

THE COMMUNITY REINVESTMENT ACT: ITS IMPACT ON LENDING IN LOW-INCOME COMMUNITIES IN THE UNITED STATES

By

Michael S. Barr

Lynda Y. de la Viña

Valerie A. Personick

Melissa A. Schroder

(The authors are employees of the U.S. Department of the Treasury. This paper is the sole responsibility of the authors and may not reflect the official views of the Treasury Department.)

The Community Reinvestment Act: Its Impact on Lending in Low-Income Communities in the United States

The Community Reinvestment Act (CRA) was enacted in 1977 to encourage banks and thrifts to help meet the credit needs of their entire communities in a manner consistent with safe and financially sound banking practices. According to many financial institutions, government regulators, community groups, and academic researchers, CRA has been successful in assisting banks and thrifts to identify previously unrealized market opportunities in these communities.

CRA encourages federally insured financial institutions to meet the obligations of their bank charter by providing banking and credit services to all segments of the communities in which they operate. Under CRA, the bank regulatory agencies -- the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation -- regularly review how well each institution has provided lending, investment, and banking services to low- and moderate-income groups within their assessment areas. Home mortgage lending is also considered in the CRA review, coupled with the reporting requirements under the Home Mortgage Disclosure Act (HMDA) and the fair housing lending laws. The CRA ratings are made public and are used by the regulatory agencies in their consideration of certain applications, including those for proposed mergers and acquisitions.

Changes to HMDA and CRA regulations since the late 1980s have made these laws more effective. In 1989 HMDA was amended to require public disclosure of an institution's home mortgage loan portfolio, which includes information about the race, income and location of borrowers. This

enhancement contributed to the strengthening of fair lending enforcement in the 1990s.

CRA regulations were amended in 1989 to make public each institution's rating. In 1993, at the request of President Clinton, banking regulators began reforming the regulations implementing CRA by replacing criteria that had been viewed as subjective and process oriented with objective performance measures. Revised regulations were issued in 1995 which effectively streamlined the CRA review process to assure consistency in regulatory oversight. Banking and thrift regulators began to apply the new criteria to small banks in 1996 and to large banks in 1997.

Lending to low- and moderate-income neighborhoods and minority communities has increased significantly. According to private community organizations, banks and thrifts have made \$1.051 trillion in loan pledges to low-income areas since the inception of CRA in 1977, with over 95 percent of the total occurring in the past six years.¹ Other data confirm a rapid increase in lending to low- and moderate-income and minority communities in recent years. Home mortgage lending, for example, has risen faster for these groups since 1993 than for the market as a whole. The volume of small business loans under CRA has grown to sizable levels and accounts for two-thirds of all the small business loans made by federally insured banks and thrifts. A substantial share of the loans, more than one-fifth, went to businesses in low- and moderate-income neighborhoods. As Federal Reserve Governor Edward Gramlich noted, "There seems to be little doubt that most of these outcomes would not have occurred in the absence of

¹ National Community Reinvestment Coalition, "CRA Dollar Commitments Since 1977", December 1998.

CRA and other fair lending laws.”²

This paper reviews data and research studies that demonstrate that CRA has helped to increase lending to low-income borrowers and in low-income neighborhoods, and that expanded CRA lending has been accomplished while maintaining sound lending practices and bank profitability. The paper also discusses literature that draws alternative conclusions, as well as studies that find, despite increases in lending and banking services to low- and moderate-income areas and to minority borrowers, that disparities still exist between the services afforded to these communities and those offered to the market as a whole.

Home Mortgage Lending

Home mortgage lending data show that since improved disclosure of HMDA data first demonstrated a lending gap in the early 1990s, minority borrowers’ access to the mortgage market has improved dramatically compared to the average for the market as a whole.³

As demonstrated in Table 1, there has been a sizable upward shift in the share of loans obtained by low-income and minority borrowers. The total number of conventional mortgage loans increased by 33.0 percent between 1993 and 1997. In contrast, loans to census tracts where the median income is less than 80 percent of the median income of the whole metropolitan area increased much more rapidly -- by 45.1 percent. Similarly, loans to African Americans and Hispanics also increased much faster than the 33 percent average over the 1993-97 period -- by 71.6 percent and 45.4 percent, respectively.

² Edward M. Gramlich, “Examining Community Reinvestment,” remarks at Widener University, November 6, 1998.

³ The significant income disparity between minorities and whites is the basis for the reference to minority data as a proxy for low- and moderate-income individuals in some cases. In 1997, black households comprised 12 percent of all households in the U.S. and Hispanic households (which can be of any race) represented 8 percent of the total. Median income for black households that year was \$25,050, 35.7 percent lower than the \$38,972 for white households, and Hispanic median income was \$26,628, 31.7 percent lower than white income.

Table 1. Number of Conventional Home Purchase Loans, 1993-1997
 Between 1993 and 1997, conventional home purchase loans to low-income and minority borrowers grew more rapidly than to other borrowers

	Percent <u>change</u>
Total U.S. Market	33.0
<i>By race or ethnicity:</i>	
African American	71.6
Hispanic	45.4
<i>By income of borrower (% of MSA median):</i>	
Less than 80	40.3
80-99	30.0
100-119	24.6
120 or more	31.7
<i>By income of census tract:</i>	
Low or moderate	45.1
Middle	32.0
Upper	31.5

Source: Federal Financial Institutions Examination Council, August 24, 1998.

Other factors may also have contributed to the relatively quicker expansion in home lending to these groups. The strong economy has led to widespread employment opportunities, a reduction in unemployment rates among all demographic groups, and a rise in real income. Very favorable mortgage interest rates have lowered the costs of homeownership and made housing more affordable. Nevertheless, research discussed later tends to confirm that CRA has been a significant factor in the shift in mortgage lending towards low- and moderate-income communities. As Governor Gramlich noted, "it is likely that CRA played an important role in bringing about this shift."⁴

The strong growth in home lending to minorities is effectively demonstrated in the more rapid rise in homeownership rates among minority households than for the population as a whole, as seen in Table 2. Homeownership rates for African Americans and Hispanics surpassed 46 percent in the first quarter of 1999, rising from 42.1 percent for African Americans and 40.3 percent for Hispanics at the beginning of 1994. Homeownership rates for all households in the United States increased from 63.8 percent in the first quarter of 1994 to 66.7 percent by the first quarter of 1999.

⁴ Gramlich, op. cit.

Table 2. Homeownership Rates, 1994-1999

Since the beginning of 1994, the homeownership rate for African Americans, Hispanics and lower income households rose much faster than the US average

	US Total	African American	Hispanic	Households with income less than or equal to the median
1994:Q1	63.8	42.1	40.3	48.1
1999:Q1	66.7	46.3	46.2	51.2
Percentage Point Increase	2.9	4.2	5.9	3.1
94:1 to 99:1				

Note: Quarterly data on homeownership by categories shown in table were first tabulated in 1994.

Although homeownership rates for both minority groups still remain well below the average of all households, both African Americans and Hispanics experienced more rapid growth in homeownership than the general population over the past five years. The homeownership rate for African Americans increased by 4.2 percentage points, almost one and a half times more than the increase in the average homeownership rate. The homeownership rate for Hispanics increased by 5.9 percentage points, over two times as much as the average. Growth in homeownership rates for low-income households also exceeded the average for all households.

Research Findings of CRA-Related Lending

Research has identified a linkage between CRA and expanded lending in low and moderate income communities. Evanoff and Segal (1996) tested the post-1990 impact of CRA and other regulatory changes on mortgage lending to low-income individuals and areas and found that through the 1980s, growth in mortgage originations in low- and moderate-income groups lagged behind that of other groups. For four of the years in which the overall mortgage market was expanding rapidly, the low-income group showed the slowest growth and the moderate-income growth also posted below average growth. HMDA data shows significant change, however, in the 1990s. After 1991, growth was relatively faster in the two lowest-income groups, with the change "overwhelmingly statistically significant." The authors conclude that "this finding suggests that banks have responded to the CRA and have made significantly more loans in the low- and moderate-income markets," consistent with the view that banks were making a significant effort to encourage applications from those neighborhoods.

Evanoff and Segal also tested lenders'

objectivity in extending mortgages to minorities. They found that the odds that a minority applicant would be rejected for a mortgage loan over the years 1990-1995 diminished relative to the denial rates for whites. These findings led them to conclude that stricter enforcement of the CRA and fair lending laws since the early 1990s, contributed to the surge in credit both to low-income neighborhoods and to minority groups.

Avery, Bostic, Calem, and Canner (1996) also found that increased lending to low- and moderate-income borrowers relative to other groups (1992 to 1994) meant that affordable home loan programs were having an effect in metropolitan areas. In 1993 the number of conventional home purchase loans to low- and moderate-income borrowers increased by 38 percent. In contrast, the increase that year to upper-income borrowers was only 8 percent. Figures for growth in 1994 showed a similar pattern, with the number of loans extended to the lower-income groups rising by 27 percent while loans to upper-income applicants increased 13 percent. The study notes a number of factors which may have contributed to the relatively rapid increase in such lending on the part of financial institutions. Among them were newly perceived profit opportunities in previously underserved markets, a desire to enhance CRA compliance, or a determination that such lending would serve the lenders' interest in community stability.

A case study by LaCour-Little, cited by Governor Gramlich, supports the conclusion that CRA has made a significant contribution to the growth in the volume of lending to low- and moderate-income individuals in recent years.⁵ LaCour-Little analyzed lending data from 1993-97

⁵ Cited by Gramlich, op. cit.; Michael LaCour-Little, unpublished paper, May 1998.

for a large mortgage lender that uses credit scoring to screen applicants. He concluded that at least half of the loans made to low-income individuals living in low-income census tracts would not have been made if standard credit-scoring methods were the only screening criteria. He attributed to CRA the fact that loans which scored below the cut-off level were nonetheless made. Further, the data showed that CRA lending was reaching its intended target, as recipients of the low-scoring loans were more likely to have lower income, be members of a minority group, or live in a lower-income area.

Shlay (1998) confirmed that a strong CRA in the past few years has led to a climate of favorable lending patterns to minority and lower-income communities overall. A comparison of lending patterns in six cities showed that residential loan growth between 1990 and 1995 to low-income borrowers and in low-income census tracts was either comparable to or exceeded overall market trends. Lending patterns improved both for lenders with CRA agreements with communities and for those without, although gains were smaller among the latter group. Shlay attributes the widespread growth in lending to previously underserved communities as a general shift in institutional thinking, spurred by heightened recognition of new profit opportunities and increased attention to CRA ratings.

According to Federal Reserve economists Avery, Bostic, Calem, and Canner (1999), the recent wave of consolidation among banking organizations has not reduced home mortgage lending to lower-income and minority borrowers and neighborhoods.

The study found that while consolidated organizations reduced their home mortgage lending in counties in which they operated offices, they expanded their out-of-market lending by an even larger amount, and increased their proportion of loans going to lower-income and minority borrowers by more than institutions not involved in consolidations. These results, the study notes, are consistent with the view that CRA has been effective in encouraging financial institutions, particularly those undergoing consolidation, to better serve lower-income and minority borrowers and neighborhoods.

Small Business Lending

In order to help regulators evaluate a bank's CRA performance, the 1995 changes to CRA also required large commercial banks and savings associations to collect data on lending activity to small businesses and small farms within their service areas, in addition to the data already reported on home mortgages. Reporting on these markets began

in 1996, and a look at the recent data shows that "CRA appears to be a highly effective federal government program in dealing with the credit needs of low and moderate income groups."⁶

In the small business market, according to the data collected under CRA reporting, banks and thrifts made 2.4 million small business loans in 1996, amounting to \$147 billion. In 1997, 2.6 million loans were awarded with total dollar volume at \$159 billion.⁷ These loans represented two-thirds of all the small business loans made by commercial banks and savings associations in those years, and about 45 percent of loans from all sources.⁸

Roughly half of the loans reported under CRA were awarded to small businesses with revenues of \$1 million or less, and the vast majority (about 87 percent) were for amounts under \$100,000. About 485,000 loans in 1996 and 525,000 in 1997, or one-fifth of the total small business loans, went to low- and moderate-income areas.

In addition to small business loans, commercial banks made large investments in community development projects -- \$17.7 billion in 1996 and \$18.6 billion in 1997. These funds were used for multi-family affordable housing, community services, and retail and commercial revitalization in lower-income neighborhoods. In addition, data collected by the Office of Comptroller of the Currency found that from 1993 through 1998, national banks invested seven times as much in real dollar terms in community development as they did in the previous twenty-eight years.⁹

Because comprehensive data on CRA-related lending is only available starting in 1996, statistically quantifying the impact of CRA on small business and community development lending is not possible. However, many financial institutions, government regulators, community groups, and academic researchers have concluded that CRA has helped banks and thrifts discover previously unrealized market opportunities in low- to moderate-income communities. As Governor Gramlich has noted, "While many of these [small business] loans would presumably have been made without CRA, the size of the gross loan numbers and their distribution across geographical areas suggest the

⁶ Gramlich, op. cit.

⁷ Federal Financial Institutions Examination Council, 1998.

⁸ Canner, 1999.

⁹ Office of the Comptroller of the Currency, 1999.

importance of CRA in the process. There is also a great deal of anecdotal evidence, contained in periodic reports of the Federal Reserve Banks, of the success of various CRA community lending programs.¹⁰

According to the 1998 Federal Reserve Board's *Report to the Congress on the Availability of Credit to Small Businesses*, many financial institutions have aggressively expanded small business lending in connection with community reinvestment programs. Bankers have indicated that identifying new marketing opportunities and redesigning their products and services to increase lending to underserved segments of the small business community are important outcomes of the new CRA reporting requirements. For the first time, financial institutions have accurate information on the geographical distribution of small business loans, and can better tailor their products to meet the needs of the various segments of the small business market.

While CRA has been viewed as effective in encouraging banks undergoing consolidation to expand their home mortgage lending in low- and moderate-income markets, research results on the effects of bank mergers and acquisitions on small business lending are more mixed. Bank consolidation has reduced the number of small banks and consequently led small business owners increasingly to turn to large banks for credit. These banks typically rely on strictly objective lending criteria such as credit scoring in order to reduce the high transactions costs typically associated with small loans. Large banks are also less likely to make relationship or "character" loans. As a result, some empirical evidence shows that small business credit appears to decline when smaller banks merge with larger ones. This pattern was most notable for lines-of-credit loans. At least, the loan search and transaction costs for a small business to obtain a loan have been shown to be higher.¹¹

Other studies of the effects of consolidation have reached the opposite conclusion, finding that credit scoring does not restrict the total amount of credit extended to low- and moderate-income areas overall. That result may be related to the expansion of lending by credit-scoring banks to low-income borrowers outside of their local area, as the Avery et al. paper found for the mortgage market. One study reported that within their local service area, banks that credit score have a smaller share of loans in low-income tracts than local banks that do not credit

score, indicating that "relationship banking may still be the best way to reach small businesses in low-income areas."¹²

Lending and Profitability

Available evidence suggests that CRA lending has been expanded consistent with safe and sound banking practices. Banks report strong performance of loans in the low- to moderate-income housing market. For example, Bank of America in San Francisco has profitably lent more than \$10 billion as part of its Neighborhood Advantage program -- a system of low- and moderate-income home loans -- to borrowers throughout the western United States.¹³ BankBoston lent \$140 million to low- and moderate-income borrowers and found performance to be no different than in its regular mortgage portfolio.¹⁴ From 1996 through 1998, Chase Manhattan Bank financed the development of more than 1.6 million square feet of commercial space and the development of 20,271 units of affordable housing to benefit the stability, growth and economic expansion of lower-income communities. Chase Manhattan Bank "made these loans at market rate and found these activities to be a profitable business for Chase and the performance of these loans to be excellent."¹⁵ First National Bank of Chicago found that by increasing the availability of its consumer and mortgage lending products, and introducing flexible underwriting criteria, the bank's penetration in low- and moderate-income community markets grew.¹⁶ According to Federal Reserve Chairman Alan Greenspan, "there is little or no evidence that banks' safety and soundness have been compromised by [low- and moderate-income] lending and bankers often report sound business opportunities."¹⁷

Banks have also partnered with Community Development Financial Institutions (CDFIs) as an effective way of making loans in low-income neighborhoods. CDFIs are specialized local financial institutions serving low-income communities. CDFIs may include banks, thrifts,

¹² Padhi, Srinivasan, and Woosley, 1999.

¹³ Cited by Secretary Robert E. Rubin, at the National Community Reinvestment Coalition Annual Conference, March 19, 1998.

¹⁴ "Success in Community Development Lending: 33 Examples from around the Country", The Federal Reserve Bank of Philadelphia, 1993.

¹⁵ *Chase Community Development Success Stories*, 1998.

¹⁶ "Community Reinvestment Advocates", The Federal Reserve Bank of Philadelphia, 1993, p. 19.

¹⁷ Los Angeles, California, January 1998.

¹⁰ Gramlich, op. cit.

¹¹ Haynes, Ou, and Berney, 1999.

credit unions, revolving loan funds, venture capital or micro-enterprise funds that share the mission of serving unmet credit and financial services needs in these communities. According to Marisco (1995), CDFIs have the expertise and local market knowledge necessary to meet community credit needs. They are often well positioned to evaluate the creditworthiness of low-income applicants and to provide loan counseling.¹⁸ These partnerships may lower information costs for banks, enabling them to make profitable, sound CRA loans.¹⁹ In addition, partnerships with Neighborhood Housing Service organizations, which have reported a significant increase in investments since the new CRA regulations have taken effect, have helped nearly 16,000 Americans own their own homes for the first time.²⁰

In 1996, a survey of 600 large financial institutions active in single-family lending in metropolitan areas found that 98 percent said CRA lending was profitable and that credit risk was manageable.²¹ Federal Reserve Board roundtable discussions with lenders of affordable home lending programs showed that participants viewed costs of origination and servicing of these loans as higher but delinquency and default rates no worse.²² Statistical analysis did not find any notable relationship between bank profitability and the level of lower-income mortgage lending. The lenders noted that increased risks can be mitigated through the use of flexible underwriting guidelines, buyer education, credit counseling, and early delinquency intervention. Similarly, a study by Bear Stearns found that CRA home mortgage loans had low prepayment risk for investors, and borrower credit scores (and risk) were consistent with conventional

financing guidelines.²³

The Office of the Comptroller of the Currency found that risk management techniques can be successful in reducing delinquency rates of affordable mortgage portfolios to levels that are comparable to conventional residential mortgage portfolios.²⁴ Delinquencies in affordable mortgage portfolios averaged 4 percent in 1996 compared to 3 percent for residential real estate portfolios as a whole. Most of the disparity was in banks new to the affordable lending market, while banks that had been in the business for several years had developed strategies for reducing delinquencies, such as pre-purchase counseling, rapid response intervention programs, and a limit to the layering of risk factors. These techniques helped to improve loan performance to a level consistent with conventional mortgage loans.

Federal Reserve Board and other studies consistently reaffirm the OCC conclusions. One study examined the net operating income of commercial banks that vary in the extent to which they provide home-purchase loans to lower-income borrowers or in lower-income neighborhoods, and found that banks that are active lenders in these markets do not have any lower profitability than other mortgage-oriented commercial banks.²⁵ Lenders were compensated for the higher costs of low-income lending through the adjustment of interest rates or fees for the credit risk of the particular loan products.

Barriers to Capital

As demonstrated, CRA can be an effective tool for expanding credit opportunities, and hence economic development, to its targeted communities. However, market imperfections in the supply of credit persist, highlighting the continuing importance of a CRA-type mechanism for both the business and home mortgage markets.²⁶ In addition to empirical

¹⁸ See also Calomiris et al. (1994), who argue that support for community development banks is an effective policy response to discrimination in credit markets.

¹⁹ For example, five local banks invested equity in the Louisville Community Development Bank and donated Bank Enterprise Award funds to its non-profit arm, boosting its capabilities to provide small business technical assistance. In 1998, the Community Development Bank was recognized by the Small Business Administration for providing more loans to African Americans than any other bank in Kentucky. *Courier-Journal*, Business Section, 1998.

²⁰ Michael Collins, "The Many Benefits of Home Ownership", Neighborhood Reinvestment Corporation, November 1998.

²¹ Meeker and Myers, 1996.

²² Avery, Bostic, Calem, and Canner, 1996.

²³ Bear Stearns, "Securities Backed by CRA Loans: A New Product for Mortgage and Asset-backed Investors", October 2, 1997.

²⁴ OCC Advisory Letter 97-7, July 23, 1997.

²⁵ Canner and Passmore, 1997.

²⁶ Many of the studies in this section refer to racial rather than neighborhood disparities in lending. However, the effects of the racial or ethnic composition of the neighborhood are difficult to separate from the race or ethnicity of the individual borrower since the two tend to be highly correlated, and in many instances indirect neighborhood effects can be surmised from the direct racial effects.

evidence discussed more fully below, economic literature provides theoretical support for CRA by identifying some of the market imperfections which may impede equal access to capital for credit-worthy borrowers.

The theoretical studies, such as those by Beshouri and Glennon (1996) and Calomiris et al (1994), argue that government intervention may be required in circumstances where there is concentration or imperfect competition between lenders serving a region. The presence of uncertainties or the lack of information may lead to missed opportunities for profitable lending as well. If lenders are uncertain about the profitability of lending in low-income or minority neighborhoods, but acquiring information about such opportunities involves some cost, lenders may forego or postpone such lending even if at some point in the future it may be potentially profitable. Also, since information has the properties of a public good, individual lenders may invest considerably less in researching such possibilities than they would if they could permanently retain the rights to such information. This would be particularly true for institutions that do not have prior experience in minority or low-income markets and thus may find assessing the creditworthiness of minority borrowers relatively difficult. Altering the incentives of competing lenders through regulations such as CRA, these authors argue, can effectively induce lenders to incur such costs, thereby leading to a benefit for the community as a whole as well as for similar communities elsewhere.

Barriers to Business Credit

Although data on CRA-related lending in 1996 and 1997 showed a large volume of small business loans to low- and moderate-income areas, the same data reveal that the number of loans per business and the aggregate dollar amount of loans per business were smaller in low-income areas than in upper-income neighborhoods.²⁷ In 1997, the loan-to-business ratio in upper-income areas was roughly 40 percent greater than the ratio in low-income areas. The disparity in the aggregate dollar amount of loans relative to the number of businesses in the area was somewhat narrower, due to a higher concentration of larger businesses (such as manufacturing plants) in low-income tracts.

Lack of financial assets and access to credit are often cited as among the primary barriers to the expansion and success of minority self-employment and minority-owned businesses. Minority

enterprises represent a small share of the business community, accounting for just 11.4 percent of all firms and six percent of total business receipts in 1992 despite the fact that minorities represent one-fourth of the U.S. population. While African Americans accounted for approximately 12 percent of the population in 1992, African American-owned businesses represented 3.6 percent of all businesses that year and accounted for just 1 percent of all business receipts. A study of self-employment trends since 1910 (Fairlie and Meyer, 1997) found that white workers were three times as likely to be self-employed as were African American workers.

Of 200 minority business owners responding to a 1998 survey by the Organization for a New Equality (O.N.E.), 89 percent had applied for a bank credit product, but fewer than half of the applicants (43 percent) had ever received a product.²⁸

Numerous studies reveal that minority-owned small businesses face greater obstacles in obtaining credit than do other businesses. Bates (1991, 1997) found that after controlling for net worth, education, age, and other factors, African Americans get smaller bank loans than whites who possess identical traits. Further, the smaller loans made to African American-owned businesses contributed to higher failure rates. After adjusting for the smaller loan size that is associated solely with being African American, the predicted number of African American firm failures drops to a rate that is close to the failure rate for white firms with otherwise similar characteristics. According to Bates, the reason African Americans receive smaller loans is rooted in both low household wealth, and an inability to leverage equity capital and human capital because of discriminatory lending patterns. All other things being equal, African Americans were able to borrow an extra \$0.92 worth of debt for every dollar of equity, while whites were able to borrow \$1.17. Human capital variables such as education and managerial experience were significant determinants of loan size for whites but not for African Americans; in other words, African Americans were unable to leverage their college credentials when applying for a loan to finance a small business.

A study by the Woodstock Institute (Immergluck, 1998) using CRA data found that loan marketing and originations for small business lending is consistent with explanations of discrimination or redlining. After controlling for industrial mix, firm size, and firm population, Immergluck found that lower-income and minority

²⁷ Federal Financial Institutions Examination Council, 1998.

²⁸ *Scoring with Minority Owned Business: Closing the Credit Gap*, 1998.

areas (particularly Hispanic) suffer from lower lending rates than higher-income and white neighborhoods. Wells Fargo Bank (1997) sponsored a study that demonstrated that Hispanic business owners are far less likely than non-Hispanic owners to have the business capital they need. Moreover, Hispanics are rejected far more often for financing compared with non-Hispanics.

According to a study based on data from the 1993 National Survey of Small Business Finances (Blanchflower, Levine, and Zimmerman, 1998), African American-owned firms are more than twice as likely to have a loan application rejected than white-owned firms (66 percent versus 27 percent), while the rejection rate for Hispanic-owned firms (36 percent) is about one-third higher. Even after controlling for a large number of characteristics, including location, African American-owned firms in particular are substantially more likely to be denied credit. All other things equal, the likelihood of loan denial is 26 percent higher than for white-owned firms. For African American owners with no history of credit problems the increased likelihood is still 24 percent. In addition, African American-owned businesses pay one percentage point more in interest, even for firms with good credit histories. The authors conclude that African Americans face a significant disadvantage in the market for small business credit that does not appear to be due to differences in creditworthiness or geography.

The study also found that African American and white-owned firms with similar financial and other characteristics differed widely in only one area when asked about the major business problems they faced, and that was in access to capital. This result mirrors evidence from other surveys. For example, the Census Bureau's 1992 *Characteristics of Business Owners Survey* found that African American and Hispanic-owned firms reported stronger negative impacts from credit market conditions and a lack of financial capital than white-owned firms.

Blanchflower et al. note that the results of their study may be biased toward finding too *small* a disparity in lending rates, since minority-owned firms that actually apply for credit may represent a selected subsample of the most creditworthy. Some existing firms did not apply for a loan, although credit was needed, for fear that their application would be rejected. African American-owned firms were 44 percentage points more likely to cite this, and Hispanic-owned firms 22 points more likely. After adjusting for credit factors, a gap of 26 and 15 points still remained.

In another study, the Greenlining Institute also found evidence that minority business owners are more likely to be discouraged about obtaining credit.²⁹ Their survey of minority firms in Orange and Los Angeles counties revealed that three-quarters of minority-owned firms do not even bother to apply for business loans or lines of credit because they are convinced that banks have little to offer them or will reject their application.

Barriers to Mortgage Credit

Although relative lending rates for low-income and minority borrowers have improved dramatically, wide disparities persist. Munnell et al. (1996) showed that even after controlling for wealth, credit histories, loan-to-value ratios, and other factors affecting the mortgage loan decision, a statistically and economically significant gap between white and minority rejection rates remained.

Their results showed that African American and Hispanic mortgage applicants in the Boston area face a probability of denial that is roughly eight percentage points higher than that facing a white individual with the same economic characteristics.

A number of other studies confirmed the results from the Munnell et al. study and an earlier version.³⁰ Carr and Megbolugbe (1993) used adjusted data from Munnell et al., plus supplementary information on credit risk, and found clear statistical evidence of differential treatment, with minorities receiving systematically lower credit ratings. Using a model similar to Munnell et al. to evaluate the Boston and Philadelphia markets, Schill and Wachter (1993) also found that since individual risk characteristics may be highly correlated with neighborhood risk characteristics, the evidence on individual lending patterns was consistent with redlining and discrimination.

Tootell (1996) reached similar conclusions about neighborhood discrimination. His study found evidence of discrimination based on the race of the applicant, and notes that the racial composition of the neighborhood is highly correlated with the race of the applicant. His evidence further suggests the existence of redlining because there is a higher

²⁹ Lee Romney, "Survey Suggests Need for Reform in Inner-City Lending", *Los Angeles Times*, Business Section, p.1, December 17, 1998.

³⁰ In addition to those described above, many other researchers find that housing discrimination is still a common problem for minorities. See, for example, Avery, Beeson, and Sniderman (1996); Ladd (1998); and Yinger (1996, 1998).

chance that private mortgage insurance (PMI) will be required in minority neighborhoods, even after controlling for the economic and personal variables of the applicant, thereby raising the cost of borrowing. An applicant rejected for PMI is usually rejected for a mortgage, while if PMI is required and approved, the cost of the loan is higher.

Another report (Canner, Gabriel, and Woolley, 1991) concludes that after controlling for default risk, minority households are less likely to obtain conventional financing than white households. Minorities with the same demographic and economic characteristics as white borrowers are approximately three-fifths as likely as their white counterparts to get a conventional loan, while white borrowers with the same characteristics as minority borrowers are 2-1/2 times as likely to obtain such loans.

Critiques of CRA

Many of the negative reviews of CRA in the literature seem to have their foundation in an article by Macey and Miller (1993), which, the authors acknowledge, was dependent on "impressionistic evidence" rather than on empirical work based on thorough statistical testing. The authors' main criticisms are first, if there were profitable lending opportunities within a community, banks would seek them out on their own. Second, they argue that the CRA burden is not equally shared. CRA imposes a "tax" on some types of financial institutions (banks and saving associations) and not others (pension funds, credit unions, mortgage banks, etc.); and banks that have few retail operations (such as wholesale and trust banks) find compliance difficult. They also contend that banks located within economically depressed areas have more responsibilities and costs than other banks, discouraging banks from expanding to these areas. Third, according to the authors banks cannot comply with CRA without sacrificing profit and safety, because CRA loans are less profitable on average than other loans, and banks are forced to adopt high loan-to-value ratios, low-cost checking, and other practices that have a higher degree of risk. Further, CRA puts up obstacles to mergers and acquisitions, impeding the efficiency of the banking system. Fourth, they assert that CRA raises costs. Direct costs of compliance are high and excessive documentation is required because the CRA ratings are inexact and subjective, they contend, and indirect costs also arise from the public relations campaigns that banks have to wage in order to convince community groups not to challenge their merger applications.

Bierman, Frasar, and Zardkoohi (1994)

followed up with a paper specifically designed to test Macey and Miller's conclusions with actual data. They found that banks with high CRA ratings did have significantly lower interest income, which the authors equate to a measure of bank profitability. They argue that this conforms with Macey and Miller's contention that institutions subject to CRA are at a competitive disadvantage. However, other tests of loan performance in the Bierman et al. study, as well as those undertaken by the Federal Reserve and the OCC, do not support the Macey and Miller contention that CRA lending is less safe. In fact, loans made by banks that have high CRA ratings were not found by the authors to be any riskier than those made by low-rated banks.

The Macey and Bierman analyses were performed before the 1995 reform of the CRA enforcement system was put into place. As explained above, those reforms transformed the somewhat vague criteria into evaluations based on actual performance. The examination process was also streamlined, particularly for small banks, to make compliance less burdensome. A recent analysis by the banking regulators estimated that small banks spend only 10 hours per year on CRA record keeping and reporting requirements.³¹

Another critique by Lacker (1995) argues that evidence of market failure in neighborhood lending or of redlining by banks is inconclusive. According to Lacker, CRA thus becomes a redistributive program, transferring resources to low-income neighborhoods by imposing a "tax" on banks and savings associations. When the law was enacted in 1977, bank charters conveyed numerous benefits; however, Lacker argues that the banking environment and technology have changed substantially since then, eroding the advantages of banks relative to nonbank competitors. He argues that banks now compete with non-bank lenders and that the CRA is an unfair burden. However, Lacker offers no evidence that the burdens of the bank charter outweigh its benefits, including deposit insurance, access to the Federal Reserve Board's discount window, and other services, and as noted above, evidence of continued barriers to capital is well documented in numerous other studies.

A further review of the Macey and Miller arguments was conducted by Hylton and Rougeau (1996). They provide theoretical arguments refuting several of the major arguments against the CRA but supporting several others. For example, they show that there are circumstances where banks will miss

³¹ 1999 Paperwork Reduction Act findings released by banking regulators, June 1999.

REFERENCES

- Avery, Robert B., Patricia E. Beeson, and Mark S. Sniderman, "Accounting for Racial Differences in Housing Credit Markets", in John Goering and Ron Wienk, eds., *Mortgage Lending, Racial Discrimination, and Federal Policy*, 1996, Washington, D.C.: Urban Institute Press, pp.75-142.
- Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages", *Federal Reserve Bulletin*, July 1996, Vol. 82, No. 7, pp. 621-648.
- Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act", *Federal Reserve Bulletin*, February 1999, Vol. 85, No. 2, pp. 81-102.
- Bates, Timothy, "Commercial Bank Financing of White- and Black-Owned Small Business Startups", *Quarterly Review of Economics and Business*, 1991, Vol. 31, No. 1, pp. 64-80.
- Bates, Timothy, "Unequal Access: Financial Institution Lending to Black- and White-Owned Small Business Startups", *Journal of Urban Affairs*, 1997, Vol. 19, No. 19, pp. 487-495.
- Beshouri, Christopher P. and Dennis C. Glennon, "CRA as Market Development or Tax: An Analysis of Lending Decisions and Economic Development", *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1996, pp. 556-585.
- Bierman, Leonard, Donald R. Frasar, and Asghar Zardkoohi, "The Community Reinvestment Act: A Preliminary Empirical Analysis", University of California, *Hastings Law Journal*, Vol. 45, March 1994.
- Blanchflower, David G., Phillip B. Levine, and David J. Zimmerman, "Discrimination in the Small Business Credit Market", *National Bureau of Economic Research Working Paper*, No. 6840, December 1998.
- Bostic, Raphael W. and Glenn B. Canner, "New Information on Lending to Small Businesses and Small Farms: The 1996 CRA Data", *Federal Reserve Bulletin*, Vol. 84, Jan. 1998, No. 1, pp. 1-21.
- Calomiris, Charles W., Charles M. Kahn, and Stanley D. Longhofer, "Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor", *Journal of Money, Credit, and Banking*, Vol. 26, August 1994, No. 2, pp. 634-674.
- Canner, Glenn B., "Evaluation of CRA Data on Small Business Lending", paper presented at the Federal Reserve's "Conference on Business Access to Capital and Credit", Washington, D.C., March 1999.
- Canner, Glenn B., Stuart A. Gabriel, and J. Michael Woolley, "Race, Default Risk and Mortgage Lending: A Study of the FHA and Conventional Loan Markets", *Southern Economic Journal*, Vol. 58, July 1991, No. 1, pp. 249-262.
- Canner, Glen and Wayne Passmore, "The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks", Federal Reserve Board *Finance and Economics Discussion Series* draft 1997-7, January 1997.
- Canner, Glenn B. and Wayne Passmore, "Residential Lending to Low-Income and Minority Families: Evidence from the 1992 HMDA Data", *Federal Reserve Bulletin*, February 1994, Vol. 80, No. 2, pp. 79-108.
- Carr, James H. and Isaac F. Megbolugbe, "The Federal Reserve Bank of Boston Study on Mortgage Lending Revisited", *Journal of Housing Research*, 1993, Vol. 4, No. 2, pp. 277-314.

Cole, Rebel A. and John D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 1993 National Survey of Small Business Finances", *Federal Reserve Bulletin*, July 1995, Vol. 81, No. 7, pp. 629-667.

Evanoff, Douglas D. and Lewis M. Segal, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending", Federal Reserve Bank of Chicago, *Economic Perspectives*, Nov./Dec. 1996, pp. 19-43.

Fairlie, Robert W. and Bruce D. Meyer, "Trends in Self-Employment Among White and Black Men: 1910-1990", University of California Santa Cruz Working Paper, 1997.

Goering, John and Ron Wienk, eds., *Mortgage Lending, Racial Discrimination, and Federal Policy*, 1996, Washington, D.C.: Urban Institute Press.

Haynes, George W., Charles Ou, and Robert Berney, "Small Business Borrowing from Large and Small Banks", paper presented at the Federal Reserve's "Conference on Business Access to Capital and Credit", Washington, D.C., March 1999.

Hylton, Keith N. and Vincent D. Rougeau, "Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act", *Georgetown Law Journal*, Vol. 85, No. 2, December 1996.

Immergluck, Daniel, "Intrametropolitan Patterns of Small Business Lending; What Do the New Community Reinvestment Act Data Reveal?", *Urban Affairs Review*, 1998, forthcoming.

Kim, S. and G. Squires, "Lender Characteristics and Racial Disparities in Mortgage Lending", *Journal of Housing Research*, 1995, Vol. 6, pp. 99-113.

Lacker, Jeffrey M., "Neighborhoods and Banking", Federal Reserve Bank of Richmond, *Economic Quarterly*, March 1995.

Ladd, Helen F., "Evidence of Discrimination on Mortgage Lending", *Journal of Economic Perspectives*, Vol. 12, Spring 1998, No. 2, pp. 41-62.

Macey, Jonathan R. and Geoffrey P. Miller, "The Community Reinvestment Act: An Economic Analysis", *Virginia Law Review*, Vol. 79, No. 2, March 1993.

Marisco, Richard D., "Fighting Poverty Through Community Empowerment and Economic Development: The Role of the Community Reinvestment and Home Mortgage Disclosure Acts", *New York Law School Journal of Human Rights*, Spring 1995, Vol. 12, pp. 281-309.

Meeker, Larry and Forest Myers, "Community Reinvestment Act Lending: Is it Profitable?", Federal Reserve Bank of Kansas City, *Financial Industry Perspectives*, December 1996, pp. 13-35.

Munnell, Alicia H., Geoffrey M. B. Tootell, Lynn E. Browne, and James McEneany, "Mortgage Lending in Boston: Interpreting HMDA Data", *American Economic Review*, 1996, Vol. 86, No. 1, pp. 25-53.

Office of the Comptroller of the Currency, "Home Mortgage Lending in 1996: An Analysis of Home Loan Growth to Minorities and Denial Rate Patterns", March 31, 1998.

Padhi, Michael, Aruna Srinivasan, and Lynn W. Woosley, "Credit Scoring and Small Business Lending in Low- and Moderate-Income Communities", paper presented at the Federal Reserve's "Conference on Business Access to Capital and Credit", Washington, D.C., March 1999.

Schill, Michael H. and Susan M. Wachter, "A Tale of Two Cities: Racial and Ethnic Geographic Disparities in Home Mortgage Lending in Boston and Philadelphia", *Journal of Housing Research*, 1993, Vol. 4, No. 2, pp. 245-276.