BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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To: Sandra Braunstein, Director, Consumer & Community Affairs Division

From: Glenn Canner and Neil Bhutta

Subject: Staff Analysis of the Relationship between the CRA and the Subprime Crisis

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SUMMARY

As the financial crisis has unfolded, an argument that the Community Reinvestment Act (CRA) is at its root has gained a foothold. This argument draws on the fact that the CRA encourages commercial banks and savings institutions (banking institutions) to help meet the credit needs of lower-income borrowers and borrowers in lower-income neighborhoods. Critics of the CRA contend that the law pushed banking institutions to undertake high risk mortgage lending.

In this memorandum, we discuss key features of the CRA and present results from our analysis of several data sources regarding the volume and performance of CRA-related mortgage lending. In the end, our analysis on balance runs counter to the contention that the CRA contributed in any substantive way to the current crisis.

BACKGROUND ON THE COMMUNITY REINVESTMENT ACT

The CRA directs the four federal banking agencies to use their supervisory authority to encourage banking institutions to help meet the credit needs of their *local* communities – primarily those areas where banking institutions have a physical branch office presence and take deposits (referred to hereafter as their *CRA assessment areas*) including the low- and moderate-income areas. To that end, the agencies periodically assess the performance of these institutions in serving their local communities, including their patterns of lower-income lending, and take their record of doing so into consideration when reviewing applications for mergers, acquisitions and branches.

The CRA emphasizes that banking institutions fulfill their CRA obligations within the framework of safe and sound operation. Although CRA performance evaluations have become more quantitative since regulatory changes in 1995, stressing actual performance rather than documented efforts to serve their community's credit needs, the CRA does not stipulate minimum targets or even goals for lending, service or investments. At the same time it is fair to say that the primary focus of the CRA evaluations is the number and dollar amount of lending to lower-income borrowers or areas. However, the agencies instruct examiners to determine an institution's capacity to extend credit to lower-income groups and assess local economic and market conditions that might affect the income and geographic distribution of their lending and to judge their performance in this context.

Since 1995, there has been essentially no change in basic CRA rules or the enforcement process that can be reasonably linked to subprime lending activity.[1] This fact weakens the link between the CRA and the current crisis since the crisis is rooted in the poor performance of mortgage loans made between 2004 and 2007.

A final important point is that the CRA does not cover independent non-bank lending institutions, such as mortgage and finance companies and credit unions. In other words, these institutions are not directly affected by CRA incentives. CRA may or may not directly affect non-banks that are subsidiaries or affiliates of banks. Banks can elect to have their affiliate lending activity counted in CRA performance evaluations. If the banking institution elects to include affiliate activity it cannot be done in a selective way, for example, to only include or cherry pick loans that would be favorably considered.

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[1] The change in the CRA rules in 2005 focused primarily on reducing burden for smaller lenders and expanding the focus of CRA to include some middle-income census tracts in distressed rural areas.

CRA-RELATED LENDING VOLUME AND DISTRIBUTION

Analysis of 2006 Home Mortgage Disclosure Act (HMDA) data indicates that two-thirds of mortgage loans (first-lien home purchase and refinance loans for site-built properties) are entirely unrelated to CRA; these loans were extended to middle- or higher-income borrowers or to borrowers located outside of lower-income neighborhoods (table 1). These data also indicate that only ten percent of all loans are "CRA-related" — that is, lower-income loans made by banks and their affiliates in their CRA assessment areas.

More important for this discussion is CRA's relationship to subprime mortgage lending. As shown table 2, in 2005 and 2006, the peak years of subprime volume, independent mortgage companies (institutions not covered by the CRA) accounted for about half of all higher-priced loans (our proxy for subprime lending derived from HMDA data).

Also, 57 percent of all higher-priced loans in 2006 were effectively unrelated to CRA because they were made to non-lower-income borrowers or neighborhoods (table 3). **Most importantly, only 6 percent of all higher-priced loans in 2006 were made by CRA-covered institutions or their affiliates to lower-income borrowers or neighborhoods in their assessment areas.** As noted, CRA performance evaluations focus on lower-income lending in CRA assessment areas.

To the extent that banking institutions chose not to include their affiliates' lending in their CRA examinations, the 6 percent figure overstates the volume of higher-priced lower-income lending that CRA examiners would have counted. It is possible, however, that examiners might have considered at least some of the lower-income lending outside of CRA assessment areas. The fact that most higher-priced loans made by CRA-covered banking institutions and their affiliates were made outside of their CRA assessment areas suggests that the CRA was likely not an important incentive for making these loans.

It is also possible that the remaining share of higher-priced lower-income lending may be indirectly attributable to CRA to some degree due to the incentives under the CRA investment test. Specifically, banking institutions may have received "CRA credit" for purchases of higher-priced loans or mortgage-backed securities (MBS) that subsequently affect the credit supply in the mortgage market.

The HMDA provides some information on loan sales and purchases, and suggests a weak link between independent mortgage companies and banks through secondary market sales, especially for lower-income loans (table 4). In 2006, only about 9 percent of independent mortgage company loan sales were to banking institutions (percent not shown in table) and of these only 15 percent involved higher-priced loans to lower-income borrowers or areas.

MORTGAGE BORROWER PERFORMANCE

Finally, we use data from *LoanPerformance* (LP) on subprime and alt-A mortgage securitizations to compare delinquency rates for subprime and alt-A loans in lower-income neighborhoods relative to those in middle- and higher-income neighborhoods. (The LP data do not allow us to identify borrower income, only neighborhood income by zip code.)[2] The results indicate that the 90-day or more delinquency rate as of August 2008 for subprime and alt-A loans originated between January 2006 and April 2008 is high regardless of neighborhood income, with delinquency rates comparable, but somewhat higher in lower-income areas than in middle- or higher-income areas (table 5).[3]

To some degree, it is not surprising that delinquency rates would be, at least somewhat higher in lower-income areas because lower-income borrowers

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[2] We classify zip code delinquency data by relative income in two different ways. First, we use information published by the U. S. Census Bureau on income at the ZCTA level of geography. Because the ZCTA data provide an income estimate for each zip code, delinquency rates can be calculated directly from the LP data based on the zip code location of the properties securing the loans (see http://www.census.gov/geo/ZCTA/zcta.html). Second, we calculate delinquency rates for each relative income group (lower, middle and higher) as the weighted sum of delinquencies divided by the weighted sum of mortgages, where the weights equal each zip code's share of population in census tracts of the particular relative income group. Relative income is based on the 2000 decennial census and is calculated as the median family income of the census tract divided by the median family income of its metropolitan statistical area or nonmetropolitan portion of the state. Both approaches yield virtually identical results.

[3] A virtually identical relationship across neighborhood income groups is found if the pool of loans evaluated is expanded to cover those originated between January 2004 and April 2008. The only material difference is that the levels of delinquency are lower for both subprime and alt A loans for the larger sample of loans.

tend to be more sensitive to economic shocks, in part, because they have fewer resources to draw on in emergencies.

In order to better gauge the possible effects of the CRA, we used the LP data again and focused attention on the subset of zip codes that in principle would be similar except for their relationship to the CRA. For this exercise, we focused only on zip codes right above and right below the CRA eligibility threshold (median neighborhood income of 80 percent of broader area median). As such, the only major difference between these two sets of neighborhoods should be that the CRA focuses on one group and not the other. This analysis indicates that subprime loans in zip codes that are the focus of the CRA (those just below the threshold) have performed slightly better and alt A loans in these areas slightly worse than those that are not (table 6).[4]

To gain further insight into the risks of lending to lower-income borrowers or areas, we compare the performance of first mortgages originated and held in portfolio under the affordable lending programs operated by the NeighborWorks partners across the country and information from the Mortgage Bankers Association. Many loans originated through NeighborWorks programs are done in conjunction with banking institutions subject to the CRA so the performance of these loans provides another basis to address the relationship between the CRA and the subprime crisis. Along any measure of the severity of loan delinquency or the incidence of foreclosure the loans originated under the NeighborWorks program have performed better than subprime or FHA-insured loans, and, although they have higher delinquency rates than prime loans, the incidence of foreclosure for the affordable loans is lower (table 7).[5]

Another way to measure the likely effects of the CRA on the subprime crisis is by examining foreclosure activity across neighborhoods classified by

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[5] No information was available on the geographic distribution of the NeighborWorks loans. The geographic pattern of lending can matter as certain areas of the country are experiencing much more difficult housing conditions than other areas.

income. Data made available by RealtyTrac on foreclosure filings from January 2006 through August 2008 indicates that most foreclosure filings (e.g. about 70 percent in 2006) have taken place in middle- or higher-income neighborhoods and that foreclosure filings have increased at a faster pace in middle- or higher-income areas than in lower-income areas that are the focus of the CRA (table 8).[6]

Taken together, the available evidence to date does not lend support to the argument that the CRA is a root cause of the subprime crisis.

[6] These data are reported at the zip code level. We calculate the statistics by relative income group in table 8 as before; see footnote 2. Foreclosure filings have been consolidated at the property level so separate filings on a first and subordinate lien loans on the same property are counted as a single filing.

1. Profile of Mortage Lending in 2006

	Banking Institutions & Affiliates		Independent Mortgage Company (%)	Total (%)
	Within CRA Assessment Area (%)	Outside CRA Assessment Area (%)		
Non-Lower Income	19	26	21	66
Lower-Income	10	13	11	34
Total	28	39	33	100

Source FFIEC, HMDA Data

2. Who Extends Higher-Priced Loans

	2005		2006	
	Distribution (%)	Incidence (%)	Distribution (%)	Incidence (%)
Independent Mortgage Company	52	41	46	42
Depository	23	13	29	19
Subsidary of Depository	13	21	12	23
Affiliate of Depository	12	31	13	38
Total	100	25	100	28

Source FFIEC, HMDA Data

3. Profile of Higher-Priced Lending in 2006

	Banking Institutions & Affiliates		Independent Mortgage Company (%)	Total (%)
	Within CRA Assessment Area (%)	Outside CRA Assessment Area (%)		
Non-Lower Income	7	23	27	57
Lower-Income	6	18	20	44
Total	13	41	47	100

Source FFIEC, HMDA Data

4. Loans Sold by Independent Mortgage Companies to Depositories

	Depository Purchases (Percent Distribution)
Lower-Priced Loans	
Non-Lower Income	45
Lower-Income	18
Higher-Priced Loans	
Non-Lower Income	22
Lower-Income	15
Total	100

Source: FFIEC, HMDA Data

5. 90 Day plus Delinquency Rates by Relative Income Zip Code[1]

	Subprime	Alt-A	Total
	Delinquency Rate as of August, 2008[2]		
Lower-Income Zip Code	25.0	16.1	21.5
Middle-Income Zip Code	21.3	12.9	17.7
Higher-Income Zip Code	19.5	10.9	14.5

Notes

1 Source LoanPerformance

2 For mortgages orıgınated between January, 2006 and Aprıl, 2008

6. 90 Day plus Delinquency Rates for Zip Codes Just Above and Below CRA Threshold[1]

	Subprime	Alt-A	Total
	Delinquency as of August, 2008[2]		
Zip Code Just Below Theshold[3]	24.1	15.6	20.7
Zip Code Just Above Theshold	24.9	15.4	21.0

Notes:

1. Source: LoanPerformance.

2. For mortgages originated between January, 2006 and April, 2008.

3. Zip codes below threshold have median family income greater than 75% and less than 80% of area median family income, while zip codes above the threshold have median family income between 80% and 85% of area median family income.

7. Comparative Data on Single-Family First Mortgage Home Loans, as of June 30, 2008[1]

	Past Due Loans				
	30 Days	60 Days	90+ Days	Total	Foreclosures[2]
All Loans (U.S.)	3.23%	1.24%	1.75%	6.22%	1.08%
Prime Loans	2.08%	0.72%	0.93%	3.73%	0.61%
Subprime Loans	8.30%	3.87%	6.04%	18.21%	4.26%
VA	3.76%	1.23%	1.67%	6.66%	0.57%
FHA	6.64%	2.33%	3.19%	12.16%	0.95%
NeighborWorks® Campaign Clients	3.90%	1.93%	3.54%	9.36%	0.21%

Notes:

1. Sources - NeighborWorks® Campaign clients' data pertaining to Neighborhood Housing Services of America (NHSA) portfolio of 2,986 loans, amounting to $234.30 million; all other data are provided by the Mortgage Bankers Association of America's (MBAA) economic department

2. Foreclosures started between April 1, 2008 and June 30, 2008

8. Foreclosure Filing Activity by Neighborhood Income[1]

Relative Income Group	Share of Filings (%)[2]	Change in Filings[3]
Lower	29.7	118%
Middle	50.7	159%
Higher	19.6	143%
Total	100	-

Notes

1 Foreclosure filings from RealtyTrac, January 2006 to August 2008

2 Share of filings based on foreclosures filings in 2006

3 Change between first half of 2006 and first half of 2008

4 Relative income groups based on ZCTA income data