The Community Reinvestment Act within a Changing Financial Landscape

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I. THE FINANCIAL LANDSCAPE FROM 1977 TO 2007[1]

In 2007, the Community Reinvestment Act (the CRA) celebrated its thirtieth anniversary. The CRA was originally a response to the perception that depository institutions had failed to meet the credit needs of their communities and that this failure was encouraging urban flight and the deterioration of cities. Reasons expressed for the limited access to credit included social (discrimination in lending practices), economic (limited information on credit; limited access to capital), and regulatory (prohibitions on interstate branching and mergers; interest rate ceilings) reasons.

The intent of the CRA was not to address each and every limitation of the banking system with respect to access to credit. It had a particular focus, and Congress carefully evaluated the benefits provided by government to the banking community before determining that CRA coverage, which would impose costs on covered institutions, would best be applied only to those receiving benefits from the federal government. Consequently, when the CRA was enacted, it applied only institutions covered by federally-insured deposit insurance including commercial banks and savings associations (savings and loans, henceforth S&Ls, and savings banks). As noted recently by Federal Reserve Chairman Bernanke, "The obligation of financial institutions to serve their communities was seen as a *quid pro quo* for privileges such as the protection afforded by federal deposit insurance and access to the Federal Reserve's discount window."[2]

In 1977, households typically saved by making deposits in institutions covered under the newly enacted CRA; they also borrowed from these same institutions. The CRA-regulated depositories, in turn, were generally locally based, and the industry was relatively unconcentrated. The financial landscape has changed significantly since the passage of the CRA in 1977. In this paper we provide an overview of how these changes have affected the coverage of the CRA, the structure of CRA-regulated institutions, and the effectiveness of those institutions in meeting the goals of the CRA. In taking a broad approach, we hope to provide a useful context for the other articles in this volume that offer a more detailed focus on changes in the CRA's implementing regulations and more specific aspects of the CRA's coverage and effectiveness.

II. BACKGROUND

Much has changed in the financial landscape in the past 30 years. Changes in household behavior can be seen as the response to an expanded array of financial services, arising primarily from the relaxation of regulations that affect institutions' offerings of products and the locations of their activities. Three changes in the financial landscape are

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[1] We thank Lemene Wakjira for her excellent work in checking the data and preparing the charts for this paper. We also thank Christopher Smith for his assistance with the tables. The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Board of Governors or the Staff of the Federal Reserve System, or of Freddie Mac or its Board of Directors.

[2] Chairman Ben Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges," (Speech at the Community Affairs Research Conference, Washington, D.C., March 30, 2007).

particularly notable, and all have arguably encouraged or allowed financial institutions to seek economies of scale or scope in the provision of services to communities.

First, several important legislative changes freed commercial banks and savings associations from regulatory constraints in terms of the types of activities in which they could participate and the geographies in which they could operate. The first major phase of deregulation took place from 1979 through 1982. These years saw a rapid increase in interest rates, driven primarily by a change in monetary policy that attempted to reduce inflation by targeting bank reserves rather than interest rates. This caused S&Ls to face negative interest rate spreads in the funding of their long-term mortgage assets. Further, Regulation Q usury ceilings on savings deposits meant that S&Ls faced disintermediation as households withdrew their deposits and placed them into higher-paying mutual fund accounts.

In an effort to improve the competitiveness of the S&Ls, two important Acts were passed. The Depository Institution Deregulation and Monetary Control Act of 1980 allowed S&Ls and credit unions to offer checkable deposits and compete directly with the commercial banks for these deposits. It also phased out Regulation Q ceilings on savings deposits (over six years) and allowed payment of interest on S&L demand deposits. The 1982 Garn-St.Germain Depository Institutions Act allowed savings associations to offer money market deposit accounts and super negotiable order of withdrawal accounts with limited checking features. Federally chartered savings associations were now permitted to make consumer and commercial loans and offer floating and adjustable-rate mortgages.

A decade later, the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted mergers and acquisitions of financial institutions across state lines. Reigle-Neal was passed not only as a response to the S&L crisis of the 1980's, but also to recognize that asset size is a factor in the financial health of banks and that healthy banks improve the stability of the banking system.

These three Acts enabled financial institutions to grow in both scale and scope. Commercial banks and savings associations have taken full advantage of this opportunity, and the industry has evolved substantially since 1977.

Second, the emergence of national credit repositories and the subsequent development of statistically based credit models have led to the rapid growth of automated underwriting systems for all types of lending. This allowed lenders to be less reliant on local knowledge of their customer bases and provided economies of scale in both underwriting and the assessment of credit. Both of these also encouraged industry concentration, as well as the growth of a national secondary market for mortgages and other assets.

Third, there was a rapid growth of secondary markets for financial products on both sides of the financial institution balance sheet, with two key effects.[3] First, because of secondary market funding, financial institutions were given more alternatives for obtaining capital; many have been able to obtain their funding at lower cost than was possible through deposit growth. Instead of relying primarily on a (local) deposit base for raising funds, institutions can rely on warehouse lenders and brokers for short-term capital, using securitization and a broad base of investors for long-term funding. Second, the secondary market allows lenders to pool loans from anywhere in the country and sell these securities through the secondary market. This increases the liquidity of lenders' assets, dramatically reduces localized variations in lending rates and the availability of credit, and reduces credit risks through geographic diversification. The growth of the secondary market, therefore, encouraged economies of scale, as well as the growth of non-depository institutions not covered under the CRA.

Overall, these changes have led to significant alterations in the financial landscape facing the typical United States household. Since the CRA's passage, households' savings/investment and borrowing options have expanded, both in terms of products and in the types of institutions offering them. Although CRA-regulated institutions still play a dominant role in financial markets, many new, non-covered institutions have entered the marketplace. Moreover, financial institutions have grown substantially in scale. The result is that households' financial activity is increasingly conducted with institutions not covered under the CRA, and the institutions with which they do transact business are increasingly national in scale rather than local.

Of course, these changes themselves do not speak directly to Congress' concern that financial institutions meet the credit needs of their communities. In the remainder of this paper, therefore, we spend some time considering how financial institutions' service to their communities may have changed in response to this evolving financial landscape. We start with a brief discussion of our data and empirical approach. We then consider changes in household balance sheets (savings and borrowing behavior) since the passage of the CRA. We follow this with a discussion of market share effects, comparing deposits and lending behavior by different types of institutions, including those that are CRA-regulated and those that are not. We turn next to an examination of the changes in CRA performance over time. Finally, we conclude with some thoughts about the current financial environment.

III. THE APPROACH AND THE DATA

We provide a series of charts to illustrate the effects of the changing financial landscape on CRA-regulated institutions and their success at meeting the credit needs of their communities. The charts themselves are based on data available for download through

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[3] The securitization of mortgages had, arguably, the largest impact on the growth of nonbank financial entities, but growth in other asset-backed securities also meant that deposit-taking was not essential for lending.

the Federal Reserve Bank of San Francisco. Underlying these charts and data are a series of consistent assumptions and empirical approaches that we outline in this section.

We consider all federally-insured commercial banks and savings associations to be CRA-regulated institutions. By this we mean that they must meet obligations set forth under the Community Reinvestment Act. Generally we distinguish among the CRA-regulated institutions by separately looking at the top 25 banking organizations as measured by total dollars of domestic deposits annually (including all the depositories and affiliates that belong to the organization), other large institutions (at least $1 billion in assets), and small institutions (less than $1 billion in assets).[4]

As envisioned at its inception in 1977 and today in 2008, the CRA encourages federally-insured banking institutions to meet the credit needs of their communities while maintaining safe and sound operation.[5] The financial institution itself is allowed (within limits) to define its deposit-taking "community" or the areas in which its performance will be assessed. This is known as the institution's assessment area. Because we do not have access to every institution's definition, we approximate each institution's assessment area as the counties in which it reports having a banking office in its annual regulatory filing.

Under the CRA, various tests are applied to measure each institution's performance, particularly in its assessment area. The performance criteria are flexible, and examination for compliance focuses on both the quantity and the quality of the institution's CRA qualifying activities.[6] The CRA distinguishes between retail activities, regarded as the traditional business of banking, and other community development activities meant to meet the credit or revitalization needs of lower-income borrowers or neighborhoods. The regulations focus on four categories of community development: affordable housing, community services, and economic development through either small business or small farm lending. For large institutions, evaluation also includes sub-ratings on activity-based tests for lending, investment, and service.

[4] Unlike the top 25, the large and small institutions are defined only in terms of the institution itself and not the larger organization to which they belong. The top 25 organizations are considered separately because they are the most likely to seek regulatory approval for acquisitions or mergers for which their CRA rating is relevant. The distinction between institutions with assets under or over $1 billion reflects a difference in the type of CRA performance evaluation to which those institutions are subject. In practice, this distinction has been determined by the "current" value of such assets, but in our charts we use an inflation-adjusted threshold normalized to the price level at the end of 2007 to improve consistency.

[5] For an overview of the history of the CRA, see Griffith L. Garwood and Dolores S. Smith, "The Community Reinvestment Act: Evolution and Current Issues," *Federal Reserve Bulletin* (vol. 79, April 1993), pp. 251-67. For a discussion of recently proposed and current regulations, see Robert B. Avery, Glenn B. Canner, Shannon C. Mok, and Dan S. Sokolov, "Community Banks and Rural Development: Research Relating to Proposals to Revise the Regulations that Implement the Community Reinvestment Act'," *Federal Reserve Bulletin,* (vol. 91, Spring 2005), pp. 202-235, available at www.federalreserve.gov/pubs/bulletin.

[6] We provide information that reflects the quantity of lending and change over time in activities, but we do not attempt any discussion of the quality of performance.

As a practical matter, assessing the full range of these performance distinctions is beyond the scope of this article. Therefore we focus primarily on traditional lending activities, particularly residential mortgage and small business finance, for which reporting of geographic data is mandated for most institutions under the CRA. Within such lending, we examine the percentage of loans made to borrowers in low- and moderate-income (LMI) census tracts.[7] This approach mimics a common performance measure used by CRA examiners. For residential mortgage lending, we also include loans to LMI borrowers, regardless of whether they reside in LMI geographies.

The CRA generally measures performance in a flow rather than stock framework. That is, it considers the flow of deposit-taking and lending activity within a given time period when assessing performance, not the stock of liabilities and assets on an institution's year-end balance sheets. Nonetheless, data limitations force us to use a combination of stock and flow measures in creating our charts and tables. We provide data on deposit-taking and lending activity over the 30-year period since the passage of the CRA (1977 through 2007), which are by necessity of a stock nature. Analysis of flow data is primarily focused on mortgage lending, both because of its intrinsic importance and the ready availability of the Home Mortgage Disclosure Act (HMDA) data. HMDA data are provided on a flow basis (yearly originations), but are available in a comprehensive manner only from 1990 through 2007. We also provide information on small business and small farm lending reported on a flow basis for the larger (top 25 and large) CRA-regulated institutions since 1996.

IV. CHANGES IN HOUSEHOLD BEHAVIOR

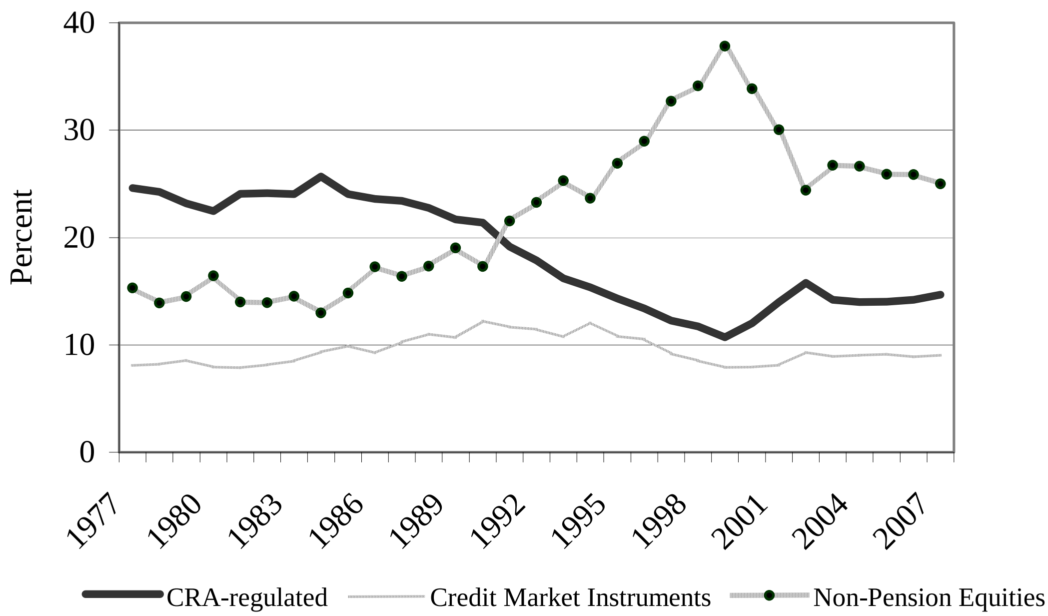
Over the past 30 years, households have been presented with many savings and lending alternatives. As financial regulations have evolved, so too has household financial behavior. While we cannot fully document all of the changes over the past three decades in terms of the proliferation of savings and lending vehicles, we do provide information on some select assets and liabilities of households. In Exhibits 1-3, we present information on stocks of household financial assets, including checkable and savings deposits (Exhibit 1), and outstanding stocks of consumer loans (Exhibit 2) and mortgage debt (Exhibit 3).

Consumer deposits are important for the CRA for two reasons. First, as suggested earlier, deposit insurance is often viewed as the *quid pro quo* for the CRA. Second, consumer deposits are included in the performance tests for CRA examinations.

[7] Census tract income categories are determined by the ratio of a census tract's median family income to the median family income of the relevant surrounding area as measured at the last decennial census. The categories are: 0-49 percent (low), 50-79 percent (moderate), 80-119 percent (middle), and 120 percent or more (upper). Similar categories are used to classify individual residential mortgage borrowers based on their income (as reflected in the mortgage underwriting) compared to a contemporaneous measure of the median family income of the surrounding area as estimated by the Department of Housing and Urban Development.

In 1977, at the time of the enactment of the CRA, households held 25 percent of their financial assets in the form of checking, time, and savings deposits in CRA-regulated institutions. The household share of financial assets held in such institutions has declined substantially since that time (see Exhibit 1), reaching a low of 11 percent in 1999 and then rebounding somewhat to 15 percent in 2007.[8] Some of the decline may have resulted from the expanding array of other deposit-type vehicles available to consumers from non-CRA-regulated institutions. Households' shares in credit market instruments (about one-third of which are money market mutual funds), for example, rose by about 1 percentage point over this period. Most of the decline, however, appears to stem from a switch in household assets toward the holding of non-deposit-type vehicles. In particular, the holdings of non-pension equities (including direct stock holdings and mutual fund shares) rose from 15 percent of household financial assets in 1977 to a peak of 38 percent in 1999, and then declined to 25 percent in 2007.

Exhibit 1
Shares of Households' Financial Assets



During this same period, households changed considerably the types of institutions from which they borrowed, particularly when they sought consumer loans and mortgages. For example, the share of U.S. consumer debt outstanding held at commercial banks and savings associations fell from 57 percent in 1977 to 35 percent by the end of 2007

[8] Exhibit 1 illustrates the share of household sector financial assets held as deposits (and other financial assets) from the Federal Reserve Board's Flow of Funds, Table B100e. The deposit figure was adjusted to exclude credit union deposits (obtained from Flow of Funds Table L115). The household sector in the Flow of Funds accounts includes non-profit organizations such as foundations and universities.

(Exhibit 2).[9] During that same period, the share of consumer loans securitized remained at zero until 1989, but increased to 27 percent in 1998, where it has remained with little variation.

Exhibit 2
Dollar Holdings of Consumer Loans

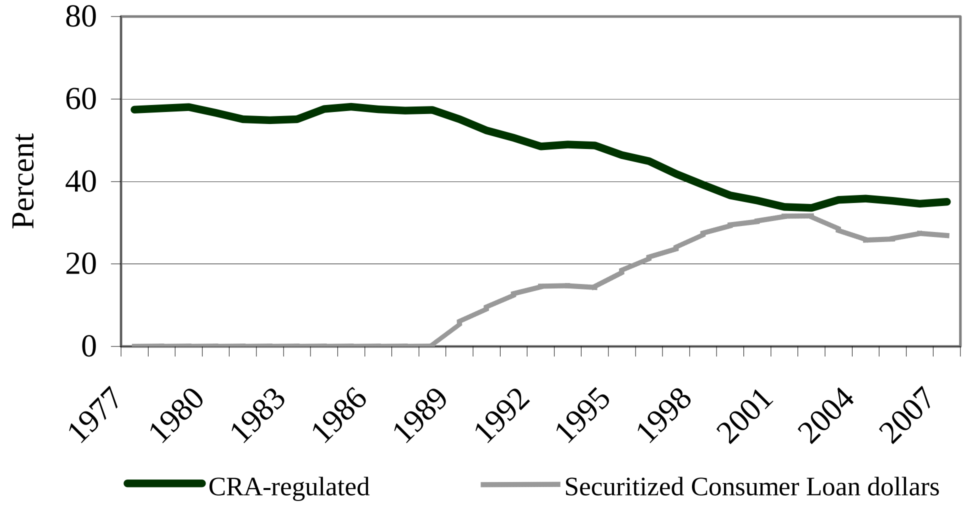
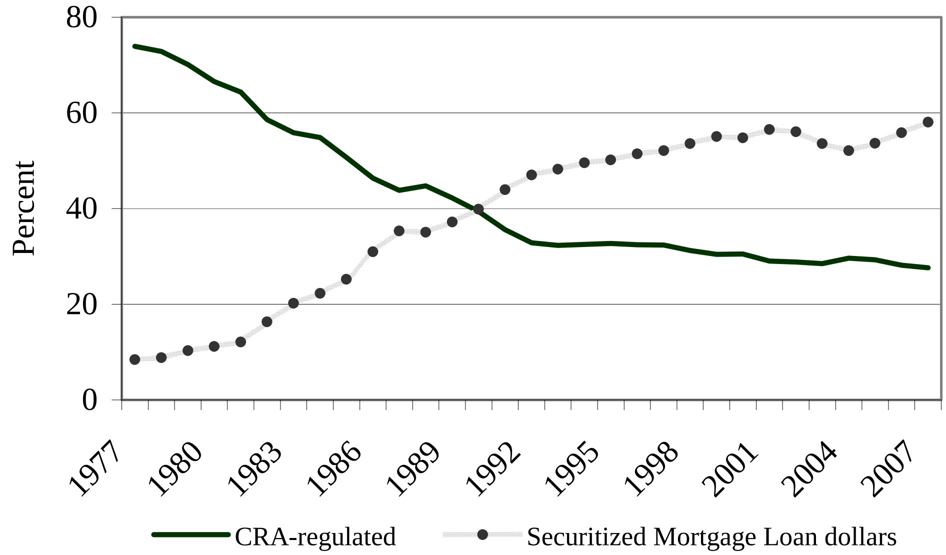


Exhibit 3 provides equivalent information on the change in mortgage debt.[10] The share of U.S. home mortgage debt outstanding held at commercial banks and savings associations fell from nearly three-fourths (74 percent) in 1977 to only slightly more than one-fourth (28 percent) by the end of 2007. At the same time, the percent of home mortgage debt outstanding that was securitized in the secondary market through either mortgage-backed securities (by the government-sponsored enterprises Fannie Mae and Freddie Mac) or privately through asset-backed securities increased from only 9 percent in 1977 to 58 percent in 2007.

[9] The data for this exhibit come from the Federal Reserve Data Release Table G19, also part of the Flow of Funds, Table L222. All consumer debt reflected in these data is owed by the household sector. Shares are expressed in dollars (rather than loans).

[10] The data for this exhibit come from the Flow of Funds Table L218. Home mortgage debt is calculated as all residential mortgage debt, including 1-4 family and farm houses. Home equity loans are included. Most home mortgage debt is owed by the household sector (about 94 percent in 2007).

Exhibit 3
Dollar Volume of Home Mortgage Debt Outstanding



The trends in the CRA-regulated institutions' share of consumer and mortgage loans are likely due to two key factors. The first is that, beginning in the 1980s and throughout the next two decades, institutions not covered under the CRA increasingly entered into competition with depositories for all forms of household borrowing (and savings). One such example is credit unions. Compared with commercial banks and S&Ls, the role of credit unions in the financial landscape remains relatively small. Moreover, they are not the largest competitors of CRA-regulated institutions. However, they remain interesting because they have federally-insured deposits but are not covered under the CRA. The data indicate that credit unions have increased their share of household deposits (increasing from 4 percent in 1977 to almost 10 percent in 2007) and home mortgage lending (rising from about one-half of one percent of mortgage assets in 1977 to 3 percent in 2007). However, the credit union share of consumer lending simultaneously declined from 14 percent in 1977 to 9 percent in 2007.

The second key factor that explains changing patterns in loans to households is the rapid growth in loan securitization. The secondary market dramatically increased the investor base for these assets and reduced the relative importance of a deposit base for purposes of funding loans to consumers. In the mortgage market, for example, the rapid growth in volume and liquidity of the mortgage-backed securities (MBS) issued by Freddie Mac and Fannie Mae has meant that wholesale lenders, through a broker network, can originate loans to distribute as securitized assets. Under this model, mortgage lenders need not rely on traditional checkable or savings deposits for funding, but instead can borrow the funds needed to make loans using a line of credit from a warehouse lender, originate mortgages, combine and sell them into secondary market securitized pools, and use these proceeds to repay the line of credit. This method of injecting capital into the credit market effectively bypasses the localized deposit collection and lending activity model that was central to mortgage funding at the passage of the CRA in 1977.

It is likely that all of these changes have had both significant and subtle impacts on lending and deposit-taking by CRA-regulated institutions. In the next section, we explore how these changes may have affected institutions of different size classes in different ways.

V. CHANGES IN THE STRUCTURE OF FINANCIAL INSTITUTIONS

Like households, financial institutions have also responded to changes in both the legislative and regulatory environments that allowed for growth and consolidation across the country. We provide a series of charts that show the changing market share of CRA-regulated institutions grouped by asset size for various financial products.

A. OFFICES AND DEPOSITS

In order to discuss market shares, we need to define a unit of measure for the financial institution. One such measure, the "office," is generally used as the unit of accounting for depositories covered under the CRA and other regulations.[11] Deposits held by an institution must be assigned to a particular office, and office location is typically used to define the geographic reach of each institution's assessment area. This information is used for the lending test under CRA examinations and for the branch service test, where particular attention is paid to offices in LMI neighborhoods.

One way to track the localized focus of institutions, therefore, is to consider trends in the average number of offices per institution—the higher the number, the more widespread (less localized) the activity. In 1977, fully 54 percent of the nation's 18,834 federally regulated commercial banks and savings associations were unit institutions—that is, they had a single location, with a single office, and no branches.[12] By 2007, however, the share of unit institutions had fallen to only 24 percent (out of 8,605 federally-insured banking institutions). The last 30 years, moreover, have led to the concentration of assets among the largest institutions. In 1977, for example, each institution had an average of 3.5 offices. By 2007, this figure had more than tripled to 11.5 offices per institution.

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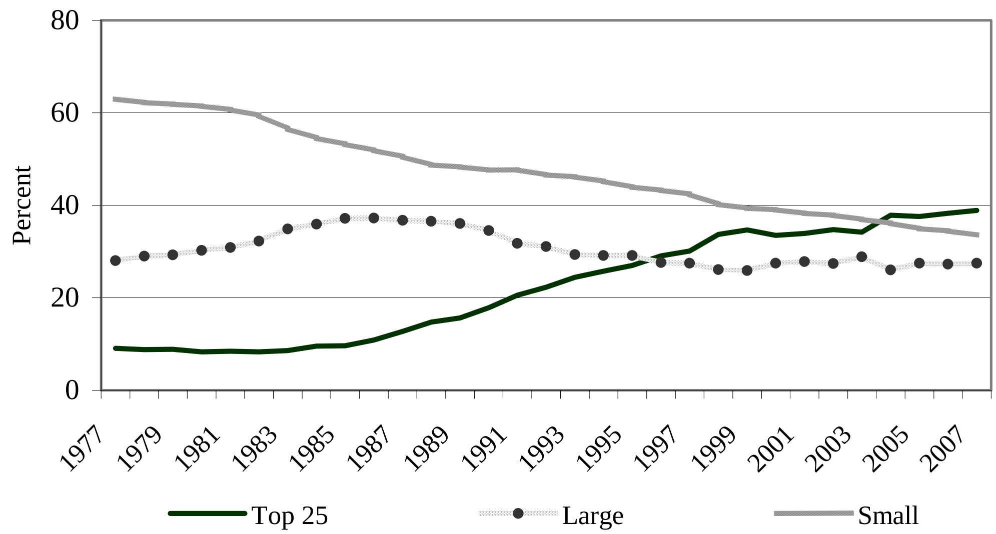
[11] While state law defines an office, generally it includes the institution's self-defined main office and any branches (but not stand-alone automated teller machines or ATMs). An institution with four branches operates a total of five offices.

[12] The information here (and in Exhibits 4, 5, and 6) is based on annual June 30th Summary of Deposits (Federal Deposit Insurance Corporation, FDIC) and Thrift Financial Reports (Office of Thrift Supervision, OTS) offices filings. Data since 1994 are available at http://www2.fdic.gov/hsob/hsobRpt.asp. Data for earlier years are based on the authors' calculations using information from the national archives and Federal Reserve Board records. Data include offices in U.S. territories.

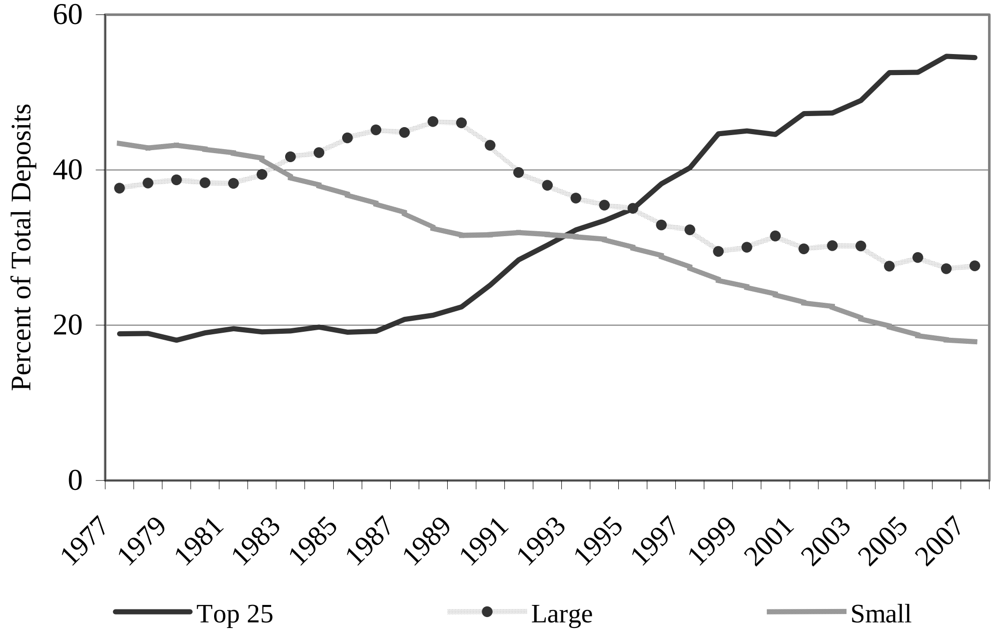
The increasing concentration of the banking industry is illustrated by trends in the market shares of offices owned by institutions of different size classes, as shown in Exhibit 4. Beginning in the mid-1980s, the share of offices held by the top 25 organizations steadily increased, while the share of offices held by small institutions declined. Clearly the top 25 institutions have commanded an increasing share of offices as they have grown more geographically dispersed in their activities. Interestingly, we do not observe a dramatic drop in the share of offices of the large institutions, which is consistent with the considerable share of banking activity these institutions retain in the United States.

Exhibit 4
Market Share of Offices



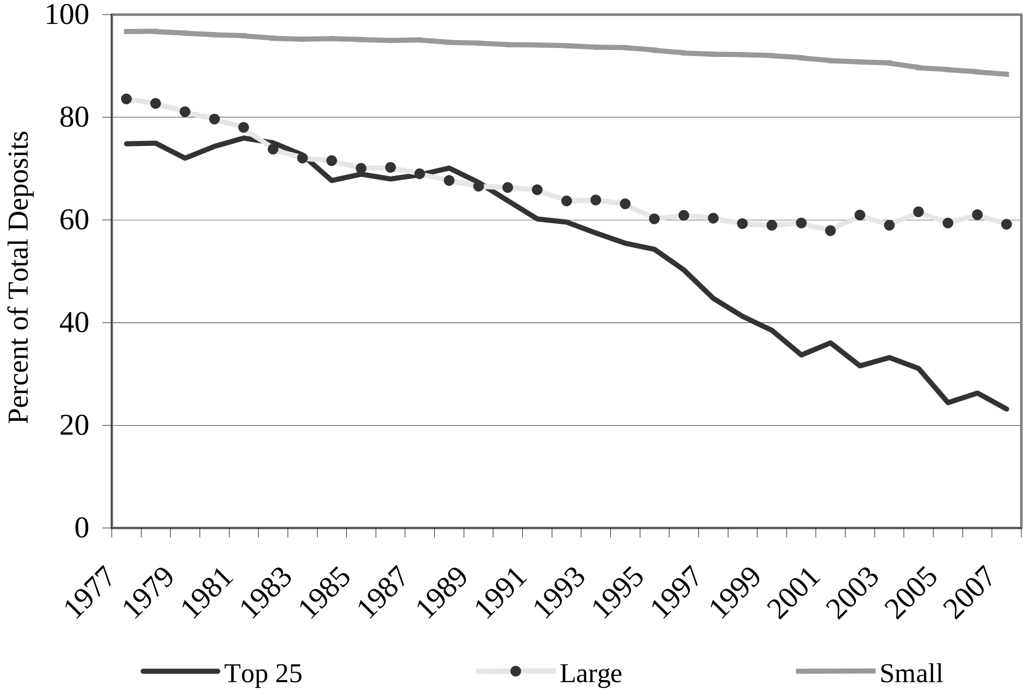
Trends in the concentration of deposits mirror those of offices. As indicated in Exhibit 5, the market share of total deposits held by the top 25 CRA-regulated organizations grew significantly, from under 20 percent in 1977 to over 50 percent by 2007. During the same period the share of deposits held by small institutions fell from over 40 percent to under 20 percent. The largest institutions have been getting larger; the industry is becoming more concentrated.

Exhibit 5
Market Share of Deposits



Over the past 30 years, CRA-regulated institutions have grown in size and become more geographically dispersed. Depositories were largely locally based at the time of the CRA's passage in 1977, consistent with the CRA's focus on allocating lending within a geographic market. However, as noted above, deposits have become increasingly concentrated in larger institutions over the past 30 years. Accompanying this increase was a reduction in the share of deposits that institutions collected in the same metropolitan statistical area (MSA) as their main office. This latter trend is illustrated in Exhibit 6.

Exhibit 6
Concentration of Deposits in same MSA as Main Office



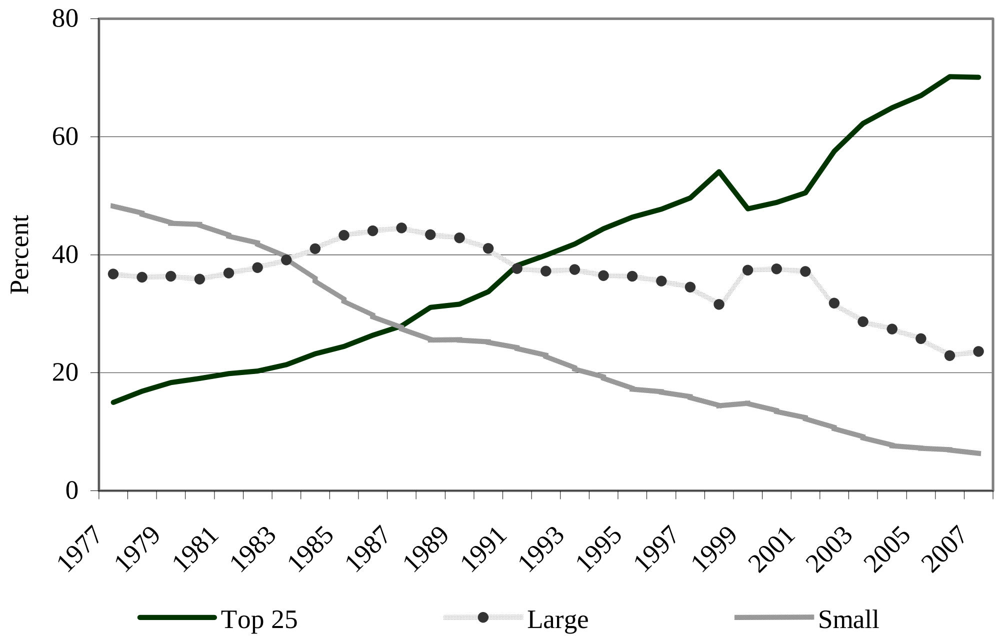
In 1977, all three groups of institutions collected the vast majority of their deposits in the same MSA as their main office. This largely remained true of small institutions through 2007. However, for large institutions the share of deposits collected in the MSA of their main office declined consistently, and for the top 25 declined from over 80 percent in 1977 to under 25 percent in 2007. Some of this decline is an artifact of the decline in the number of institutions relative to offices, yielding fewer main offices. However, most of the decline reflects a real increase in the geographic reach of larger institutions, much of it expanding across state lines. In 1977, for example, there were no nationwide depository institutions. By 2007, most of the top 25 organizations had truly become national, drawing deposits (and lending) in markets across the United States.

Collectively these changes in industry structure have had significant implications for the CRA. The CRA was originally designed for institutions operating in a single urban market and for an environment with a large and diverse set of financial institutions. As just shown, this model no longer applies to much of the marketplace.

B. LENDING ACTIVITIES

Not surprisingly, the concentration in deposit collection over the past 30 years has been associated with a growing concentration in consumer lending. Exhibit 7 shows the share of consumer loan dollars held by depositories of different size classes from 1977 through 2007.[13] Again, we see rapid growth in the dominance of the top 25 organizations, from holding 15 percent of consumer loan dollars in 1977 to 70 percent in 2007. This period also saw a concomitant decline in the share of consumer loan dollars held by small institutions, from nearly 50 percent to under 10 percent.

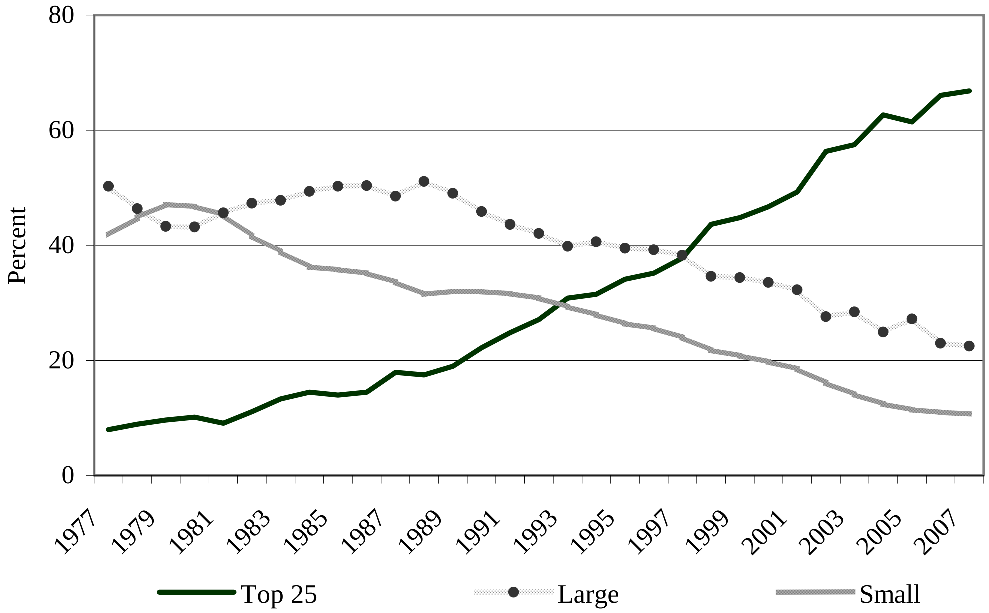
Exhibit 7
Market Share of Consumer Loan Dollars



Similar trends are apparent in the shares of single-family (1- to 4-unit) residential mortgage lending held by institutions of different size classes (Exhibit 8). Again, we see dramatic growth in the share of mortgage dollars held by the top 25, accompanied by declines in the shares held by both large and small institutions.

[13] The information in Exhibits 7 and 8 is calculated from end-of-year Call Report (commercial banks and some savings banks) and Thrift Financial Reports (S&Ls and other savings banks) data. Some data for the late 1970's and early 1980's had to be imputed by the authors because of changes in the information collected in the reports.

Exhibit 8
Market Share of 1-4 Family Home Mortgage Dollars

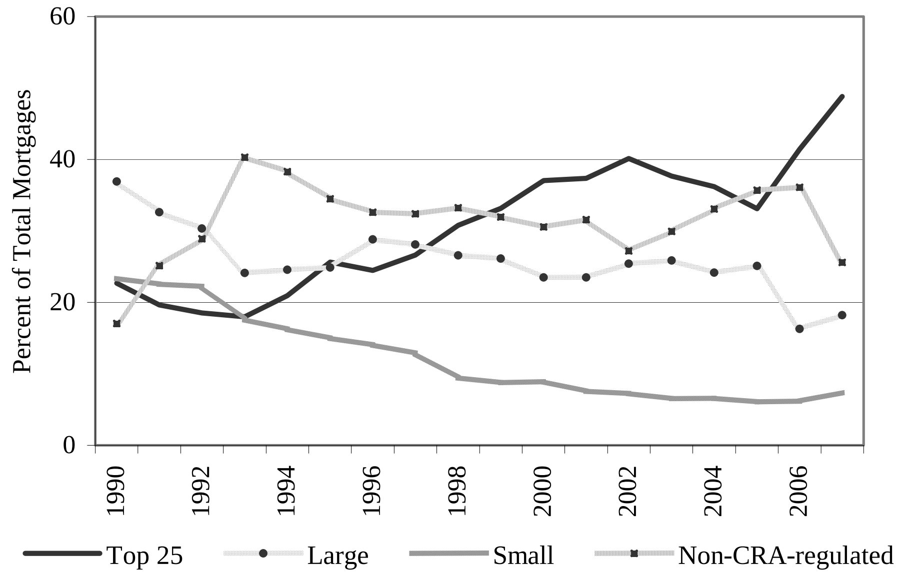


Not only has mortgage lending among depositories become more concentrated over the past 30 years, the share of mortgages originated by institutions not covered by the CRA has increased. We track this trend using HMDA data, which allow us to consider changes using a flow concept (originations), arguably more consistent with the focus of the CRA than the stock concepts thus far discussed. Unfortunately, the use of HMDA restricts us to data beginning in 1990, before which HMDA reporting applied only to CRA-regulated institutions.

Exhibit 9 shows the share of total mortgage originations for the top 25 organizations, large institutions, small institutions, and institutions not covered by the CRA.[14] The latter group includes independent mortgage companies and credit unions. The increasing share of mortgage originations by the top 25 organizations is quite evident, as is the declining share of originations by small institutions. Among CRA-regulated institutions, therefore, mortgages are now more likely to have been originated by depositories with a large (often national) footprint.

[14] Data are calculated based on single-family, first-lien mortgage loan originations reported annually under HMDA. Data here, and in other exhibits using HMDA data, are based on the number of loans rather than loan dollars and exclude loans in U.S. territories and those for which geographic data are missing. Lien status has only been reported since 2004. Prior to 2004, we assume a loan threshold size of $50,000 in 2007 real dollars to distinguish between first- and junior-lien loans. HMDA data include originations only by depositories with offices in an MSA and distinguish between loans extended directly and those extended by a subsidiary or affiliate of the depository. Depositories with assets below $30 million are not required to report. Exhibit 9 includes loans extended by subsidiaries and affiliates when computing institution or organization loans.

Exhibit 9
Mortgages Originated by Institution Type



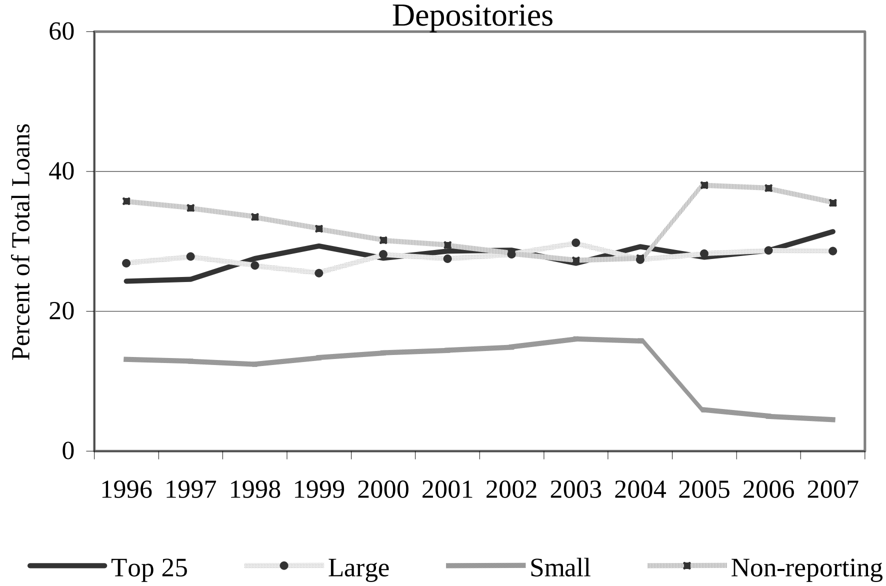
On the surface it looks like there was a dramatic increase in the share of originations by non-CRA-regulated institutions in the early 1990s, from 17 percent in 1990 to 40 percent in 1993. However, most of this increase is likely due to changes in the HMDA reporting requirements for non-depositories, which were greatly expanded in 1993. Interestingly, since 1993 the share of mortgage originations by non-CRA-regulated institutions has trended somewhat downward, although it has generally remained over 30 percent.

The relatively constant share of non-CRA-regulated institution share since 1993 suggests that the rise in the importance of securitization (as shown in Exhibit 3) and the increasing role of subprime lending cannot be solely attributed to a rising share of independent mortgage companies but must reflect more complex changes in behavior and/or industry structure.

The CRA does not focus solely on mortgage lending. Regulatory changes to the CRA in 1995 placed increased emphasis on performance measures related to small business and small farm lending, defined as loans of $1 million or less for small business and $500,000 or less for small farm.[15] Data on this type of lending from 1996 through 2007 are shown in Exhibit 10.

[15] Starting in 1996, larger institutions were required to report annually on their small business and small farm loan originations by census tract. Larger institutions were defined as those: (1) with over $250 million in assets, or (2) over $100 million in assets and who were part of an organization with over $1 billion in assets. These regulations were amended in 2005 to require reporting only from institutions

Exhibit 10
Dollars of Small Business and Small Farm Loans held by Depositories



Market trends in small business and small farm lending look markedly different from those in consumer and mortgage lending. The top 25 market share of consumer loan dollars outstanding rose by over one-half from 1996 to 2007, and almost doubled for home mortgage loan dollars outstanding over the same period (earlier shown in Exhibits 7 and 8). In contrast, the market share of the dollars outstanding of small business and small farm loans for the top 25 rose only from 24 to 32 percent. Moreover, the absolute share of the small business and small farm market of the top 25 was only about one-half their share of the consumer and mortgage loan market in 2007. Clearly, while the percent of total lending accounted for by small business and small farm lending is decreasing among the top 25 institutions; it is on the rise among small institutions.

with $1 billion or more in assets (although smaller institutions can, and do, report voluntarily). Unfortunately, smaller depositories are not required to report small business and small farm origination data, so it is impossible to discern market trends from the flow data. However, since 1993 institutions of all sizes have been required to report balance sheet data on small business and small farm loan dollars outstanding using the same loan definitions as the origination data.

VI. CHANGES IN CRA PERFORMANCE MEASURES

CRA performance can be assessed across many dimensions. All CRA-regulated institutions are judged on their lending activity, including home mortgage, small business, and small farm loans. Larger institutions also receive ratings for service and investment activities. The service test evaluates institutions' retail banking delivery systems and institution's community development services, innovativeness and responsiveness. The investment test considers qualified investments whose primary purpose is assessment area community development. All these tests are combined into an overall CRA rating.

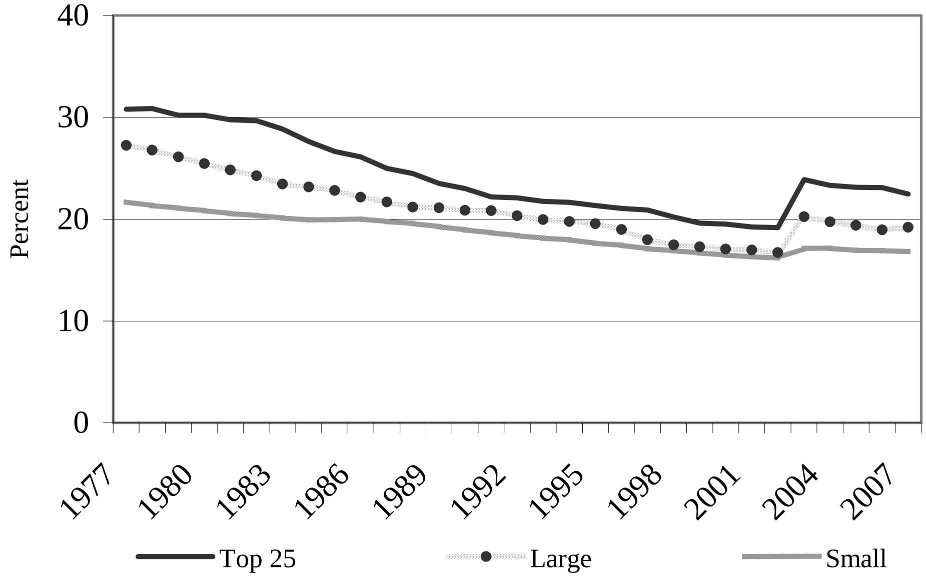
Tracking trends in CRA performance tests can provide useful insights into how well the law is working, a topic we pursue in this section. We focus on four quantitative metrics of performance. First we consider a metric related to the service test. Next, we turn to two metrics related to the lending test—lending in LMI areas and lending in and out of the institution's assessment area. Finally we look at institutions' overall CRA ratings.

A. THE SERVICE METRIC

One of the questions asked under CRA is how well institutions are serving their communities, and one common metric is the percentage of offices a given institution has in LMI tracts. The trends in this percentage between 1997 and 2007 are shown in Exhibit 11.[16]

[16] These data are drawn from the Summary of Deposits and Thrift Financial Reports information used for Exhibits 4-6. Each office was geocoded and placed in both a 1990 and 2000 census tract. We excluded all offices in census tracts with fewer than 1,000 people in urban areas and 500 people in rural areas. These offices are disproportionately in central business districts with deposit figures reflecting business rather than personal accounts. The 2000 tract designation was used to classify offices into an LMI income class for reporting years 2003 through 2007. The 1990 tract designation was used to classify offices for all previous years. In practice, 1980 tract classifications were used under the CRA for reporting years 1982 to 1991, and 1970 tracts were used for 1977 to 1981. A number of rural areas were not assigned tracts in the 1980 or 1970 census; consequently we chose to use the 1990 tract designation for this period.

Exhibit 11
Share of Offices in LMI Census Tracts



Trends in the LMI share of offices do not seem to vary significantly with asset size of institution. However, the percent of CRA-regulated institutions' offices in LMI tracts clearly declined modestly throughout the 30-year period. There is a striking increase in this share in 2003, but this likely primarily reflects the change in definition of the LMI tracts in that year, although there may also have been a contribution from the increased activity by depositories in lower-income areas as credit standards were relaxed.

Interpreting the decline in the share of deposits or banking offices in LMI tracts as a reflection of the CRA may be problematic. On the one hand, there were roughly equal proportions of banking offices and population in LMI tracts in 1977, but by 2007 the office share was lower than the population share (20 percent versus 26 percent). On the other hand, the absolute number of banking offices in LMI tracts increased by 25 percent over the 30 years since CRA's passage.

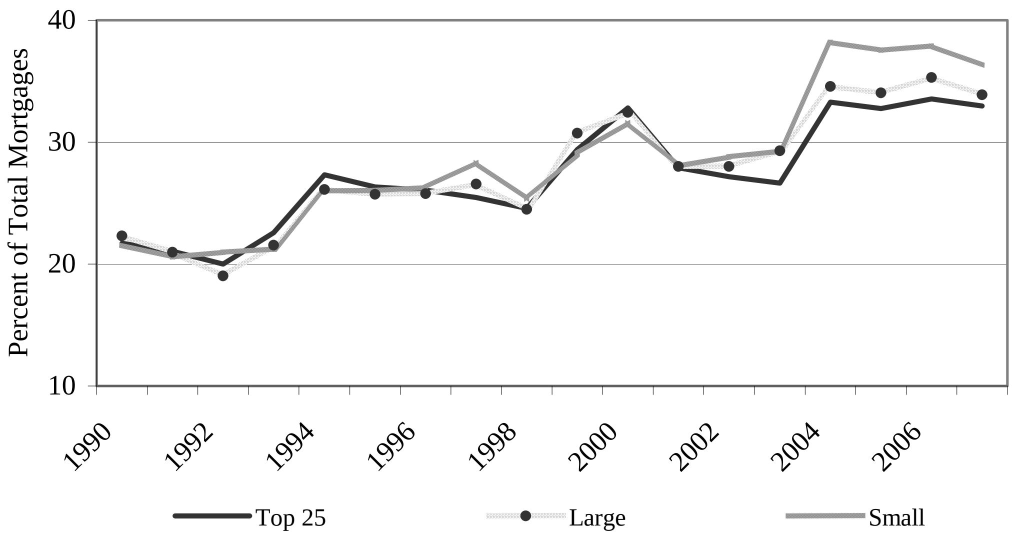
Thus, the decreased share of LMI offices reflects office growth in middle- and high-income tracts rather than office closures in LMI areas. Moreover, the growth of offices in these non-LMI tracts may have actually increased the ability of institutions to serve LMI communities. In particular, the relaxation of state branching laws allowed institutions to increase their geographic reach. Thus institutions with main offices in commercial districts (which were nominally LMI but sparsely populated) may then have expanded into the residential communities where their LMI and other customers lived.

B. THE MORTGAGE LENDING METRIC

The CRA was meant to encourage institutions to meet the lending needs of their assessment areas, particularly LMI neighborhoods and borrowers. Lending tests measure these neighborhoods and borrowers separately, but for ease of exposition we refer to these two lending activities together as LMI lending.

Exhibit 12 uses HMDA data to calculate the LMI shares of mortgage originations over time.[17] As was the case with offices, these data show a fairly consistent trend across types of institution. Unlike offices, however, there is a general upward trend in the percent of LMI lending by CRA-regulated institutions from 1990 through 2006, though the trend seems to level out after 2004.[18]

Exhibit 12
Share of LMI Mortgage Lending



As a consequence, during this period LMI borrowers and tracts were receiving a greater share of the mortgage activity of CRA-regulated institutions, while contributing a reduced share to these institutions' deposit base. Moreover, these trends began when LMI customers were arguably underserved. For example, the 1990 census shows that 16 percent of all owner-occupied single-family homes were in LMI tracts, versus a 10 percent overall average LMI-tract share for CRA-regulated lenders in 1994. By 2007, the

[17] CRA evaluation includes mortgage purchases as well as mortgage originations. We focus on originations here but provide data on purchases as well in the linked website data file. Data definitions are the same as those used in Exhibit 9.

[18] There is some "lumpiness" in the data due to the fact that LMI income classes for census tracts are changed only every 10 years and are sensitive to MSA boundaries. This accounts for much of the increase in LMI lending from 2003 to 2004, when MSAs based on the 2000 census were introduced (a similar pattern is evident in 1994, when MSAs based on the 1990 census were first used). Exhibit 12 shows data for both LMI borrowers and census tracts. If the data are limited to LMI census tracts, CRA-regulated institutions originated about 10 percent of their loans in LMI tracts in 1994 versus 17 percent in 2007, supporting an increase in LMI lending.

average CRA-regulated lender share of loans in LMI tracts had risen to 17 percent, a figure equal to the 2000 census percent of owner-occupied single-family homes in LMI tracts. By this metric, therefore, there has been an improvement in CRA performance over the past 15 years.

However, while there appears to be strong evidence that LMI mortgage customers have enjoyed an improvement in service from CRA-regulated lenders, it is not clear how much of this, if any, can be attributed to the CRA. While CRA-regulated lenders increased the share of mortgages that were LMI from 26 percent in 1994 to 34 percent in 2007, institutions unregulated by the CRA increased their share of lending to such customers by a similar amount, from 29 percent to 35 percent. Moreover, within CRA-regulated organizations, the growth in LMI share was somewhat greater in subsidiary/affiliate lending (which is subject to CRA evaluation on only a voluntary basis) than in lending directly done by CRA-regulated depositories (26 percent versus 33 percent).

The similarity of changes in the share of lending to LMI customers by lenders facing different regulatory environments suggests either that the growth of LMI lending stems from market rather than regulatory forces, or that other regulatory forces beyond the CRA may have played a role. One such regulatory change that might have contributed to the growth of LMI lending by non-CRA regulated lenders over this period was the enactment of affordable housing goals for Fannie Mae and Freddie Mac by Congress in the mid-1990s.

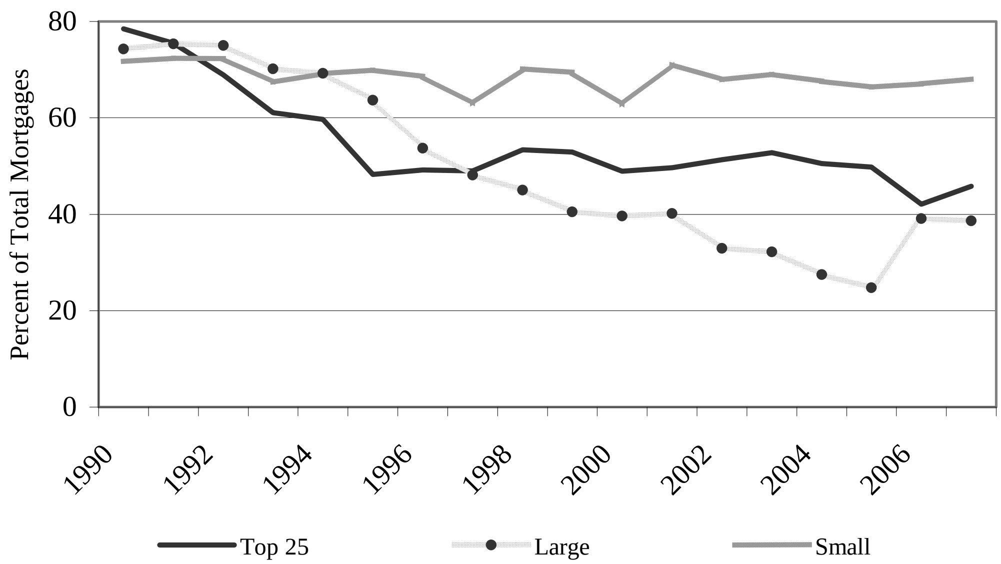
Similar to the quantitative lending activity requirements under the CRA, albeit taking a somewhat more expansive view of qualified lending, Fannie Mae and Freddie Mac are subject to annual percentage of business requirements on their purchases of mortgages that serve LMI borrowers, borrowers in underserved areas, and special affordable populations.[19] Mortgages that satisfy CRA requirements qualify under the affordable housing goals and may be counted toward these requirements if purchased by Fannie Mae or Freddie Mac. However, not all mortgages counting toward the affordable housing goals satisfy CRA requirements, nor are they originated or purchased by CRA-regulated institutions. So, although the CRA and the affordable housing goals of Fannie Mae and Freddie Mac both encourage LMI lending, some of this activity may occur outside CRA reporting channels.[20]

[19] Underserved portions of metropolitan areas are currently defined for Fannie Mae and Freddie Mac goals as census tracts with median incomes less than or equal to 90 percent of area median income, or tracts with minority population greater than or equal to 30 percent and median incomes less than or equal to 120 percent of area median income. Slightly more flexible guidelines apply for underserved rural areas. Special affordable populations are currently defined as borrowers with incomes less than or equal to 60 percent of area median income, or borrowers with incomes less than or equal to 80 percent of area median income that are located in a census tract that has a median income that is less than or equal to 80 percent of area median income.

[20] The growth patterns of LMI lending raise some interesting questions that we pose, but do not answer here. Looking at the market as a whole (all HMDA lenders), all of the increase in the share of LMI lending from 1994 to 2007 resulted from an increase in lending to borrowers in LMI tracts (10 percent in 1994 to 17 percent in 2007). There was no increase at all (indeed a modest decrease) in the share of lending to LMI borrowers who were not in LMI tracts. Further, the difference in the growth in the share of lending to LMI tracts and LMI borrowers outside such tracts would have been even larger if measured

We next turn to the share of mortgage loans that institutions make within their own assessment areas. CRA requirements pertain primarily to activities within institutions' assessment areas, so out-of-assessment-area activity is, arguably, less regulated and scrutinized. As a result, an increase in institutions' share of activity outside their assessment areas is of potential concern. Exhibit 13 illustrates this aspect of CRA performance.

Exhibit 13
Share of Mortgages in Assessment Area



We find that small institutions have continued to originate a fairly large share of mortgages within their assessment areas (around 70 percent). Not surprisingly, however, the growth in the size of the top 25 organizations is associated with a decline in the percent of mortgages they originate within their assessment areas. In particular, the top 25 fell from almost an 80 percent share in 1990, to originating only 46 percent of their mortgages within their assessment area after 1994. The share of lending in assessment areas also declined for large institutions from slightly over 70 percent in 1990 to less than 30 percent in 2005. In 2006 and 2007, however, there has been a recovery to nearly 40 percent in lending in assessment areas among large institutions.

The concentration of activity among larger CRA-regulated institutions (as shown in Exhibit 9) is of potential concern, because it is accompanied by a reduced share of mortgage activity in assessment areas (as shown in Exhibit 13). To explore this concern, we turn in Exhibit 14 to a comparison of LMI mortgage lending by institutions within

only to 2006, thus excluding the collapse of the subprime market. On the surface, this evidence suggests that LMI tracts were previously underserved and have now caught up. Yet there was very little change in the percentage of owner-occupied units that were in LMI tracts from 1990 to 2000. It may be that the 2000 census data on owner-occupancy do not reflect the potentially strong growth of housing in LMI areas post-2000. If so, it is possible that these areas may remain underserved.

and outside their assessment areas.[21] Ideally, from a CRA perspective, the share of an institution's LMI lending in its assessment area should be greater than or equal to the share of its LMI lending outside that area. There is, therefore, potential reason for concern if the opposite is the case.

Exhibit 14
Ratio of Shares of LMI Lending that are in/out of Assessment Area

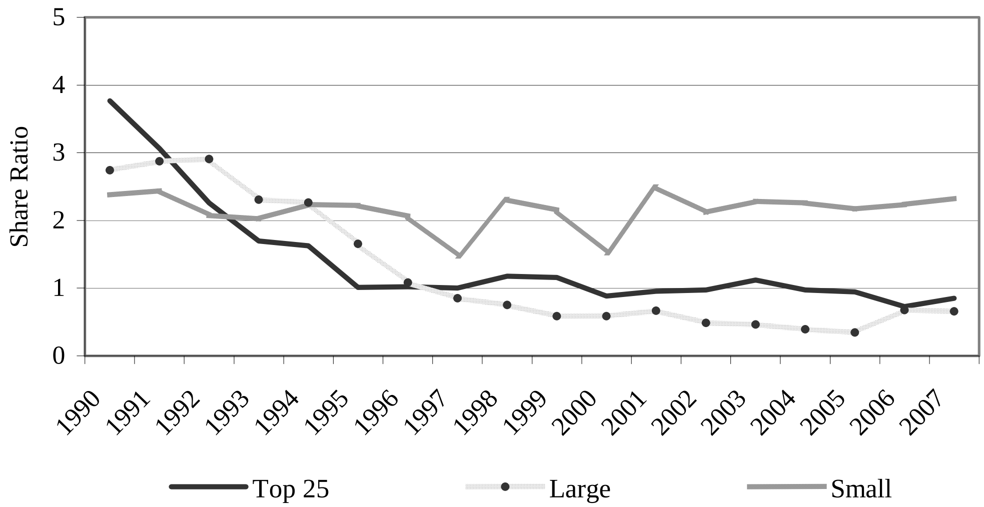


Exhibit 14 shows that small institutions generally perform well by this metric, consistently providing LMI mortgage lending within their assessment areas at rates twice those outside their assessment areas. In contrast, top 25 and large institutions show a decline in this metric throughout the mid-1990s. Since then, the top 25 have leveled off; their LMI lending rates are about equal within and outside their assessment areas. In even starker contrast to small institutions, large institutions now originate fewer LMI mortgages inside their assessment areas than they do outside.

Overall, therefore, trends among different-sized institutions almost cancel each other out. In particular, the increase in the share of lending going to LMI customers from all CRA-regulated institutions within their assessment areas (27 percent in 1994 to 34 percent in 2007) is virtually the same as the change in the share of such lending outside their assessment areas (26 percent in 1994 to 33 percent).

Potentially troubling, nonetheless, is the dramatic decline in mortgage lending within assessment areas by the top 25 and large institutions. This, coupled with increased concentration, arguably is reducing the coverage of the CRA. Moreover, because much

[21] We counted direct lending by depositories as being in the assessment area if the loan is originated in a county in which the depository has an office. Loans originated by affiliates or subsidiaries of depositories are counted as being in an assessment area if they are originated in a county in which any depository member of the same organization (e.g. bank holding company) has an office. In practice, an institution has discretion in how they treat loans originated by non-depository subsidiaries or affiliates under the CRA, and may choose whether to count such loans.

lending outside the assessment area is associated with affiliates of the larger institutions, it may not be subject to scrutiny under the CRA.

C. HIGHER-RATE MORTGAGE LENDING

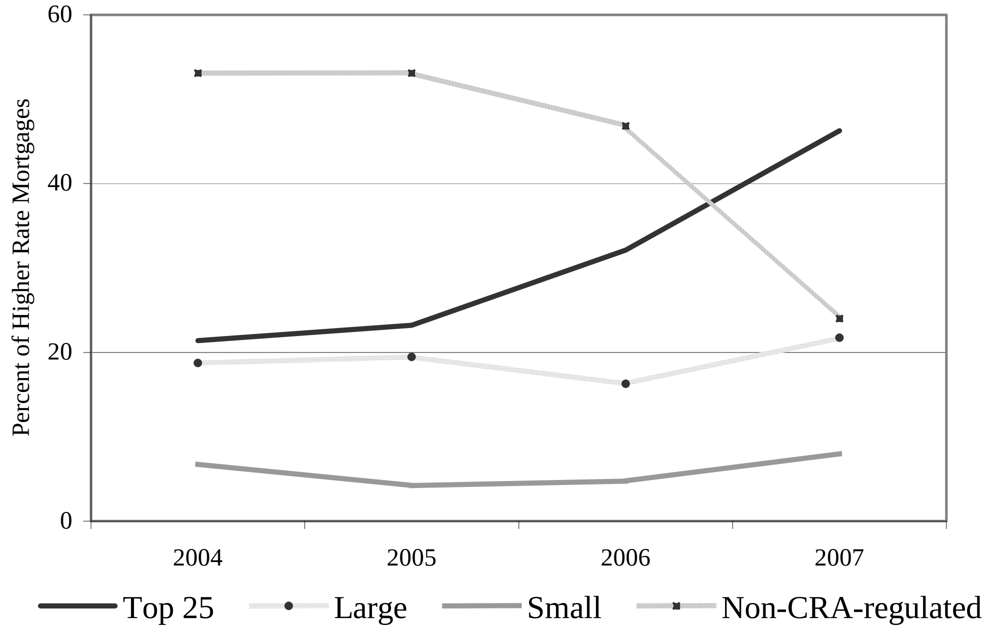
Since 2000 there has been a dramatic increase in mortgage originations by subprime lenders, many of whom are independent mortgage companies, which are not depository institutions and thus not subject to the CRA. Disproportionately these lenders originate loans at rates substantially higher than those offered by prime lenders.

Considerable regulatory scrutiny has been directed towards these higher-rate loans, generally defined as those originated above the HMDA rate-spread reporting threshold.[22] It has been a particular focus within the context of CRA, because higher-rate mortgages appear to be originated disproportionately frequently in LMI census tracts. The intent behind the CRA was to promote LMI lending within assessment areas. However, the goal was never to encourage LMI lending at rates higher than those available to borrowers with higher incomes, or those in higher-income communities.

Exhibit 15 illustrates the distribution of higher-rate mortgage originations across CRA-regulated and non-CRA-regulated institutions. The data needed to assess higher-rate mortgage lending were reported in HMDA only starting in 2004, so the time series is necessarily short.

[22] HMDA requires the reporting of first-lien loans for which the annual percentage rate is 300 basis points higher than a comparable Treasury rate. See Robert B. Avery, Kenneth B. Breevort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin*, (vol. 93, December 2007), pp. A73-A109 for a discussion of HMDA higher-rate loans.

Exhibit 15
Higher Rate Mortgages



The exhibit shows that until 2006 the greatest percentage of higher-rate mortgages came from institutions not subject to the CRA. During this same period, not surprisingly, small institutions originated the smallest percentage of higher-rate loans, with the top 25 and large institutions originating more than small institutions, but many fewer than non-CRA institutions.[23]

In 2007, however, the subprime market collapsed, and 169 lenders (almost all non-CRA-regulated) went out of business and stopped reporting in HMDA.[24] This led to a dramatic decline not only in higher-rate mortgage lending (not shown), but also in the share of higher-rate mortgages originated by institutions not covered under the CRA.

From a CRA perspective, the 2007 changes are arguably welcome news. In particular, CRA-regulated institutions have become more likely to originate higher-rate loans than institutions outside the CRA regulatory structure. Because of this, CRA-regulated

[23] Arguments have been made in the media that some inappropriate high-rate lending may have stemmed from CRA-related pressure to lend to LMI customers. However, in 2006, at the height of the subprime boom, 43 percent of the loans by non-CRA regulated lenders to LMI customers were high-rate, as compared to 39 percent of CRA-regulated lenders lending outside their assessment areas and only 18 percent for CRA-regulated lenders lending within their assessment areas. On the other hand, the overall incidence of LMI lending across these three groups was about the same. This suggests that differences in the overall incidence of high-rate lending did not stem from a differential focus on LMI customers by CRA-regulated institutions, but rather from the choice of product offered to such customers.

[24] See Robert B. Avery, Kenneth B. Brevoort, and Glenn B. Canner, "The 2007 HMDA Data," *Federal Reserve Bulletin,* (vol. 94, December 2008), pp. A107-A146.

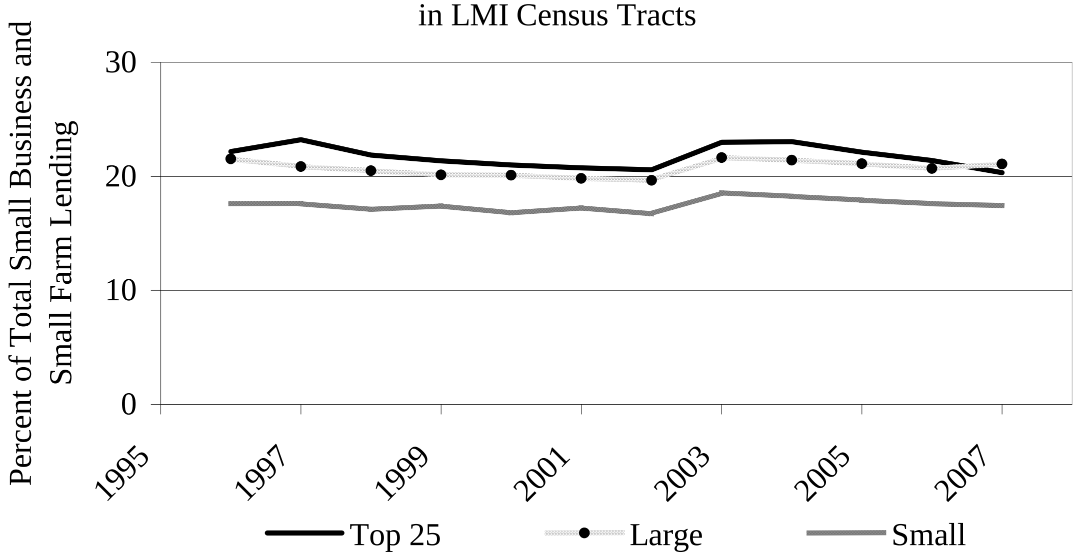
institutions (and regulators) may have a better opportunity to strike the appropriate balance in serving borrowers in this market niche.

D. SMALL BUSINESS AND SMALL FARM LENDING

Larger institutions are subject to lending performance tests related to their small business and small farm lending. Examiners typically employ tests similar to those used for mortgage lending, comparing LMI to total lending and lending within and outside of assessment areas. However, because there is no direct analog to a LMI mortgage borrower for a business, only the business's location is typically used to determine its LMI status.

Exhibits 16, 17, and 18 present data on small business and small farm loan originations for the period 1996 to 2007, using the same metrics as used in Exhibits 12, 13, and 14. Exhibit 16 shows overall trends in LMI lending; Exhibit 17 presents evidence on lending in and out of assessment areas; and Exhibit 18 gives the relative propensity for LMI lending for assessment area versus non-assessment area loans.[25]

Exhibit 16
Share of LMI Small Business and Small Farm Lending
in LMI Census Tracts



[25] Unlike mortgage loans, Exhibits 16-18 are based on loan dollars rather than the number of loans. Many very small business loans reported in the CRA data are actually credit card loans issued to business owners. In order to give these loans limited emphasis, the figures are dollar- rather than loan-weighted.

Exhibit 17
Share of Small Business and Small Farm Lending in Assessment Area

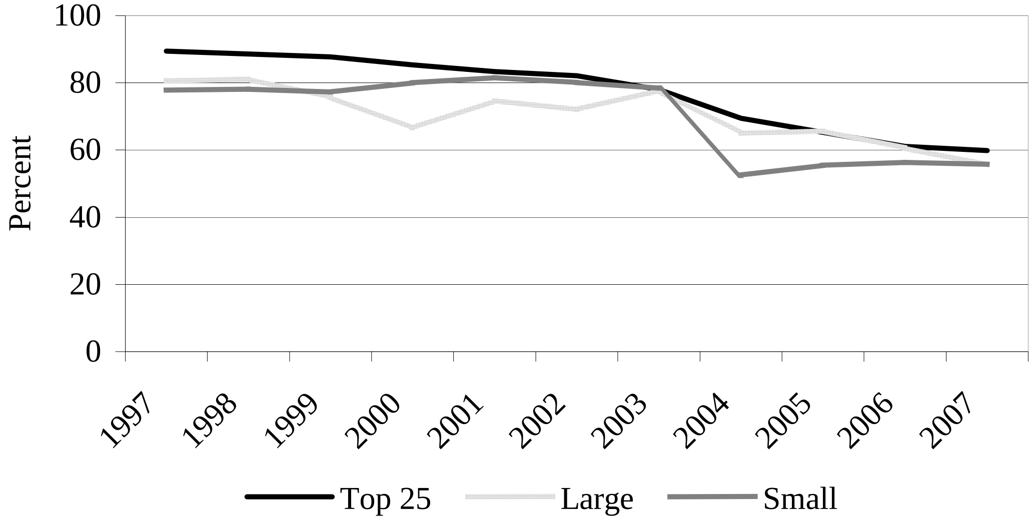
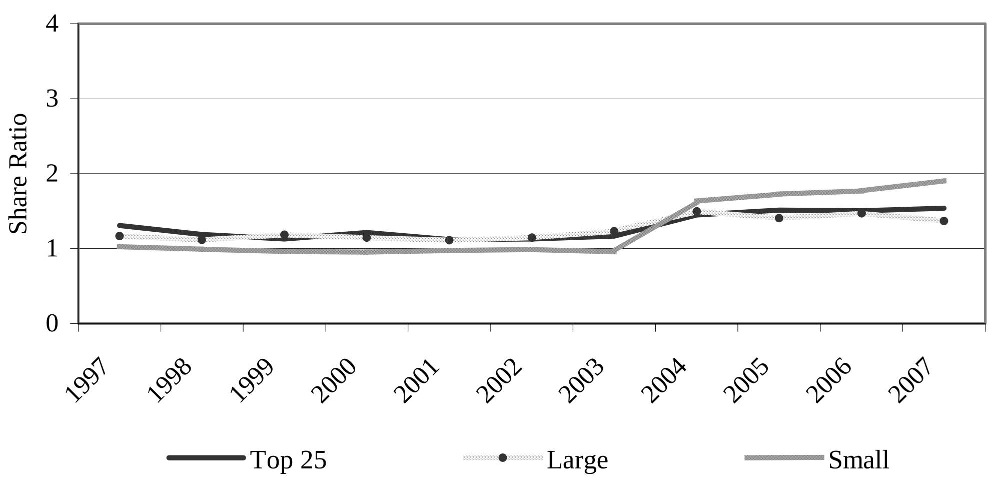


Exhibit 18
Ratio of Shares of Small Business and Small Farm Lending in LMI Census Tracts that are in/out of Assessment Area



The data for small business and small farm loans show a somewhat different pattern than those for mortgage loans. Exhibit 16 shows a largely constant level of LMI lending over the ten-year period, although there is a slight decline among top 25 institutions. In-assessment area lending shows a clear decline for institutions of all sizes, especially starting in 2004 (Exhibit 17). CRA-regulated institutions show an equal propensity toward LMI lending both inside and outside assessment areas through 2003. Starting in

2004, however, institutions originate a higher share of LMI loans in their assessment areas.

Overall, these trends are small in comparison to those for mortgages, and there are not significant differences by size of institution. Of potential concern is the reduction in in-assessment area lending by CRA-regulated institutions. Mitigating this, however, is the fact that in-assessment-area lending shares are higher than those for mortgage lending. Moreover, the within-assessment area LMI lending rate shows a relative increase precisely when in-assessment shares decline, explaining why overall LMI lending shows almost no change. On the basis of these trends, therefore, there is arguably little reason for concern regarding the small business and small farm lending performance of CRA-regulated institutions.

E. OVERALL CRA RATINGS

Finally, we turn to an analysis of overall CRA ratings. Under the revised regulations that became effective July 1, 1995 (as under the earlier regulations), CRA-regulated institutions are to be assigned one of four statutory ratings: outstanding, satisfactory, needs to improve, or substantial noncompliance. Every institution's rating is posted and includes a written evaluation explaining the rating.[26] The public release of CRA performance results continues to be an important aspect of the regulations. The CRA rating is especially important, because regulatory agencies consider an institution's record when evaluating its application for deposit insurance, or for a charter, branch or other deposit facility, office relocation, merger, or acquisition. For our analysis, therefore, we focus on the outstanding and less-than-satisfactory (needs to improve or substantial noncompliance) ratings—because they imply the least and most difficulties for institutions, respectively.

Each CRA-regulated institution is assigned a primary federal banking agency regulator to conduct its exam. The Office of the Comptroller of the Currency (OCC) is primary regulator of commercial banks with national bank charters, including most of the top 25. The Federal Reserve Board (FRB) is the primary regulator of state-chartered commercial banks that are members of the Federal Reserve System. The Office of Thrift Supervision (OTS) has primary regulatory authority over most savings associations, and the Federal Deposit Insurance Corporation (FDIC) has primary authority over state-chartered, non-FRB-member commercial banks and some federally chartered savings banks.

Exhibit 19 provides information, by regulatory agency, on institutions receiving outstanding ratings 1990-2007. Since 2000, considerably more OTS-regulated than FDIC-regulated institutions have received outstanding ratings.

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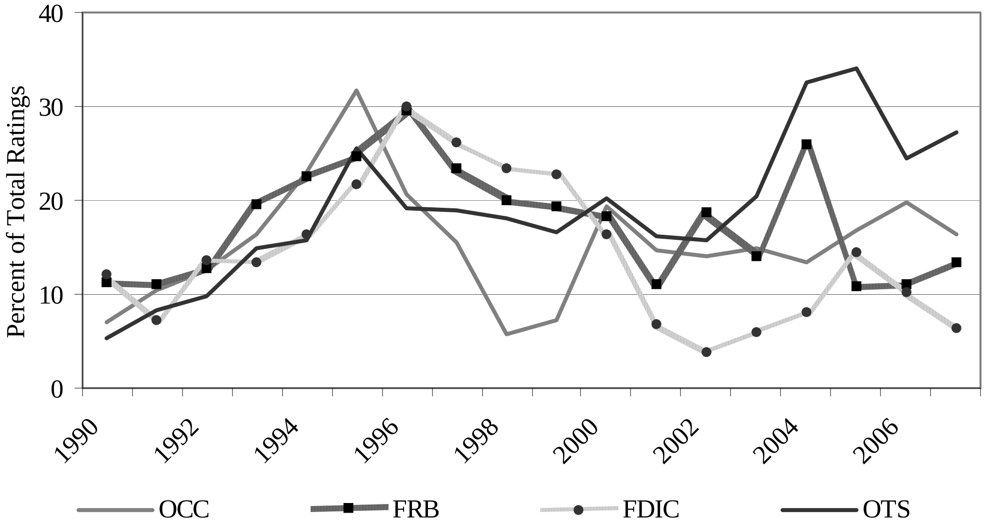
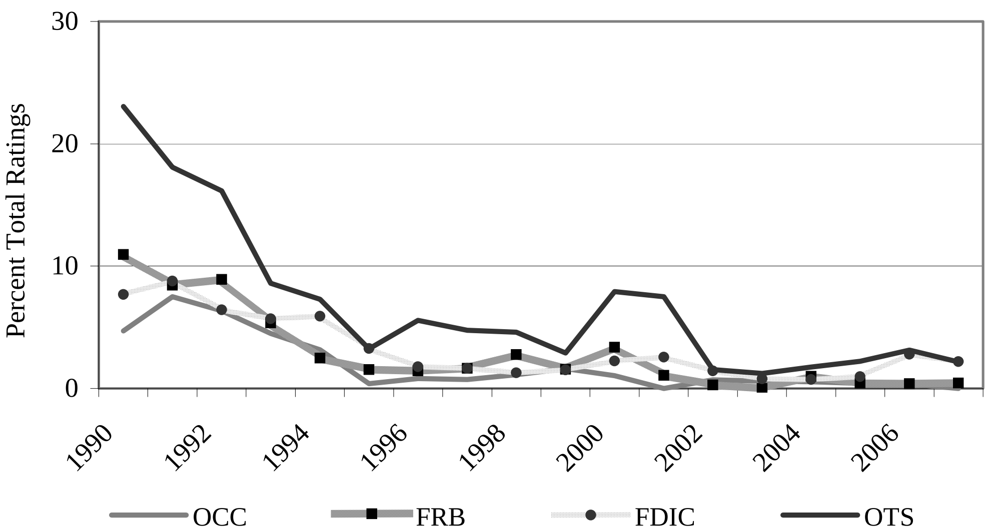
[26] Available at http://www.ffiec.gov/cra/ratings.htm for ratings information (last accessed November 22, 2008).

Exhibit 19
Percent of Outstanding Ratings by Agency



Regulatory agencies also differ in the percent of less-than-satisfactory CRA ratings they give. Exhibit 20 indicates that only a small share of institutions since 1995 continues to receive unsatisfactory ratings, but that the share of those with poor ratings is marginally highest for OTS-regulated institutions.

Exhibit 20
Percent of Unsatisfactory Ratings by Agency



It is not only the regulatory supervision process that varies with CRA ratings; the size of the institution also seems to matter. Exhibits 21 and 22 present information parallel to that in Exhibits 19 and 20, but separated by size of institution rather than regulatory agency. The top 25 clearly perform best as measured by their share of outstanding ratings, and their differential above both large and small institutions increased substantially starting in 2003. This may reflect the importance that the largest institutions place on good performance ratings in an effort to reduce CRA impediments to mergers or acquisitions.

Exhibit 21
Percent of Outstanding Ratings by Insitution Size

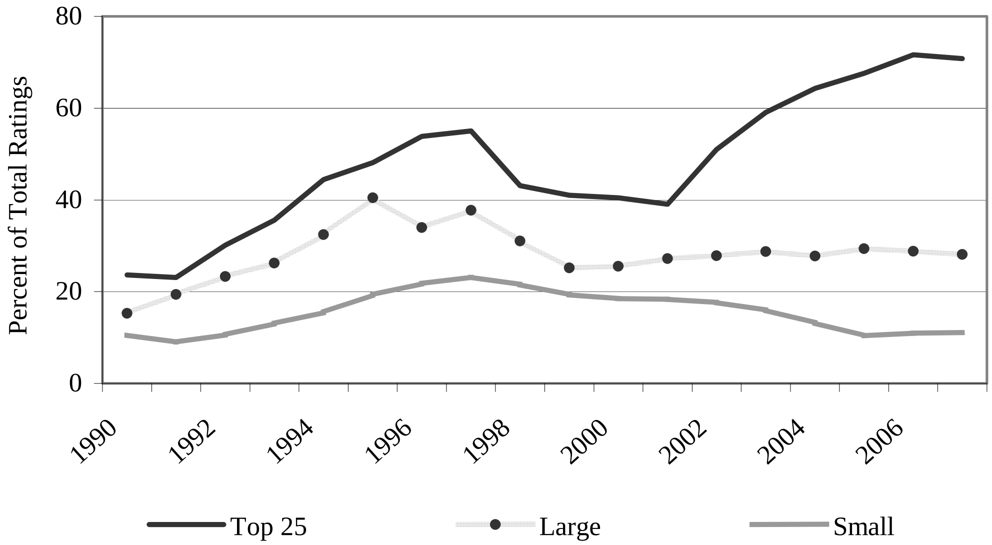


Exhibit 22
Percent of Unsatisfactory Ratings by Institution Size

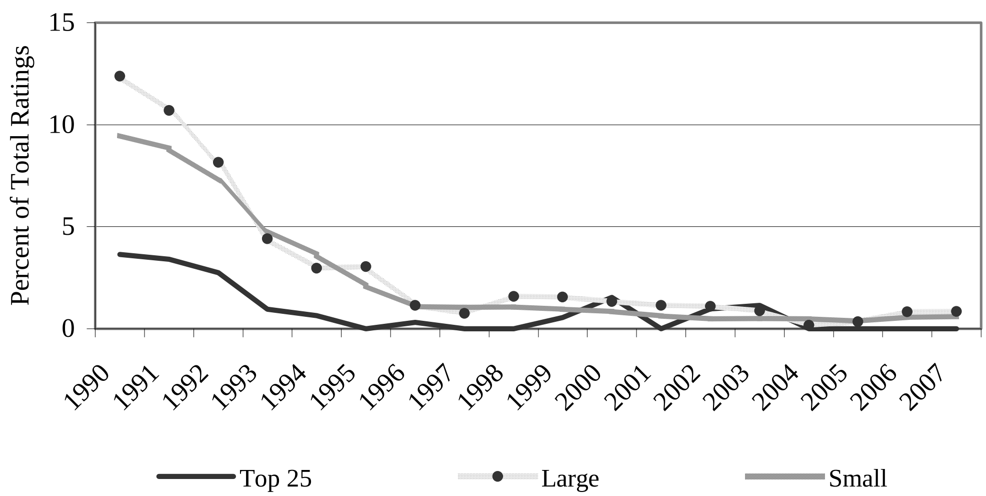


Exhibit 22 shows that the top 25 institutions have historically been less likely than smaller entities to receive unsatisfactory ratings. Since 1996, however, there has been little difference in the unsatisfactory rate across institution size, with levels generally under one percent. This may reflect "satisficing" behavior on the part of depositories, ensuring that they at least do not receive unsatisfactory rating given the increased public scrutiny of CRA performance.

VII. CONCLUDING COMMENTS

Since the passage of CRA in 1977, the financial market has evolved in several ways that have potentially critical implications for the CRA. First, the share of overall financial activity covered under the CRA has declined substantially, for two key reasons including: (1) the growth of financial institutions not covered by the CRA, and (2) the reduction in in-assessment area activity by the larger CRA-regulated institutions. Second, the footprint of financial institutions has increased dramatically. No longer is financial activity largely locally based. Instead, institutions that operate across several states, if not nationally, conduct most financial activity. Third, there has been an increase in LMI lending, although much of this occurs outside of assessment areas, and the role of CRA in this trend is debatable.

We leave it to others to fully assess the implications of these changes for the CRA. However, at this writing, at the close of calendar year 2008, we are arguably in the midst of the most dramatic financial changes of the past several decades. We therefore conclude with some observations regarding how these changes may affect CRA-regulated institutions.

First, due to several recent changes, we expect to see CRA-regulated institutions regain market share. Independent, non-chartered investment banks no longer exist—they have either merged with depositories or become bank-chartered institutions. The collapse of the subprime mortgage sector means that institutions not covered under the CRA have lost significant market share. Finally, with the current credit and liquidity crisis, borrower confidence has fallen to historic lows, and consumers understandably prefer to keep deposits in federally-insured institutions. These trends are all likely to give the CRA increased leverage and importance.

Second, we expect increased concentration among CRA-regulated institutions. The current financial crisis has already led to a number of mergers and acquisitions, and we expect this trend to continue. However, the impact of this trend on the overall performance of CRA-regulated institutions is far from certain. On a positive note, as concentration among CRA-regulated institutions has increased, so too has apparent overall CRA performance (although, as we have noted, such trends are less apparent in small business and small farm lending and may be due to other market forces). Potentially troubling, however, is that if historical trends continue, increased concentration in mortgage lending could reduce the overall share of in-assessment area mortgage lending, possibly muting the impact of the CRA. Further, much lending by larger institutions—even in assessment areas—has been done through affiliates rather than directly by depositories and thus may be subject to a different degree of regulatory scrutiny. How these forces balance each other will determine whether CRA regulations have an increased or decreased impact on the marketplace.

Finally, underwriting standards have tightened significantly in primary, secondary, and mortgage insurance markets, likely significantly reducing the share of higher-rate mortgage originations. This may mean that there is less access to credit for LMI borrowers and in LMI neighborhoods. If such a trend were confirmed, the importance of the CRA may increase as it mandates focus on these otherwise less well-served areas. The role of the CRA might be even further enlarged by changes to the affordable housing goals for Fannie Mae and Freddie Mac included in the Housing Economic Recovery Act of 2008, which more closely align the purchase goals of Fannie Mae and Freddie Mac to those of the CRA.