent of the respondents (29 respondents) to a question on future profitability saw their CRA lending being at least as profitable as their other lending. The remaining 69 percent did not believe their CRA lending would ever be as profitable as their conventional lending. This suggests that lenders in our data set may be well along the CRA lending learning curve, since few perceived that future profitability would change significantly from current levels.

Besides dollar profitability, institutions may receive other, less tangible benefits that make CRA lending attractive. Approximately 90 percent of survey respondents said there were non-monetary benefits to CRA lending.¹⁴ These included:

“Community image improves.”

“Helps the community grow and prosper.”

“A stronger community equals future profitability.”

“Future customers for other products.”

“[It] pacifies regulators and community groups.”

Comments such as these reflect differences in both attitude and approaches toward CRA lending, both of which may have implications for profitability at individual institutions.

Since our principal concern was with the longer run profitability of CRA lending and how some institutions achieve it, we separated survey responses into two lender categories: lenders who reported

their CRA lending was at least as profitable as their conventional lending, and those who reported it was not. We then examined income, expenses, and other related information to identify factors that may account for CRA lending profitability differences between the groups.

Before discussing the comparative results, several observations about the data and the study methodology are in order. First, despite attempts to identify institutions with seasoned CRA lending programs, most reported results were from programs of recent vintage. Thus, the results reflect a period during which the U.S. economy performed well, and may not reflect profitability over future business cycles.

Additionally, there may be limitations in extrapolating the results into future years because of changes in CRA enforcement which began in 1996. The survey covers lending under the earlier period’s “process oriented” approach to CRA enforcement. Under the new “results oriented” approach¹⁵ to CRA enforcement, some lenders may be more aggressive in their CRA lending, absorbing more borrower fees and offering lower loan interest rates to establish larger CRA loan portfolios. Such behavior would clearly have implications for future CRA loan profitability.

Finally, the analysis we present makes simple bi-variate comparisons between the profitability of an institution’s CRA lending and its conventional lending. However, many factors may influence profitability simultaneously, making it difficult to draw conclusions from our comparisons. To deal with these influences, we used the multi-variate statistical models presented in Appendix A to hold constant institutions’ loan origination volume (a proxy for institution size), economic conditions, CRA program age and FHA/VA participation. This analysis provides support for the more simply drawn observations from the bi-variate comparisons.

¹⁴ Ninety institutions responded to the survey question “Other than profitability considerations, are there additional benefits to your institution from making CRA loans?”

¹⁵ The new regulation became effective for small banks in January 1996 and will become effective for large banks in July 1997. It is the product of both industry and community pressures to refocus examinations from process to results.

Table 1

Interest rates and profitability

Annual percentage rate charged on CRA loans relative to similar size traditional loans	Banks reporting CRA lending to be	
	As profitable as conventional lending	Less profitable than conventional lending
Higher	9%	9%
Same	86	52
Lower	5	39

Respondents whose CRA lending was as profitable as their conventional lending gave up a smaller portion of their fees (23 percent on average) than institutions with less profitable CRA programs (40 percent).

Reduced interest rates is another factor that can affect the relative profitability of CRA lending programs. Table 1 shows that those with CRA lending pro-

grams as profitable as their conventional lending programs were less likely (5 percent versus 39 percent) to lower rates for borrowers than those with less profitable programs.

Lower fees and reduced interest rates, however, do not have to lessen profitability. Various government programs, including grants and other assistance, may allow institutions to give up fees and charge lower interest rates without sacrificing profitability. Indeed, 22 percent of those responding to the survey indicated that various government programs allowed them to offer lower fees on CRA loans. Further, 29 percent said government programs allowed them to offer lower interest rates on their CRA loans. However, even with government assistance, many respondents suggested there is significant lender subsidization of CRA loans:

“Bank absorbs all nonvendor fees — i.e., appraisal, underwriting, loan service, escrow.”

“We absorbed some of the costs and providers of services lowered some costs.”

“Too many lenders are subsidizing the CRA loans, eliminating the profit.”

Past performance of CRA lending programs: Revenue and expense comparisons

Loan fees, down payments, interest rates, debt ratios, and credit histories are important constraints on home ownership for all borrowers, but especially for low-income borrowers. The CRA programs offered by survey respondents loosen many of these constraints (See Appendix B). This loosening can have revenue and expense consequences and, hence, profitability implications for lenders. In the following sections, we examine these factors to evaluate their effect on overall profitability.

Revenue comparisons: Loan fees and interest rates

Many of the survey respondents’ CRA loan programs subsidize borrowers by absorbing some to nearly all of the fees (appraisal, title search, credit check, filing fees, and other administrative costs) associated with making a residential loan. This makes home ownership more affordable for low- to moderate-income borrowers but lowers lender revenues and decreases the relative profitability of CRA programs. Survey responses show this may be one reason why some find CRA lending less profitable than others.

Expense comparisons: transactions costs

Transactions costs are an important factor in mortgage lending that may affect the relative profitability of CRA lending. To help analyze transactions costs, we asked how CRA lending was conducted within institutions, as well as about origination and servicing costs.

A majority of respondents (62 percent) conducted their CRA operations through loan officers who did other types of lending as well. The remaining 38 percent (35 respondents) indicated they used a separate department, loan officers specializing in CRA lending, or some other mechanism for processing their CRA loans.¹⁶

We found that 83 percent of the institutions that treated CRA lending as a separate activity (30 respondents) were in the less profitable group. This result was somewhat unexpected. Since CRA lending often requires specialized expertise, we expected that institutions with separately structured CRA programs might benefit from the specialization. Indeed, they may have and our results may simply reflect better accounting for CRA loan profitability at institutions that treat it separately.¹⁷

However, there may be more than accounting differences at work. For example, we found that institutions with separate CRA lending programs were more likely to offer special incentives to loan officers for making single-family residential CRA loans (44 percent of respondents) than those that did not (18 percent). These incentives can raise the cost of originating CRA loans, thus reducing their profitability.

Our results may also reflect institutional size differences. We noted earlier that larger institutions, with their standardized systems, may find it more costly than smaller institutions to make CRA loans. Although we did not collect size

information in our survey in order to preserve respondent anonymity, the residential loan origination information we did collect can be used as a proxy for size and suggests that size may be a factor in CRA loan profitability.¹⁸ For example, average total single-family loan originations for institutions with comparatively profitable CRA programs was \$26 million during 1994, the year covered in our survey. Average total residential originations for institutions with less profitable CRA programs was \$361 million.¹⁹

Our results may also reflect differences in aggressiveness among institutions in making CRA loans. Institutions with a separate CRA lending function may be reaching further into the pool of potential borrowers, working with borrowers who have fewer financial resources and poorer credit records. Consequently, cost advantages gained through specialization may be offset by the added expense associated with working with more marginal borrowers who have more financial problems to overcome.

To supplement this broader view of CRA lending costs, we asked for specific information on origination and servicing costs.²⁰ We found that institutions with less profitable CRA programs tended to have higher origination costs than those with comparatively profitable programs (see Figure 2). Almost 70 percent of institutions with less profitable programs said origination costs on their CRA loans were higher than those on their conventional loans. In contrast, approximately 82 percent of the institutions with CRA lending programs that are as profitable as their conventional lending indicated that origination costs on their CRA and traditional loans were the same.

Table 2 lists reasons for higher origination costs given by institutions with less profitable CRA programs.²¹ "Time spent with borrower" was the most frequently cited

¹⁶ The other mechanisms included residential mortgage departments, special administrative areas of the institution, a mortgage banking subsidiary, and use of special underwriters for real estate mortgages.

¹⁷ For example, some institutions may treat CRA lending as a separate profit center. In such cases, the center may be allocated a portion of the institution's overhead cost. Where CRA lending is not treated separately, no such allocation may have been done, tending to make the relative profitability of those without separate CRA programs appear to be higher than those with separate programs.

¹⁸ We assumed that larger institutions would generally report larger origination amounts.

¹⁹ The average size CRA loan for the "as profitable" group was approximately \$52,000. For the "less profitable" group, the average size CRA loan was \$59,500. Although the average size loan amounts differ, a means difference test indicates the values are not statistically different.

²⁰ Origination costs include processing, underwriting, and closing a loan. Servicing costs include collecting monthly payments, managing escrow accounts, and handling any delinquency and foreclosure problems that

Table 2

Reasons for higher origination costs

Source of higher origination costs	Less profitable	
	Percent*	Number of institutions
Time spent with borrower	90	44
Developing borrower information	65	32
Paperwork	49	24
Grant or payments made to community groups	33	16
Incentives paid to loan officers	14	7
Other factors	24	12

* Percentage is based on 49 respondents indicating their servicing costs were higher.

might occur with a loan. See *Mortgage Banking Performance Review: Single-Family Residential Mortgage Production and Servicing Profitability 1990-1993*, Fannie Mae, Volume 1, December 1994, pp. 11, 21.

²¹ Since only four respondents with more profitable CRA programs indicated that their origination costs on CRA loans were higher, our discussion of factors influencing origination costs focuses on institutions with less profitable programs.

²² Roberto G. Quercia and Michael A. Stegman, "Residential Mortgage Default: A Review of the Literature." *Journal of Housing Research*, Vol. 3, Issue 2, 1992,

reason. "Developing borrower information" and "Paperwork" costs were also considered to be important cost factors, as were "Grants or payments made to community groups."

In addition to origination costs, we asked institutions about their loan servicing costs. Once again, institutions with comparatively profitable CRA programs showed little difference in servicing costs between their CRA loans and their conventional loans. Figure 3 shows that 95 percent of institutions with comparatively profitable CRA lending programs said their servicing costs were the same as on their conventional loans. On the other hand, 48 percent of the institutions with less profitable CRA programs tended to incur higher servicing costs on their CRA loans.

Of the 32 respondents who said their servicing costs were higher, 91 percent attributed that to higher monitoring costs. A few respondents offered comments about these monitoring costs:

"[Greater] contact with customers and work to keep [them] current on payments."

"More frequent changes to insurance. Also more past dues. More phone calls."

Loan losses and credit risk management

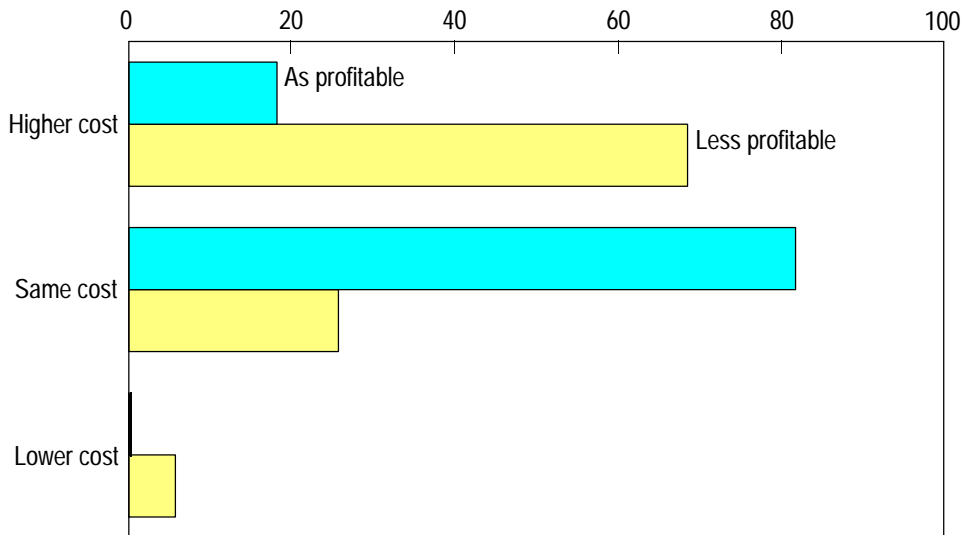
Another expense area where CRA lending may affect lender profitability is through higher loan losses. Many studies of mortgage default rates show that when home mortgage loan underwriting criteria are relaxed, default rates rise.²² CRA lending programs often relax key underwriting parameters identified as predictors of loan default—such as loan to value, debt to income ratios, junior financing, maturity, interest rate (see Appendix B). Therefore, we asked about underwriting standards, risk control methods, and manageability of credit risk for CRA residential loans.

Our questions on underwriting standards (see Appendix C) focused primarily on the three "Cs" of credit: character, capacity, and collateral. Institutions with comparatively profitable CRA programs indicated they relaxed their credit standards, but often not to the same degree as those with less profitable programs. For example, the more profitable CRA lenders placed more emphasis on repayment capacity—being less likely to accept higher debt to income ratios—and on collateral in making CRA loans.

Many of the differences in credit standards between the two groups appear to be small. Studies show, however, that loan performance deteriorates significantly when multiple standards are relaxed.²³ As a consequence, small differences in individual factors may translate into substantial differences in credit risk when many factors are relaxed. We noted that banks with more profitable CRA programs tended to relax fewer of their loan underwriting criteria than

Figure 2

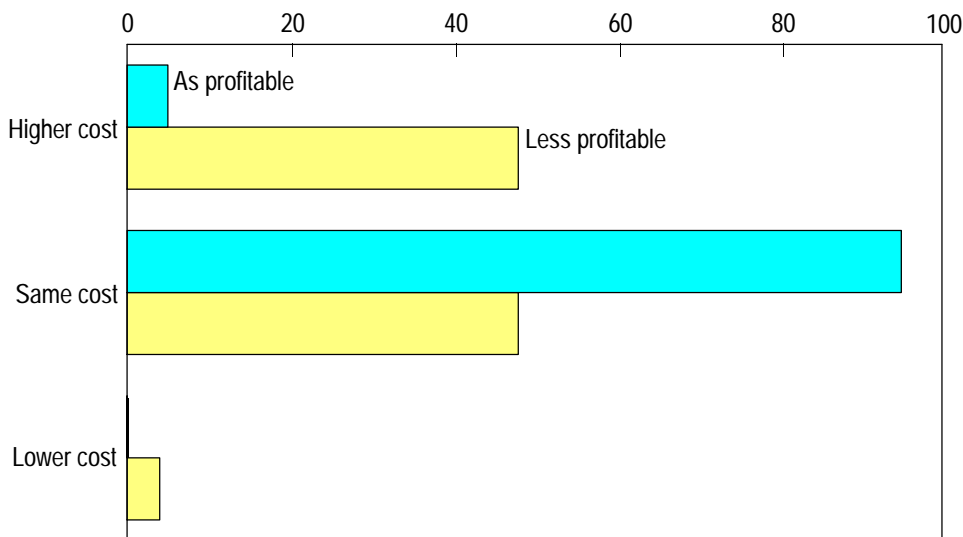
Loan origination cost comparisons



Source: Federal Reserve Bank of Kansas City.

Figure 3

Loan servicing cost comparisons



Source: Federal Reserve Bank of Kansas City.

pp.341-379. Snigdha Prakash, "Clinton's Home Ownership Plan a 2-Edged Sword for Lenders," **American Banker**, June 7, 1995, p 1. Gordon, H. Steinbach, "Entering a New World," **Mortgage Banking Magazine**, June 1995, pp. 36-42. ²³ For example, see Robert B. Avery, et al "Credit Risk, Credit Scoring, and the Performance of Home Mortgages." **Federal Reserve Bulletin**, Vol. 81 (July 1996), pp. 683, 644-647.

Table 3

Reliance on enhancements

Proportion of survey respondents, by profitability group, indicating reliance on government guarantees, community groups and lending consortia to reduce credit risk

Profitability Group	Government guarantees		Community groups		Lending consortia	
	Percent	Number	Percent	Number	Percent	Number
As profitable	45	10	64	14	27	6
Less profitable	67	47	89	63	57	40

groups, and lending consortia to lessen their credit risk exposure (see Table 3). While both groups made extensive use of these enhancements, especially community groups and government guarantees, those with the comparatively profitable programs were less likely to use these alternative risk reducing enhancements than institutions with less profitable programs. One possible explanation for this is that extension of an institution's existing underwriting standards to include CRA loans may be operationally less costly than using external risk reducing techniques.

Table 4

Importance of risk reducing enhancements

Respondents indicating they would have made 75 percent or more of their CRA loans without government guarantee programs

Respondents indicating they would have made 75 percent or more of their CRA loans without community group assistance

Profitability group	Government guarantee programs		Community group assistance	
	Percent	Number	Percent	Number
As profitable	81	17	90	20
Less profitable	75	51	75	50

To judge how important these risk reducing enhancements were in the lending process, we asked respondents what proportion of their loans would not have been made without them. Their responses are presented in Table 4. As would be expected, institutions with less profitable CRA programs were less likely to make CRA loans without them. However, a high proportion of CRA loans—75 percent or more—would have been made by either profitability group even without enhancements.

In addition to addressing underwriting criteria, the survey asked respondents to compare the

²⁴ The similarity in loss rates found in our survey are consistent with information gleaned from the survey by the Federal Reserve Bank of Philadelphia mentioned earlier. None of 11 institutions that discussed their loan loss experience in that survey reported significant differences in default rates between their CRA loans and their conventional loans.

those with less profitable programs. The 22 institutions with more profitable CRA programs relaxed, on an average, 1.3 of five broadly defined credit and underwriting standards (debt to income, loan to value, collateral, character and credit history). Those with less profitable programs relaxed an average of 2.1 of these standards.

Institutions may be comfortable relaxing some of their credit standards if they know there are other mechanisms for managing credit risk. Consequently, we asked respondents about their reliance on government guarantees, community

delinquency and loan loss rates on their CRA loans relative to their traditional loans. All respondents, regardless of profitability group, indicated that losses on their CRA loans were comparable to losses on their conventional loans.²⁴ They further believed credit risk for their CRA programs to be manageable; those with comparatively profitable CRA programs were unanimous in that belief. Approximately 72 percent (51) of those with less profitable programs thought credit risk on CRA lending was manageable. Twenty-seven percent (19) thought it was too soon to tell. Only one

respondent thought these risks could not be managed.

Unlike loss rates, delinquency rates differed between the two CRA profit groups. Institutions with less profitable CRA lending programs reported higher delinquency rates, perhaps reflecting their more lenient underwriting standards on CRA loans. The higher delinquency rates may also help explain higher servicing costs for these institutions. The information presented in Figure 4 helps clarify how more lenient credit standards and higher delinquency rates may translate into higher servicing costs.

Options for improving CRA lending profits

In addition to asking respondents about the relative profitability of their past CRA lending efforts, we asked for their insights concerning ways to improve future CRA loan profits. Forty-three respondents made suggestions on ways to improve the profitability of CRA lending. Suggestions invariably focused on ways to recoup lost revenue and to reduce CRA loan transactions costs. The most frequently mentioned suggestions are summarized in Table 5. Discussions concerning these suggestions are grouped according to their implications for revenues and costs.

Revenue enhancements

Survey responses indicated that institutions with less profitable CRA programs give up more fees and, as one respondent put it, are “giving away the shop” at the expense of profits. Less willingness to “give away” (more rational competition) and more public programs that assist CRA borrowers with loan fees would lessen subsidization by lenders and improve their profitability from CRA lending.

Suggestions for removing regulatory impediments were less specific. However, two respondents wanted to charge

Table 5

Suggestions for improving CRA loan profitability

<u>Suggested improvement</u>	<u>Number of respondents</u>	<u>Profitability factors affected</u>
Better/more flexible secondary markets	19	Costs
More transaction cost/buyer assistance	10	Revenues
More marketing assistance	6	Costs
More rational competition	5	Revenues
More buyer education	5	Costs
Less regulation	4	Revenues, Costs

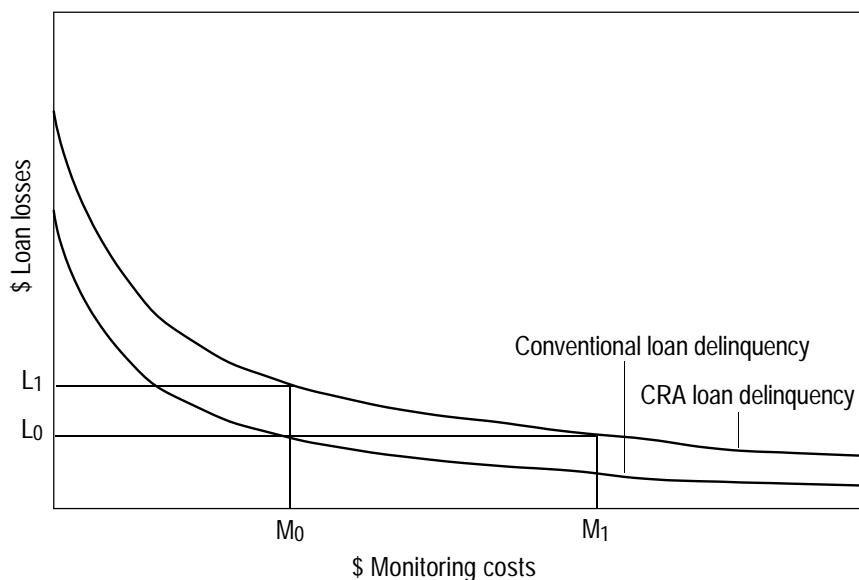
higher rates for the added risk posed by CRA loans and/or wanted to recover costs associated with making these loans. Both voiced concern that Department of Justice interpretations of fair lending laws and disparate treatment could make this difficult.

Expense reductions

The most common suggestion for improving CRA loan profitability was better access to secondary markets. Presumably some respondents would like to sell more of their CRA loans to others at higher prices, passing along the higher monitoring costs (greater credit risk) and lower interest rates. Since higher monitoring costs and below market rates lead to discounts, higher prices are not possible without more competition from charitable buyers investing for social purposes. Thus, lender actions to improve CRA loan profitability are confined to offsetting higher servicing costs and raising returns from these loans.

Respondents offered a number of other cost reducing suggestions. Three of the most frequently mentioned were: more

Figure 4

Loan Monitoring Costs and Loan Losses¹

¹In Figure 4, the two curved lines, labeled “Conventional loan delinquency” and “CRA loan delinquency,” reflect possible trade-offs between loan monitoring costs and loan losses. The CRA loan delinquency line is placed above the conventional loan delinquency line on the assumption that higher delinquencies would result from more lenient underwriting on CRA loans. M_0 spent by an institution for loan monitoring would lead to loan losses of L_0 on its conventional loans. However, because more leniently underwritten CRA loans require greater loan monitoring, spending fixed amount M_0 on CRA loan monitoring would produce higher loan losses, L_1 , on these loans. To keep CRA loan losses similar to those on conventional loans, an institution would have to spend M_1 on loan monitoring. This may explain the results reported in the text of comparable losses but higher delinquencies and servicing costs for some CRA loan programs.

marketing assistance, more buyer education programs, and less regulation. The first two suggestions rely heavily on partnering arrangements—primarily with community groups and nonprofit organizations—to lessen the costs of informing potential borrowers of available loan programs, pre-screening applicants for financial responsibility, schooling applicants on home ownership and budgeting matters, and dealing with delinquencies.²⁵ These suggestions would lower lender costs by shifting costs to other groups.

Only six respondents answered the survey question on transaction cost savings resulting from assistance provided by partners. They estimated their CRA loan transaction costs were lowered by approximately 19 percent because of assistance received.

Less regulation was another cost saving suggestion. One respondent advocated less regulation, “specifically, appraisal requirements which have added time and cost without improving quality of lower dollar home mortgage transactions.” Other comments focused more generally on reducing CRA regulation but did not offer specific recommendations for achieving cost savings.

In summary, 43 respondents offered suggestions on ways to improve the profitability of CRA lending. These suggestions focused on reducing the subsidy on CRA loans by recouping lost revenues and reducing costs. Better and more flexible secondary markets for CRA loans, the most frequently suggested method, is not likely to offset higher servicing costs and interest rate concessions made on these loans. As a result, other suggestions such as more transactions costs, buyer assistance, marketing assistance, and buyer education programs provided by government and nonprofit organizations may be better ways to improve CRA loan profitability.

Summary and implications

In this study, we used a survey to explore profitability differences between CRA and conventional home mortgage lending programs at 97 large institutions. The survey asked about factors affecting the profitability of these programs—revenues, costs, and losses—and asked lenders to compare these factors for their CRA mortgage loans with their conventional mortgage loans.

The survey was not random and was not intended to present a portrait of industry practices. Only 2 percent of respondents said their CRA lending was unprofitable. Thus, 98 percent saw their CRA home mortgage lending as making money, albeit a majority concluded it was not as profitable as their conventional home mortgage lending.

In exploring profitability differences at institutions, we found that lenders with more profitable CRA loan programs were more likely to treat their CRA lending as they did their conventional lending. That is, they gave up a smaller portion of their fees, were less willing to cut their interest rates on CRA loans, and kept their origination and servicing costs near that for conventional lending.

Nearly all institutions, including those with more profitable programs, loosened their credit standards on CRA loans relative to standards on their conventional loans. These institutions did so without appreciable increases in loan losses. Further, nearly all indicated that credit risk on CRA loans is manageable.

However, we found institutions with less profitable CRA programs experienced higher delinquencies on their CRA loans than those with comparably profitable programs. Since managing delinquencies translates into higher transaction costs, we suspect the higher transactions costs reflect a riskier loan portfolio. This higher risk may be an important factor

²⁵ *Lending consortia are another means of partnering to reduce lender transactions costs. For example, one respondent noted “Profitability will not increase when only a handful of customers qualify for any one program.” Consortia, by serving as a focal point for low-volume lending products can justify developing and maintaining lending expertise individual lenders with smaller potential customer bases could not justify. It is an economies of scale issue. However, as another respondent noted, this may not reduce costs, “if you use a consortium, you are still incurring higher costs because you still have to fund that group.”*

in explaining lower CRA loan profitability at some institutions.

Implications

The period covered in this study predates the recent change in the regulation used for CRA enforcement. In response to both industry and community pressures to quantify CRA performance measures, the new performance-based regulation will likely produce two results: give added incentive to institutions to offer alternative lending products, including small business loans, small farm loans and consumer loans; and increase the overall pressures on institutions to lend to lower-income people and in lower-income neighborhoods.

With respect to alternative lending products, there is no reason to believe that the risk, rate and transactions costs findings in this study would not be applicable to other loan products. Greater pressure to lend, however, can have serious profit implications because there are finite limits on “bankable loans” in any community that can be made without increasing credit risk and associated transactions costs. Pressure to make more loans may mean some lenders accept uncompensated credit risk. Such pressures also increase incentives for lenders to work in partnership with community organizations and government to better manage risk and address community credit needs. Our study findings have implications for each of these partners as well as for regulators.

For lenders, the key to success in CRA lending appears to be lending that follows a “business as usual” approach, incorporating CRA lending into the institution’s normal operations. In the case of some lenders, this involves no special departments, no special rates, limited concessions on fees, and only modest relaxation of credit and underwriting standards.

For community groups, a key to expanding CRA lending appears to lie in helping lenders reduce their transactions costs. Pre- and post-purchase counseling programs that help reduce borrower delinquencies are ways to reduce these costs. Assistance with delinquent borrowers is another way to keep transactions costs down. Help with marketing, putting deals together, and absorbing some of the paperwork costs with government programs are additional avenues for reducing lender costs.

For government, a key to increased program use lies in devising borrower programs and regulatory policies that do not add significantly to lender transactions costs or lessen lender revenues. Use of low documentation loan programs that reduce paperwork burdens without compromising credit standards is one way to keep origination costs down on CRA loans. Programs that help match borrowers with available resources are another way to keep a lid on CRA transactions costs.

Although regulators are not financial resource partners in CRA lending, they play an important role through their enforcement of the CRA and the fair lending laws. Here they influence two key policy areas critical to CRA lending: (1) defining what constitutes “satisfactory” CRA performance *vis a vis* profitability and the safety and soundness criteria for lending, and (2) determining what is acceptable with respect to charging customers for higher risk and/or higher transactions costs.

The first of these regulatory issues relates to examiner assessments of the credit quality of CRA loans. As with any non-traditional lending effort, examiners must assess risk in the context of the institution’s capabilities to manage that risk and absorb losses should they occur. Their goal must not be to eliminate risk, but rather to see that risk is properly

managed. This approach gives banks latitude to create new products, including CRA loan products, and not have them criticized simply because they differ from more traditional products.

The second regulatory influence pertains to fair lending law concerns that arise from charging lower-income people, who are also more likely to be protected class individuals (e.g. minorities), higher rates on loans. Higher charges to protected class borrowers may be perceived by lenders as well as regulators as violating the nation's fair lending laws, thus limiting options for achieving profitability on CRA loans. In this regard, policy statements from regulators and the Justice Department on these issues can help resolve uncertainties about fair lending law enforcement and clarify options for achieving profitability on CRA loans.

If banks and others are to be major players in community reinvestment efforts and lend to lower-income individuals and neighborhoods beyond levels they perceive required by CRA, they must achieve competitive returns on their CRA lending. The findings in this study suggest this can be done and offer guidance to lenders and others on what can be done to achieve more competitive returns.

Appendix A: CRA lending profitability model

There are many factors that can affect CRA lending profitability. These factors often are interrelated, making profitability analysis difficult. To strip away some of this complexity, we developed four models to explore various aspects of CRA lending profitability. The first model evaluates factors that may influence the overall profitability of CRA lending. Subsequent models focus on specific revenue and expense aspects of profitability and evaluate factors that may affect them.

CRA lending profitability

Ninety-seven institutions responded to the survey. All but three of these provided information on the relative profitability of their CRA lending. Twenty-two institutions said their CRA lending was as profitable or more profitable than their conventional lending. The remaining 72 said it was less profitable.¹

To evaluate factors that may explain differences in relative profitability among institutions, we estimated a logit model where the dependent variable was CRA loan profitability. This variable took the value "1" if a surveyed institution reported its CRA lending was as profitable or more profitable than its conventional lending; it took the value "0" otherwise.

The independent variables used to explain variations in CRA loan profitability, were:²

Residential loans—this variable is the logarithm of the respondent's 1994 residential loan originations. We included this variable as a proxy to capture institutional size effects. Since some suggest that larger institutions with standardized monitoring systems may be at a disadvantage relative to smaller institutions with more personalized systems, we hypothesized profitability would be negatively related to size.

Institution type— this variable takes the value "1" if the respondent is a bank, the value "0" otherwise. In our initial analysis of the survey, we noted that approximately 70 percent of those with profitable CRA programs were banks. Those with less profitable programs were more evenly distributed among institution types—savings and loans, bank holding companies, mortgage banking companies, etc. Because of this, we thought CRA profitability might be positively related to the survey respondent being a bank.

CRA program age—this variable represents the age in years of the CRA programs reported in our survey. Ages were as of year-end 1994. We assumed older programs would be more profitable, if for no other reason than the institutions offering them were well along the learning curve in making these programs successful.

FHA/VA—this variable is the percentage of the institution's single family residential CRA loans that were FHA or VA loans. These loans carry government guarantees and provide lenders with access to secondary mortgage markets. We thought guarantees and secondary market access would have a positive effect on CRA loan profitability.

¹ Only 94 institutions provided information on the profitability of their CRA programs.

² In other formulations of the profit model, we included the proportion of 1994 CRA loans to 1994 residential loans as a proxy for the importance of an institution's CRA business. This variable was not significant in explaining profit differences among CRA programs.

Appendix A: CRA lending profitability model (continued)

Economy—this variable takes the value “1” if the economy where a respondent operates is average to strong, the value “0” if the economy is weak. We thought a strong economy would lessen profitability differences between conventional and CRA loans by lowering delinquencies and losses, especially on CRA loans.

The model was estimated using multi-variate logit analysis.³ The results from the estimation are shown to the right. All coefficients have the expected signs and two of the five variables are significant at at least the 5 percent level or better. The Chi-square statistic is significant at better than the 5 percent level, indicating the model has power in explaining profitability differences among CRA programs.

These results suggest that both institution size and CRA program age are two important determinants of CRA loan program profitability. Larger volume lenders tend to have less profitable CRA programs and older CRA programs tend to be more profitable.

To delve further into CRA loan profitability, we analyzed revenue and expense factors that we thought could affect profitability.

Revenue factors

Responses to our survey, as well as surveys by others, indicate that some institutions may subsidize CRA borrowers by “giving up” fees and charging below market interest rates on their CRA loans. To test this proposition, we estimated a revenue equation for survey respondents. The dependent variable in this ordinary least squares regression equation was the ratio of fees collected on a typical single family CRA residential loan to fees collected on a similar size conventional loan. The independent variables in the equation included the logarithm of residential loan originations and program age, variables previously used in the profitability model.

In addition, we included the percent of CRA loans retained by an institution as an explanatory variable. We consider this variable to be a proxy for the subsidy given to CRA borrowers. Higher CRA loan retention rates may be indicative of subsidies given to borrowers that make these loans less suitable for resale in secondary markets.

Dependent variable: CRA loan profitability

Independent variables	Coefficient ¹
Constant	5.054
Residential loans	-.4299
Institution type	.7700
CRA program age	.0327
FHA/VA	.0113
Economy	.6111

¹ Coefficients in bold type are significant at the 5 percent level or below. The Chi-square statistic for the equation is 14.64, also significant at better than the 5 percent level.

³ When the dependent variable is not continuous, ordinary least squares estimates of the regression coefficients are not efficient, making logit analysis more appropriate. G.S. Maddala, *Introduction to Econometrics*, 2nd ed., (New York: Macmillian Publishing Company, 1992), p. 324.

Appendix A: CRA lending profitability model (continued)

The regression results shown in the table below indicate that program age and percentage retention of CRA loans are significant factors in explaining relative fee differences among institutions.

From these results, it appears there is less fee discounting as CRA programs age. One interpretation of this result is that fee discounting occurs in the early stages of programs as lenders attempt to build an initial customer base; it could be a marketing effort to introduce a new product.

The results also show that greater fee discounting is associated with higher CRA loan retention rates. As hypothesized earlier, this may imply less suitability of these loans for resale in secondary markets, reflecting among other things greater subsidies, such as below market interest rates, to borrowers.

Expenses

Responses to our survey indicate that working with borrowers, developing borrower information, paperwork costs, grants to community groups, and higher monitoring costs were factors contributing to higher transactions costs on CRA loans. To analyze transactions cost differences, we broke the lending process into two component parts—origination and servicing—and reviewed each.

Origination costs

The dependent variable in the origination cost model took the value “1” if survey respondents indicated origination costs on their CRA loans were higher than on their conventional loans. It took the value “0” otherwise. As before, we included the logarithm of residential loan originations and CRA program age variables in the equation to control for institution size and program age. We also included a CRA lending structure variable. This variable took the value “1” if a respondent conducted its CRA lending in a separate department, the value “0” otherwise. We thought that conducting CRA lending from a separate department might be associated with larger loan volumes, increased specialization, and greater familiarity with nuances of using CRA programs and working with CRA borrowers. These factors would tend to reduce origination costs and have a positive effect on CRA loan profitability.

We used logit regression analysis to estimate the origination cost equation. The results, shown in the adjacent table, indicate that origination costs tend to be higher at larger institutions. These higher costs help explain the negative relationship between CRA

Dependent variable: CRA loan fees to conventional loan fees

Independent variables	Coefficient ¹
Constant	1.7818
Residential loans ²	-.0467
CRA program age	.0060
% CRA loans retained	-.0047

¹ Coefficients in bold type are significant at the 5 percent level or better. The F value for the equation is 3.82, which is significant at the 5 percent level or better. The adjusted R² for the equation is .16.

² This variable was significant at the 12 percent level, just below our 10 percent cutoff.

Dependent variable: Origination costs

Independent variables	Coefficient ¹
Constant	-9.2762
Residential loans	.5406
CRA program age	-.0149
CRA lending structure	2.2328

¹ Coefficients in bold type are significant at the 5 percent level or better. The Chi-square statistic for the equation is 19.03, also significant at better than the 5 percent level.

Appendix A: CRA lending profitability model (continued)

loan profitability and institution size. This result is also consistent with observations of others that larger institutions, with their standardized lending systems, may be at a disadvantage in making CRA loans relative to smaller institutions that are geared more toward individualized loan analysis.

Additionally, the results indicate that origination costs are higher for institutions where CRA lending is conducted as a separate activity. This relationship is opposite from what we expected, and we have no definitive reason for this result. Perhaps it simply reflects that separate departments for CRA lending are not cost effective due to lower loan volumes. It may also reflect better cost accounting data at institutions that conduct CRA lending in a separate department. Finally, as discussed in the text, it may reflect a greater propensity to pay incentives to loan officers on CRA loans or to lend to more marginal borrowers.

Servicing costs

The dependent variable in the servicing costs model took on a value of “1” if servicing costs on a respondent’s CRA lending were higher than on its conventional lending and “0” otherwise.

The independent variables in the model included the logarithm of residential loan originations and the factors we held constant in the other models. We included the delinquency rate on CRA loans as an explanatory variable because we expected higher delinquencies would require more borrower contact and more intense loan monitoring, raising servicing costs.

The results, shown in the adjacent table, suggest that institution size and CRA program age are not significant factors in explaining differences in CRA servicing costs for survey respondents. The CRA delinquency rate, however, is significant. Higher CRA loan delinquencies are associated with higher servicing costs.

Dependent variable: Servicing costs

Independent variables	Coefficient ¹
Constant	-5.3912
Residential loans	.1809
CRA program age	.0077
CRA loan delinquency rate	.5347

¹ Coefficients in bold type are significant at the 5 percent level or better. The Chi-square statistic for the equation is 23.11, also significant at better than the 5 percent level.

In summary, analysis of CRA loan profitability can be exceedingly complex because of the interaction among the many factors that can influence profit. The models presented here attempt to hold some factors constant in order to judge the effects of others. In this regard, we found loan origination volume (our proxy for size) and CRA program age are important CRA loan profitability factors. We found smaller institutions with fewer originations tended to report higher CRA loan profitability and older CRA programs tended to be more profitable than newer programs.

Holding these factors constant, we did a more detailed analysis of revenue and expenses associated with CRA lending relative to conventional lending. After doing so, we found that more profitable CRA programs tended to subsidized borrowers less, were not generally conducted as a separate activity of the institution, and usually had lower loan delinquency rates.

Appendix B: Summary of major features of CRA programs

The accompanying table presents major features of CRA programs described by survey respondents. Some of these programs were initiated by the respondents and others were made available through or in conjunction with state agencies and private institutions. In addition to these programs, a number of respondents noted they used Rural Development, Federal Housing Administration, and Veterans Administration programs. They also used Fannie Mae's (Federal National Mortgage Association's (FNMA)) Community Homebuyer's program.

Program	Loan fees, closing costs and points	Down payment	Rate	Front ratio ¹	Back ratio ²	Other
1		1%				
2	Closing costs can be financed	0%		33%	38%	Must complete borrower education program
3	\$1,000 fee reduction	3% with PMI (private mortgage insurance)	1/4% below market rate	33%	38%	
4	Bank pays up front costs	5% with PMI		Little easier than FNMA	Little easier than FNMA	
5	No points, application fees 1/2 of regular mortgage products	10%	Fixed first five years, floats thereafter	33%	40%	
6	Closing costs reduced, points reduced	5%	Rate reduced	Higher ratio than regular products	Higher ratio than regular products	
7		5%, borrower provides 3%, bank provides 2% (3/2 option)		Higher ratio than regular products	Higher ratio than regular products	
8			1/4%, 1/2% below market rate			Depending upon program, lender pays mortgage insurance
9	Second mortgage to finance part of closing costs		Step rate			

Appendix B: Summary of major features of CRA programs (continued)

Program	Loan fees, closing costs and points	Down payment	Rate	Front ratio ¹	Back ratio ²	Other
10	Depending upon program, 1% origination fee or no fee	3%	Depending upon program, fixed rate of prime rate + 1%			No Private Mortgage Insurance (PMI)
11	Lower fees	Higher loan to value ratio		35%	42%	
12		0%		Expanded debt to income	Expanded debt to income	
13	1/2% doc prep fee	3%				No PMI
14	\$125				40%	
15	Many closing costs waived, average saving of \$750 to borrower					
16		3-5%		More liberal ratio	More liberal ratio	No PMI
17	Lower fees		Lower rate			
18	\$300 flat fee, no points, no reserves	3%		33%	41%	No PMI
19		5% (3/2 option)				
20		3%		33%	38%	
21		3-5% FNMA loans				
22				33%	42%	Borrower education program encouraged
23		3% or \$1,000		33%	40%	Borrower education program encouraged
24		Lower down payment, comparable to FHA	Lower interest rate	More liberal ratio	More liberal ratio	

Appendix B: Summary of major features of CRA programs (continued)						
Program	Loan fees, closing costs and points	Down payment	Rate	Front ratio ¹	Back ratio ²	Other
25	Discounts based on income and family size	Lower down payment		Higher ratio	Higher ratio	
26	Lower closing costs, assistance available	5%, assistance available	Market rate			
27		5%				No PMI
28	\$500 flat fee, 1 point charged	5%		33%	42%	
29	All closing costs and prepaids financed with second mortgage	\$500				
30	Reduced fees, no post closing reserves, reduced points	5%, only 2.5% from borrower	Reduced rate			
31	1 point origination fee	10%	1/4% above standard 3 year balloon rate			

¹The front ratio is the ratio of principle, interest, taxes and insurance payments to borrower income. A front ratio of 26 percent is often used as a guide for conventional loans.

²The back ratio adds other debt payments to the computation of the front ratio. A back ratio of 36 percent is often used as a guide for conventional loans.

Appendix C: Underwriting criteria by profitability group

If underwriting standards on single family residential CRA loans differ from those for traditional loans, how do they differ?

<u>Profit group</u>	<u>Percent higher/more</u>	<u>Percent same</u>	<u>Percent lower</u>	<u>Total responses</u>
<u>Debt to income ratio</u>				
As profitable	69	31	0	16
Less profitable	84	14	2	64
<u>Loan to value ratio</u>				
As profitable	73	27	0	15
Less profitable	75	20	5	65
<u>Reliance on collateral</u>				
As profitable	0	100	0	16
Less profitable	9	72	19	65
<u>Reliance on character</u>				
As profitable	6	88	6	16
Less profitable	17	70	13	64
<u>Reliance on borrower credit history</u>				
As profitable	6	53	41	17
Less profitable	8	41	51	64

