LUSK BRIEF RESEARCH

USC Lusk Center for Real Estate

Winter 2004

The Impact of CRA Agreements on Community Banks[1]

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Introduction

Concerns about equal access to mortgage credit have led to the passage of many laws whose goal is its promotion. One important example is the Community Reinvestment Act of 1977 (CRA), which directs the federal banking regulators to encourage financial institutions to provide services to their entire service areas. In response to the incentives laid out by the CRA, many banks have entered into CRA agreements, which are arrangements, often formally established with community-based organizations, in which lenders pledge to extend a certain volume of loans to targeted groups and communities.[2] Evidence suggests that CRA agreements have been effective in promoting an increased flow of mortgage credit to lower-income and minority communities by the institutions involved in the agreements (Schwartz, 1998b) and by all lenders considered together (Bostic and Robinson, 2003).

Despite these positive effects, it is also possible that the incentives provided by CRA agreements have a detrimental impact on some lenders. Clear candidates for harm are small community banks, whose viability depends on operating in less competitive markets and having a comparative advantage with respect to evaluating and monitoring loans in local niche markets (Nakamura, 1994; Bassett and Brady, 2001; Jayaratne and Wolken, 1999). CRA agreements promote increased competition and attention to precisely these niche markets, and thus could have an important negative effect on the lending and performance of community banks. This paper explores this hypothesis.

Data and Approach

To examine whether CRA agreements have influenced the lending behavior of smaller banks and thrifts, we compare mortgage lending by small lending institutions before and after the establishment of CRA agreements in their service areas. The analysis uses a reduced form model that relates mortgage lending to bank and thrift financial information and community specific variables between 1990 and 1997 and the existence of CRA agreements:

Mortgage lending variable = f(Time, Lender Financials, County and Market Characteristics, CRA Agreement Presence)

The focus is on changes in three types of lending: mortgage lending to (1) lower-income borrowers and neighborhoods (CRA lending), (2) minority borrowers and neighborhoods (minority lending), and (3) all borrowers (total lending). Within each lending category, three different measures are used as dependent variables: (1) the absolute level of a institution's lending in the county; (2) the share of total lending in the county done by the institution (market share); and (3) the share of a institution's loan portfolio that falls into the targeted lending category (portfolio share). An additional dependent variable is included in the analysis to assess whether lending institutions are originating mortgages to a riskier clientele in locations where CRA agreements are in effect.

The data are compiled from three sources. Detailed information about CRA agreements was compiled from a database maintained by the National Community Reinvestment Coalition (NCRC). Data on bank and thrift financial characteristics are drawn from the annual Reports on Income and Condition (Call Reports) and the Thrift Financial Report. Finally, since the analysis focuses on mortgage lending activity, data collected pursuant to the Home Mortgage Disclosure Act (HMDA) served as the basis for identifying the amount of lending to lower-income and minority neighborhoods and borrowers for each lending institution in the sample in each county that the institution originated mortgages from 1990 through 1997.

Results

The first line in table 1 shows the results for changes in the number of loans originated. Each column focuses on one of the three types of lending of interest – all lending, CRA lending, and minority lending – with the dependent variable being the number of the appropriate category of loans originated in a given year. The results are virtually identical across the three lending categories. The presence of a CRA agreement is associated with reduced lending by small community lenders. Controlling for other factors, small lenders operating in the presence of CRA agreements originate about 4 fewer CRA loans, 2 fewer minority loans, and 10 fewer loans overall than small lenders operating in areas without CRA agreements. In each category, the reduction in small bank mortgage credit associated with the presence of a CRA agreement is about 40 percent.

The second line in table 1 uses a mortgage lending market share measure to further explore the potential impact of CRA lending agreements on small lenders overall. Once again, the model estimates are quite similar across the three lending categories, and suggest that the overall market presence for small lenders is lower in counties in which agreements are active. Small lending institutions have a lower share of the overall mortgage market and of mortgage sub-markets in locations where lenders have entered into CRA agreements.

The third line of table 1 presents the estimates of the model in which the dependent variable is the share of the lender's mortgage portfolio that is composed of CRA or minority loans. These estimates, which provide an indication of whether the presence of CRA agreements is associated with a shifting of an institution's lending focus toward or away from CRA and minority lending, suggest that the presence of a CRA agreement is associated with a shift of lender activity toward CRA and minority lending. The average share of the portfolio that small community lenders in our sample direct towards CRA and minority lending is 35% and 14%, respectively. The shift of 3 to 6 percentage points represents a greater than 9% increase in CRA lending and a more than 42% increase in minority lending.[3] Given that we have already observed that small lenders originate fewer CRA and minority loans in areas with CRA agreements, these results imply that small lenders reduce their non-CRA and non-minority lending by even more. This may arise in part because small lenders may be more likely to compete for CRA [and minority] loans for regulatory reasons – they might have an interest in maintaining some absolute level of CRA loans to secure an acceptable CRA rating from examiners.

The final hypothesis that we explore is that small lenders may originate mortgages to riskier applicants in order to maintain their market presence in response to the increased competition induced by CRA agreements. The results, which are not shown, generally do not support this hypothesis. However, some variations on the main empirical specification suggest that some institutions may have responded to the changing market conditions in this fashion.

Conclusions

The hypothesis underlying this research is that CRA agreements induce the participating lenders to increase the amount of resources expended on these targeted groups, which increases the supply of mortgage credit and the competition for these borrowers to the detriment of small community banks, which rely on serving relatively uncompetitive markets and market niches with relatively small credit flows. The results conform to expectations. Controlling for market and lender characteristics, small community lenders originate fewer mortgages in counties where CRA agreements are in effect and also have lower market shares in those areas. Also, small lenders in areas with CRA agreements tend to refocus their lending activities more toward CRA and minority lending, perhaps to ensure that CRA performance ratings are not adversely affected. Taken with results from prior research, these findings suggest that CRA

Table 1. Effect of Presence of CRA Agreements on Community Bank Lending

	Loan category		
	All loans	CRA loans	Minority loans
Community Bank Lending Performance Measure			
Number of loans	-9.635*** (2.369)	-3.668*** (0.826)	-1.644*** (0.822)
Market share	-1.373*** (0.146)	-1.271*** (0.161)	-1.005*** (0.206)
Portfolio share	—	3.256*** (1.223)	5.976*** (1.132)

agreements have a complex impact on levels and changes of lending. Future research will undoubtedly further our understanding of this relationship.

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[1] We would like to express our extreme gratitude to the National Community Reinvestment Coalition for providing us with access to their data on CRA agreements. In addition, we thank Melissa Mugharbel for providing invaluable research assistance. Also, insightful comments by Geoffrey Tootell, two anonymous referees, the editor of the *Journal of Banking and Finance*, and seminar participants at Louisiana Tech University and Oklahoma State University were greatly appreciated. We also would like to thank the Alfred Lerner College of Business and Economics at the University of Delaware for providing a grant to help support this study.

[2] For more on CRA agreements, see Schwartz (1998a).

[3] The percentage change in portfolio share directed towards CRA and minority lending is calculated by dividing the change in portfolio share (CRA or minority lending) by the average portfolio share (CRA or minority lending).

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JEL classification: G21; G28