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DO CRA AGREEMENTS INFLUENCE LENDING PATTERNS?

(FORTHCOMING REAL ESTATE ECONOMICS)

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An increasingly common method for lending institutions to demonstrate their commitment to and compliance with the Community Reinvestment Act of 1977 (CRA) and fair lending laws has been to enter into agreements with community groups and other entities to help ensure the flow of credit throughout their service area. Table 1 shows that the volume of loan pledges associated with these agreements, referred to as "CRA agreements" in this brief, has grown significantly since the passage of the CRA.

These pledges, or "CRA agreements," often include explicit lending level targets to lower-income and minority neighborhoods and individuals; some also include non-credit provisions, such as the establishment of bank branches and investment in community-based projects. Pledges typically specify a target geographic area, such as a neighborhood, city, or county, and then a particular population within that geographic area, such as lower-income or minority communities or borrowers. More recently, lenders have begun to make voluntary lending pledges in which they commit to lend to targeted communities without explicitly signing an agreement with a specific community group or other organization. Schwartz (1998) provides a thorough review of the elements of CRA agreements.

This Research Brief considers the broader impact of CRA agreements by examining whether their presence is associated with changes in lending outcomes for the market as a whole. We ask whether CRA agreements, either through their presence, number, introduction, or expiration, are associated with changes in lending activity to lower-income and minority communities in the areas where they are initiated. This is a critical issue, as, presumably, an important goal of pursuing these arrangements is to increase the total amount of lending to the targeted groups. If CRA agreements simply result in a redistribution of targeted lending among lenders or loan types (for example, a substitution between conventional and government-backed loans) with no net increase, then their efficacy could be questioned.

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Background

The CRA was signed into law specifically to encourage federally insured banking institutions to help meet the credit needs of borrowers in all segments of the communities within their service areas. The CRA is particularly concerned with those communities believed to have been historically under-served by the financial services industry, notably lower-income communities.

Although the CRA does not explicitly cover minority communities, they have been the subject of considerable concern on these issues as well. In this regard, fair lending laws, such as the Fair Housing Act and the Equal Credit Opportunity Act, have provided a legal structure for combating and eliminating race-based discrimination in credit markets.

Both the CRA and the fair lending laws have led to greater public scrutiny of lending to these communities. And institutions with poor ratings on these scores can face serious negative consequences. For example, banking institutions face potential legal action if noncompliance with fair lending laws is demonstrated. In the case CRA ratings, a banking institution with a poor rating is more likely to be targeted by the press and community groups for their lack of financial commitment to their service area. The potential for negative publicity may serve as an incentive for banking institutions to direct additional resources to targeted communities and individuals within their service area. Furthermore, an institution that wishes to expand its banking presence may have its application for a merger or branch expansion denied or delayed because of a poor CRA rating. Regulators may need more time to scrutinize the application of a poorly performing institution, and banks with poor CRA records may be more likely to face challenges from community groups on CRA grounds. These protests can lead to considerable negative publicity for the bank and may require the use of significant bank resources to address particular allegations. Given the pace of consolidation in recent years, the demonstration of a commitment to and compliance with the CRA and fair lending laws – through CRA agreements and other means – has become a more salient issue.

Given that banking institutions have incentives to set up CRA agreements, the question arises whether these agreements have a material effect on lending market outcomes. From a theoretical perspective, the likely impact of CRA agreements is ambiguous. If the lending market is perfectly competitive, then CRA agreements are not expected to have an effect on the volume of credit flowing to neighborhoods. This is because, under competitive markets, all creditworthy households will receive credit, and agreements do not change the number of creditworthy households in a neighborhood. CRA agreements might lead to a shift in *which* lenders extend credit in a community, but the total number of households receiving credit will remain constant.

On the other hand, agreements can increase the flow of credit to a market if the market is not perfectly competitive or if it is difficult to obtain all the information about applicants from some communities. CRA agreements can be an incentive to increase competition by providing incentives for lenders to serve markets that previously had few participants. In addition, the experience gained from programs initiated under CRA agreements can help mitigate uncertainties associated with applicants from certain neighborhoods and thereby reduce the amount of credit rationing in a neighborhood.

Table 1. Annual CRA Agreement Dollar Pledges, in millions of dollars

Year	Annual	Cumulative Amount
Amount		
1999	32,377	1,085,176
1998	696,270	1,052,799
1997	221,345	356,529
1996	49,678	135,184
1995	26,521	85,506
1994	6,123	58,985
1993	10,474	52,862
1992	33,583	42,387
1991	2,427	8,805
1990	1,614	6,378
1889	2,260	4,764
1988	1,248	2,504
1987	357	1,256
1986	516	899
1985	73	382
1984	219	309
1983	1	90
1982	6	89
1981	5	83
1980	13	78
1979	15	65
1978	---	50
1977	50	50

Source: Data compiled by the National Community Reinvestment Coalition

Moreover, CRA agreements might increase the flow of credit if the agreements are viewed as a type of "insurance" against the potentially large but uncertain costs associated with CRA-related challenges. In this view, lenders incur a known cost associated with meeting CRA agreements in return for substantially reducing the probability of facing a challenge during a merger or other application or receiving negative press for having a poor CRA performance rating.

Testing for the Influence of CRA Agreements on Lending

Our tests focus on mortgage lending outcomes, because data are not generally available for other types of lending. We use a panel-based model that examines how the growth in mortgage lending in a specific county varies with the presence, number, introduction, and expiration of CRA agreements in that area. The county, rather than the metropolitan statistical area (MSA), is defined as the relevant geographic demarcation for two reasons. First, federal CRA and fair lending examiners typically assess a lender's performance at the county level. Second, most of the CRA agreements in our data are targeted at communities that are significantly smaller than MSAs.

Information on lender activities collected pursuant to the Home Mortgage Disclosure Act (HMDA) is the best source of data for addressing this issue. Since 1990, provisions in the HMDA have required that most institutions with offices in metropolitan areas provide detailed information on every application for a home mortgage that they receive over a year. For our tests, the relevant data items are application disposition (approved, denied, withdrawn), type of mortgage (conventional, government-backed), property location, and borrower race or ethnicity and income. With this information, we can determine the volume of conventional and government-backed mortgage lending to minority populations, to lower-income populations, and overall by county.

The National Community Reinvestment Coalition (NCRC), a trade association of more than 800 community groups and local public agencies that focuses on CRA-related issues, provided information on CRA agreements. From NCRC's hard copies of agreements between NCRC members and lending institutions, information was collected specifying the types and amounts of lending pledges, the targeted group or community, whether non-lending technical assistance is being provided, the duration of the agreements, and the years the agreements are active.[1] Not all CRA agreements initiated by NCRC members are included in the analysis. The sample of agreements was restricted to those that included a pledge for mortgage credit that could be tracked to a targeted community.[2]

The mortgage lending and agreement data are supplemented with non-lending variables characterizing economic and demographic conditions within counties available from the Regional Economic Information Service (REIS) of the Bureau of the Census. These data provide population, employment, and income information at the county level.

With data from these three sources, we constructed a panel of counties. Counties were restricted to those located in metropolitan statistical areas (MSAs) and were required to appear in the HMDA data in every year from 1993 to 1999.[3] The final sample includes 727 counties in metropolitan areas over seven years.

The data show that counties with CRA agreements were quite different from those without agreements. Counties with agreements tended to be larger and more affluent than those without agreements. In addition, counties with agreements grew slightly faster on average over the ensuing three years in terms of population, employment, income, and earnings than counties without agreements. In spite of this faster growth, conventional mortgage loans grew only 1.7 percent from 1994-1997 in counties with agreements, compared to 6.8 percent in counties without agreements. Significant differences across counties were observed in the growth of government-backed mortgage lending.

These relationships suggest that CRA agreements are unlikely to be associated with lending growth. For conventional mortgage lending, if they suggest anything, the implication is that CRA agreements might be associated with relative declines in lending.

However, the foregoing is only a univariate analysis of the data, which can be misleading if there are important correlations among county characteristics. A multivariate analysis is needed to account for such correlations and to determine whether such conclusions are warranted.

The multivariate empirical model used in this study relates the three-year growth in mortgage lending in a county to county characteristics, the presence of CRA agreements, and changes in these factors. The estimates show that CRA agreements affect conventional mortgage lending patterns in a county primarily through the initiation of agreements, and not through the presence, number, or expiration of agreements. Agreements initiated in the second and third years of a three-year interval were significantly associated with increases in total conventional lending, conventional lending to lower-income neighborhoods (CRA lending), and minority conventional lending in a county. The effects are proportionally the same for each type of lending.

A CRA agreement initiated in the second year of a three-year interval is associated with an increase in the growth rate of conventional mortgage lending of roughly 20 percent. A new agreement initiated in the final year of a 3-year interval is associated with about 14 percent higher growth in lending. Further, the positive relationship observed for total conventional lending suggests that the additional lending represents some new lending and not simply a substitution of targeted lending in lieu of lending to other groups.

The results are consistent with the notion that institutions quickly increase conventional mortgage lending in areas with a newly active CRA agreement. However, the analysis also suggests that these increases are relatively short-lived, as the magnitude of the *additional* amount of increase in lending declines as one moves further away from the date of agreement initiation.

By contrast, no CRA agreement-related variables are found to be significantly associated with changes in lending when government-backed lending is considered. This lack of significance is not particularly surprising, as most CRA agreements do not include specific lending targets for government-backed loans. The divergence in results for conventional and government-backed lending does suggest, though, that the observed conventional lending relationships are not simply the result of omitted economic factors but rather reflect significant economic relationships.

Conclusion

Entering into CRA agreements is one way for some banking institutions to demonstrate or affirm their commitment to serving lower-income and minority communities and for community organizations to leverage existing laws to increase the financial support lending institutions extend to those communities. Economic theory provides ambiguous predictions regarding the likely effect of CRA agreements on lending. Under different assumptions, agreements can theoretically increase, decrease, or have no effect on lending. This paper empirically examines this question.

The key result is that, of the several variables characterizing CRA agreements in a county, only the number of newly initiated CRA agreements was found to be significantly associated with three-year changes in conventional mortgage lending. Specifically, newly initiated agreements were found to be associated with significant increases in total lending in a county, a result that held for CRA, minority, and overall conventional mortgage lending. The results for CRA and minority lending are consistent with the view that institutions increase targeted conventional mortgage lending upon the introduction of a CRA agreement. The fact that total lending also increases implies that the increased targeted lending is new lending, and not lending that is substituted from other groups. Moreover, these results show that these increases in lending are relatively short-lived. Finally, no CRA agreement-related variables were found to be significantly associated with changes in government-backed lending.

The results are broadly consistent with the notion that lenders view CRA agreements as a form of insurance against the potentially large and uncertain costs of fair lending violations, poor CRA performance ratings, and negative publicity from CRA-related protests of mergers or other applications. Lenders enter into agreements and soon thereafter increase their targeted lending to build a positive CRA record.

The short duration of the increase in targeted lending implies two possibilities. First, lenders might need the "insurance" only for a short period of time, such as during the course of a merger or other application, and might alter their behavior only during this time. Indeed, Evanoff and Segal (1996) and Bostic, et al. (2000) both find evidence suggesting that lenders alter their CRA-related activities in anticipation of CRA performance reviews and merger applications.

Second, community organizations that enter into the agreements might have limited resources to conduct effective and ongoing monitoring of lending activities; as time passes and they respond to new local issues and demands, they may devote fewer resources to compliance with agreements. Thus, after a short period of relatively intense scrutiny, it becomes increasingly unlikely that a lender will face negative publicity for not meeting agreement pledge goals. An implication of this perspective is that increases in lending activity are ultimately determined by the persistence and sophistication of community groups involved in monitoring compliance with CRA agreements.

In support of this second possibility, Squires and O'Connor (2001) observe that lenders and community-based organizations have widely divergent resources at their disposal, leaving community organizations at some disadvantage; they advocate bolstering community activism that focuses on maintaining engagement on issues that remain relevant over longer time periods. The implication is that maintaining their engagement would correspond to persistent increases in lending.

Finally, while the analysis in this study has carefully considered the effects of CRA agreements on targeted lending, it has not focused on other programs whose object is targeted lending to lower-income and minority borrowers. Such programs, including those established by Fannie Mae and Freddie Mac in response to HUD's affordable goals, the Campaign for Homeownership by the Neighborhood Reinvestment Corporation, and those undertaken by lenders as an independent response to the CRA, undoubtedly play an important role in this area. A complete understanding of how policy affects targeted lending will require analyzing the impacts of these efforts as well.

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[1] NCRC (2000) includes a list of all CRA agreements on file at NCRC, as well as innovative provisions of CRA agreements in the areas of home mortgage, small business, and community development lending and other CRA-related investments. More information on NCRC can be obtained via their website at http://www.ncrc.org or by phone at 202-628-8866.

[2] We view national pledges to be too distributed to have a significant impact on a specific county.

[3] Thus, problems that could potentially arise from changes in the geographic boundaries of an MSA are avoided.