

Federal Reserve Bank of Cleveland

The Performance and Profitability of CRA-Related Lending

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Concerns about the availability of credit to lower-income borrowers and communities and to small businesses and farms are long-standing. Over the years, many government programs, such as those of the Federal Housing Administration, have been established to address these concerns. Regulation of private-sector activities also is intended to bolster such lending. The most prominent government regulatory effort to improve access to credit, the Community Reinvestment Act of 1977 (CRA), was designed to encourage commercial banks and savings associations to help meet the needs of borrowers in all segments of their communities, consistent with safe and sound operations.

Responding to the CRA, banking institutions have used various methods to expand lending to lower-income customers and those in lower-income neighborhoods, but their approaches fall into two broad types, both typically involving special marketing and outreach. In one approach, lenders have sought additional CRA-related customers who would qualify for market-priced loans using traditional standards of creditworthiness. In the other, lenders have gained customers by modifying their underwriting guidelines or loan pricing. Many banking institutions, especially the larger ones, have established or participate in special programs to foster lending.

Special lending programs vary widely but they often feature more flexible credit-underwriting guidelines than those

used for other products; education and counseling for prospective borrowers; enhanced, targeted marketing of credit products; and coordination with a wide range of third parties, both private and public. In addition, some banking institutions offer pricing incentives for loans made under these programs and have established procedures to mitigate the credit risk associated with such loans.

Although the CRA's effects on lending to lower-income populations and neighborhoods are difficult to assess, such lending has increased substantially over the past decade or so. For example, home-purchase lending to lower-income households has increased 86 percent since 1993 (compared to about 50 percent for higher-income households). Lending to borrowers in lower-income neighborhoods also has risen sharply (nearly 80 percent) since 1993.

However, despite all this experience, little systematic information has been publicly available about performance and profitability, either for CRA-related lending activities as a whole or for the loans extended under CRA special lending programs.

n Congressional Mandate

In November 1999, wanting to learn more, the U.S. Congress asked the Federal Reserve Board to do a comprehensive study on the performance (that is, the delinquency and default rates) and profitability of loans made in conformity with the CRA. Before

In November 1999, the U.S. Congress asked the Board of Governors of the Federal Reserve System to conduct a comprehensive study of loans made under the Community Reinvestment Act of 1977. The Board's study focused on the loans' delinquency and default rates—their performance—as well as their profitability. This *Commentary* reports the results of the study.

responding to their request, the Board needed to address three basic questions: What is a CRA loan? How does one measure the effect of a law or regulation on the profitability and performance of lending? Is previous research adequate to fulfill Congress' request?

In considering the first question—how to define a CRA loan—the Reserve Board staff looked to the CRA statute and regulations for guidance. Banking institutions alone are subject to the law, so we focused on them exclusively and did not consider credit unions or mortgage companies. Next, we determined that a CRA-related loan was one extended to a lower-income household anywhere in a banking institution's local community or to a borrower of any income in a lower-income neighborhood within that community. We used a similar definition for small business lending. Note that these definitions exclude about

half of all lower-income lending done by banking organizations.

The second question proved considerably more difficult. In principle, to assess a law or regulation's influence on loan performance and profitability, one must measure its "marginal" effect; ideally, this would mean considering only the additional loans made because of the law. Such an assessment, however, is impossible in practice because one cannot specify the subset of loans that are made solely because of the CRA. In the end, we chose to examine the performance and profitability of all loans made in conformity with the CRA; in other words, those that met our definition of a CRA-related loan. This approach, though not ideal, complied with the language of the law that mandated the study.

To answer the third question—whether the research already available was capable of satisfying Congress' request—Board staff reviewed the existing studies of the performance and profitability of CRA-related lending. We found that such research as did exist was too limited to meet our needs. Nearly all of it had focused on the performance and profitability of home lending, and most of this concerned the relatively narrow group of loans made under affordable-home-loan programs. Although they target much of the same population as the CRA, loans extended under affordable-home-loan programs often deviate from the definition of a CRA loan in a few important respects: They are often extended by institutions, such as mortgage companies, that are not subject to the CRA; they frequently include loans made by banking institutions outside their local communities; and they sometimes are made to borrowers whose incomes exceed our lower-income criterion.

Our review of previous research on loan performance showed wide variation in the experience of individual banking institutions, depending on such factors as their location and the kinds of approaches they used to extend credit. The delinquency rates reported are generally higher than those for other loans, while default rates are slightly higher or about the same.

Two types of research on loan profitability have been conducted, one based on a

special survey of banking institutions' experiences and the other on statistical analysis of standardized reports filed by all banking institutions. The Federal Reserve Bank of Kansas City's 1995 survey focused on home-purchase lending; its main finding was that CRA-related lending was profitable, but somewhat less so than traditional lending. Statistical analysis of Call Report data, merged with data on home-purchase lending, showed that institutions doing relatively more lower-income mortgage lending are no less profitable than other institutions.

n **The Board's Study**

Having concluded that existing research did not provide adequate data to satisfy Congress' request, the Board decided to undertake some new research. To this end, the 500 largest retail banking institutions were surveyed about their lending experience, focusing on CRA-related loans. This focus included special lending programs, which are sometimes an important aspect of institutions' CRA-related lending activities. We selected the 500 largest retail banking institutions because they account for about 75 percent of all CRA-related lending. Respondents were assured that the data reported would not be disclosed to the public in a manner that compromised confidentiality. In preparing the survey instrument, we received input from many sources, including banking institutions, community-based and nonprofit organizations, and members of Congress and their staffs.

The survey had limited goals. It is especially important to note that its results do not represent a cost/benefit analysis of the CRA. Consistent with Congress' mandate, the survey focused only on the performance and profitability of CRA-related lending. It did not examine investment and service activities that banking institutions may have undertaken because of the CRA. It did not address the CRA's effects on local communities and included little information about its benefits to individual institutions. The survey collected information about activities in only four loan-product categories (the most significant ones for most institutions). These included home purchase and refinance lending, home improvement lending, small business lending, and community development lending.

n **Special Challenges of the Survey**

Three of the challenges posed by this survey warrant particular comment. Because of statutory deadlines imposed by Congress, banking institutions had little time to prepare responses. In fact, we continued to accept responses for nearly a month beyond the deadline. The timing of our survey coincided with due dates for the annual reports that institutions must file under the provisions of the Home Mortgage Disclosure Act and the CRA, as well as several other regulatory reports.

In addition, we encountered some confusion as to the definition of a CRA loan. The definition was not well understood by all survey respondents, some of whom equated CRA loans with loans made under special lending programs.

Finally, the study used return on equity as a measure of profitability. To calculate it, we sought very comprehensive data, asking respondents to include all sources of costs and revenues. Survey responses and follow-up phone calls, however, indicated that some lenders had considered cost of capital and others had not. As a result, much of our analysis focused on a relative ranking of profitability for CRA and non-CRA lending within a bank. Such internal comparisons are not affected by failure to consider the cost of capital or any other factor, as long as it is reported consistently within a bank.

n **Survey Results: CRA-Related Lending**

We received responses from 143 of the 500 institutions to which we sent the survey (a 28.6 percent response rate). These responses and our follow-up telephone contacts revealed that banking institutions generally do not track profitability and performance separately for CRA-related lending, so our report emphasized qualitative results regarding profitability. Because fewer than half of the respondents answered quantitative questions on performance, one must be cautious when using these responses to draw qualitative inferences comparing the performance of CRA-related and other lending.

The results varied by loan product. Home purchase and refinance lending has the largest origination volume by far (\$570 billion, of which about 10 percent

is CRA-related). Responses indicated that overall as well as CRA-related home purchase and refinance lending is profitable or marginally profitable for most institutions. On a dollar-weighted basis, about 85 percent of survey respondents said that their CRA-related lending as a whole was at least marginally profitable. However, CRA-related home purchase and refinance lending was reported to be less profitable and to have similar or higher delinquency rates than other home purchase and refinance lending. Concerning this product, about 63 percent of respondents said that their CRA-related lending was less profitable than their overall lending. Differences are less dramatic when measured on a per-institution basis.

One of the strongest relationships revealed by the survey concerns the correlation between an institution's size and the profitability and performance of its CRA-related lending. Large banks were less likely than small banks to report that CRA-related lending is profitable, and much more likely to say that it is less profitable than their overall lending. A large proportion of respondents in all bank-size categories reported that CRA-related and other home purchase and refinance loans have very similar origination and servicing costs, credit losses, and pricing on a per-institution basis. However, the respondents who did report differences most often said they had lower prices or higher costs or credit losses for CRA-related home purchase and refinance loans than for others.

Home Improvement and Refinance Lending

The results for home improvement lending (\$12 billion in originations, of which about 18 percent is CRA-related) are similar to those for home purchase and refinance lending, although fewer differences between CRA-related and other home improvement lending were reported. The vast majority of respondents in all size categories said that origination and servicing costs, credit losses, and prices for home improvement lending were about the same for CRA-related loans as for others.

Small Business Lending

Nearly all respondents reported that small business lending overall (\$117 billion in originations) and CRA-related small business lending are both

profitable. They reported few differences in performance and profitability between CRA-related and other small business lending. The same was true of origination and servicing costs, credit losses, and pricing. These results may reflect the relatively large proportion (about 50 percent) of all small business loans that are CRA-related.

Community Development Lending

Virtually all respondents reported that community development lending (\$13 billion in originations) is at least marginally profitable. Comparative questions were not asked for this category of loans because it was unlikely that we would be able to construct valid comparison groups from banking institutions' loan portfolios.

Survey Results: CRA Special Lending Programs

Evidence suggests that CRA special lending programs (\$11 billion in originations across all loan-product categories) are relatively small and account for a small proportion of the loans extended by most banking institutions. Only 1 percent of respondents reported that they established these programs solely to obtain a "satisfactory" or "outstanding" CRA rating. A large share said that they established their programs to meet the local community's credit needs and to promote its growth and stability. Programs have a wide range of characteristics but they commonly feature altered underwriting standards. About three-quarters of all programs involve third parties, such as government entities, nonprofits and lending consortia, which are often a source of subsidies and provide many services such as screening of prospective borrowers. In addition, third parties often share the credit risk of a loan with the lender. A majority of CRA special lending programs were reported to be profitable or marginally profitable. About 25 percent of them were described as unprofitable or marginally unprofitable.

Here I mention an interesting debate about interpreting the results from the CRA special lending programs. One side maintains that these programs represent the marginal impact of the CRA—"the bite of the law"—and therefore are the appropriate focus for analyses of the CRA's

effects. The other side maintains that these programs exist for several different reasons, only one of which is to respond to the CRA, and do not necessarily measure the bite of the law. Ongoing research to be presented at a Federal Reserve System conference in April 2001 will examine this debate in some detail.

Concluding Comments

The report does not characterize the overall performance and profitability of banking institutions' CRA-related lending because it does not cover all the activities of a given bank. However, the performance and profitability of most institutions' CRA-related home purchase and refinance and small business lending provide a good indication of the performance and profitability of their CRA-related lending as a whole because these two categories are the most important ones for the majority of banks.

The relatively low response rate to the survey does not necessarily imply that its results are idiosyncratic. In particular, we found no evidence that the survey's results are not broadly representative of the experiences of the 500 institutions considered together. Although the response rate was 28.6 percent, the institutions that responded are estimated to account for between 45 and 50 percent of all the CRA-related lending in each loan-product category.

Furthermore, statistical tests indicate that survey respondents resemble nonrespondents along several dimensions, including overall profitability and CRA performance ratings. The survey data are primarily reflections of the experiences of larger banking institutions in a particularly healthy economic environment. Experiences may differ for small institutions or under different economic conditions. Our current research efforts are focused on a fuller assessment of the section of the survey that concerns special lending programs. In this regard, Board staff recently published an article in the November issue of the *Federal Reserve Bulletin*.

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