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# The Community Reinvestment Act at a Crossroads

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Redlining, or the denial of services based on neighborhood, is pernicious. The practice thwarts opportunities for growth and leaves economic value on the table. The Community Reinvestment Act (CRA), passed in 1977, was, on balance, a successful legislative response to that societal failure. CRA focused policy makers, supervisors, and bankers on under-served, yet profitable, neighborhoods. Everyone worked up a learning curve and benefited as a result.

The success was incomplete and came with significant costs. Moreover, those costs have increased over time as the structure of markets has evolved. The Congress recognized it was aiming at a moving target in revisions to the Act in 1989, 1995, and 2005. Given that many aspects of financial regulation have been put into legislative play, it is appropriate to reconsider how best to achieve the mission of CRA.

To do so properly requires examining four widely recognized problems with CRA.

First, CRA was designed with a “hydraulic” view of banking. Deposit funds generated in particular locales were leaking out because of an unwillingness of bankers to lend. CRA was to act as the catch basin to keep those funds within the community. That was a flawed view even in 1977 and is far more out of sync with today's reality. Banks have a nationwide footprint, offer a wide array of products and services, and compete with many nonbank financial institutions. Their workplace is the world, not the neighborhood.

Second, far more lending decisions are made off bank premises, whether by intermediaries such as mortgage brokers or on the internet. CRA's scope, therefore, is too narrow. It is important to recognize that this declining bank share is not entirely driven by technology. Rather, compliance costs associated with CRA and other bank regulations give non-bank providers a decided competitive edge. Indeed, some banks themselves spun off those activities to more lightly regulated entities. Mortgage brokering, for instance, ran under the radar screen of regulation to offer more varied products to poor communities. Some of that innovation tipped over into predation, producing mortgages that served brokers' self-interest by increasing lending volume and not the interests of borrowers or lenders. That is why studies have found that CRA-related lending fared relatively better during the financial crisis. But that is incomplete. Competition also created a vicious circle in which the remaining regulated entities in under-served areas had to stretch standards further to keep up their market shares to bolster their CRA scores. Thus, CRA probably contributed to the general worsening of standards.

Third, CRA gives broad goals without detailed requirements about how to achieve them. This leaves much to the discretion of supervisory agencies, much to their delight. But experience has shown that agency attention to such matters swings like a pendulum pushed indirectly by elections.

Fourth, enforcement of CRA is event-driven, really only coming into play in

advance of potential changes in ownership. As a consequence, bank management is especially vulnerable to interest groups that might lodge protests during the merger-approval process. Rather than changing their ways, bankers sometimes find it easier to pave the way by token support of advocacy groups. Indeed, research indicates that banks that grow faster tend to score better with CRA compliance. This is consistent with the view that regulatory approval of expansion is a convenient means of extracting contributions to community advocacy groups.

CRA is at a crossroad. The wrong path would be to increase the scale and scope of regulation to address CRA's apparent flaws. The efficiency loss for the U.S. economy could be considerable. A more productive route is to recognize its design flaws.

First, CRA was written when finance was a brick-and-mortar industry. In this century, banks are less important and lending opportunities are far more varied. Applying for a loan need not have a physical footprint, and that empowers borrowers.

Second, the financial crisis has shown that the mixed model of giving private entities a public purpose is a catastrophic failure. The wreckage includes the reputation of the rating agencies and the status of the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. By all means, make financial institutions pay for the federal safety net. But do it a transparent manner through a risk-based fee. Giving bankers diffuse goals that are only episodically relevant is a very

inefficient means of extracting a quid pro quo for protection and helping the underserved.

Third, CRA is one part of the government's overall policy of subsidizing housing. A short, and incomplete, list includes the tax-deductibility of mortgage interest, the subsidies to the GSEs, and their affordable loan limits. Collectively, this support helped inflate the housing bubble and made its bursting more severe. By construction, if the government over-subsidizes one activity, then it is disadvantaging others. The fundamental problem is that avenues for wealth creation in America are limited for lower-income households. As a nation, we funnel families toward housing, leaving them under-diversified and often over-levered. The Congress would be better served by expanding opportunities to build capital, including though support of small businesses and increased incentives for equity ownership.

If the Congress decides to continue its support of home ownership, there is a better path than building up the already-rickety structure of CRA. For example, consider four steps. Price the federal safety net so there is an explicit quid pro quo for any protection to financial firms. Use some of those proceeds to subsidize the purchase of mortgage insurance for eligible families in designated areas. Educate those households to opportunities to apply for mortgage loans in cyberspace. Enforce the existing equal opportunity laws if any of those who apply are wrongfully refused.

The problem lies not with the mission of CRA but rather in its execution.