Remarks before the House Financial Services Committee: "Proposals to Enhance the Community Reinvestment Act"

September 16, 2009

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Chairman Frank, Ranking member Bachus, and members of the committee; my name is Michael Stegman. I am the Director of Policy and Housing for the John D. and Catherine T. MacArthur Foundation. Prior to joining the Foundation in 2005, I was a professor of public policy at the University of North Carolina where I taught courses in housing policy and community development finance for 40 years, and conducted extensive research on these issues. I have also held senior policy positions at the Department of Housing and Urban Development during the Carter and Clinton Administrations, the latter as Assistant Secretary for Policy Development and Research under Secretary Henry Cisneros.

While an employee of MacArthur, the opinions I express this morning are my own and not necessarily those of the Foundation. I appear as a long-term student of the Community Reinvestment Act who believes there is solid evidence that this legislation has been directly responsible for increasing lending for low-income home purchase and in Chairman Bernanke's words, serving "as a catalyst, inducing banks to enter under-served markets that they might otherwise have ignored".[1] In my view, an enhanced CRA should continue to play a prominent role in expanding the provision of mortgage credit and financial services in

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[1] See, among others, Ben S. Bernanke, The Community Reinvestment Act: Its Evolution and New Challenges, (prepared text) before the Community Affairs Research Conference. *2007-03-30. p. Federal Reserve System (FRB).* http://www.federalreserve.gov/newsevents/speech/Bernanke20070330a.htm*;* National Community Reinvestment Coalition, NCRC Documents Trillions of CRA Dollars in Communities since 1977, February 15, 2006***;*** Liz Laderman, Has the CRA Increased Lending for Low-income Home Purchases?; Federal Reserve Bank of San Francisco, *FRBSF Economic Letter, June 25, 2004****;*** Litan, Robert E.; Nicolas P. Retsinas, Eric S. Belsky, Susan White Haag, The Community Reinvestment Act After Financial Modernization: a Baseline Report, U.S. Treasury, April 2000. http://www.treas.gov/press/releases/docs/crareport.pdf; Barr, Michael S. Credit Where it Counts: The Community Reinvestment Act and its Critics***, New York University Law Review,*** 80: 513, May 2005.

underserved market in the new financial regulatory system that will emerge over the coming months and years.

I begin my remarks by adding a personal note to Fed Reserve Governor Kroszner's public statement that based on staff analysis; there is no empirical basis to implicate the CRA in the subprime crisis.[2] The personal note is that in all my professional experience, I have never come across a CRA-mortgage program whose underwriting guidelines didn't require certification of borrower income; or that employed deeply discounted teaser rates whose payments were guaranteed to "explode" shortly into the loan term; or that enabled the low- or moderate-income borrower to decide for herself what her monthly loan payments would be, and allowed deep negative amortization. In fact, most CRA programs with which I am familiar also required escrow accounts to assure the borrower's timely payment of real estate tax and insurance obligations.

This is why respected research confirms that CRA-driven mortgage portfolios outperformed other market segments in recent years. A case in point is research that my UNC colleagues and I have conducted over much of the past decade that is tracking the performance of a $4.5 billion portfolio of nearly 50,000 CRA-loans originated by 36 lenders across the country. Absent a CRA-driven motivation for originating these prime loans, most of the low and moderate-income borrowers we are following would not have qualified for any type of mortgage, or if they did, they would have been relegated to the subprime or toxic sectors. Our research finds that after controlling for loan vintage, origination date, borrower, credit, and loan characteristics, the estimated cumulative default rate for a comparable group of subprime borrowers was about 3.5 times higher than that experienced for borrowers in our CRA portfolio. In outperforming other types of mortgage investments, CRA portfolios may have served as a stabilizing factor for many covered institutions.

[2] Randall Kroszner, The CRA and the Recent Mortgage Crisis, in Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, Federal Reserve Banks of Boston and San Francisco, February 2009.

Next, I will comment on the ongoing discussion of policy rationale for imposing community reinvestment requirements on covered institutions. The most common policy rationale is grounded in institutional receipt of federal deposit insurance and related charter benefits. While this is a powerful argument in its own right, and the one frequently cited for expanding coverage based upon the extension of FDIC insurance to an array of Wall Street investment firms, I believe there is an even more compelling argument for extending CRA requirements to the vast majority of all mortgage-related institutions.

I embrace former Federal Reserve Governor Lawrence Lindsey's public goods argument justifying community reinvestment obligations on financial institutions: that it is in the national interest and for the common good that in order for low and moderate income populations to fully participate in the American economy, the financial services industry must play a leading role in helping to meet their credit and financial services needs in the private marketplace.

A public goods argument recognizes the shrinking share of the mortgage market accounted for by CRA-covered loans[3], and that, absent a duty to serve that would apply to the broader financial services industry, the credit needs of underserved markets will continue to be undersupplied because the costs of providing financial services to these markets would exceed the benefits accruing to any single provider.[4]

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[3] "Over the last three decades, the proportion of loans under the CRA has continued to decline…[with data from 2006 indicating that "only ten percent of all loans are CRA-related" See, Ren S. Essene and William C. Apgar, The 30th Anniversary of the CRA: Restructuring the CRA to address the Mortgage Finance Revolution, Federal Reserve Banks of Boston and San Francisco, *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, February 2009, p. 12.

[4] Lawrence B. Lindsey, the CRA as a Means to Provide Public Goods, Federal Reserve Banks of Boston and San Francisco, Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, February 2009, pp. 160.

For financial institutions newly brought into the CRA system that lack charter-based local assessment areas, performance evaluations could be based upon the size of their book of business, and, lacking retail distribution channels, there might be a fee in lieu provision that could funnel resources to the new federal National Housing Trust Fund, or other facility or entities that help finance housing opportunities for low and moderate income families.

As we all recognize there is much about credit markets and financial services providers that has changed not only since the CRA was enacted in 1977, but even since the Clinton-era reforms. We now understand that the terms of credit are as important as the availability of mortgage finance to underserved markets; which suggests that the principle of *sustainable* mortgage and credit finance should be factored into CRA regulations; as should the notion of negative credit for institutions or their subsidiaries or affiliates that provide abusive loan products inside or outside of their assessment areas.

In addition to the proliferation of non-CRA-covered mortgage funders, there have been major changes within the existing class of covered institutions; among them being the extraordinary growth of top tier institutions due to the recent frenetic pace of mergers and acquisitions, some facilitated, orchestrated, and even partially financed by the federal government. One consequence of such greater concentration is a diminished institutional value of an ‘outstanding” CRA rating, and less frequent trigger events going forward where CRA performance is as consequential as it used to be. This state of affairs also suggests the need for different kinds of incentives to stimulate desired behaviors, such as a reduction in an institution’s FDIC or other assessment for earning an Outstanding CRA rating.

Among other things, this suggests the need for different kinds of incentives, such as reducing an institution’s FDIC assessment for outstanding CRA record.

Today, America's 10 largest CRA-covered institutions together have deposits of more than $3.1 trillion, which translates to a combined market share of 45 percent. Not only should this top tier of America's financial institutions have an obligation to meet the credit needs of their communities, they should have an additional *duty to lead* the financial services industry in the development and commercialization, and scale-up of innovative, affordable, and sustainable credit products and financial services for low income families and communities.

Just as Congress and the Federal Housing Finance Agency--Fannie Mae and Freddie Mac's new regulator--have imposed a duty to serve specified mortgage finance needs of underserved markets that are in addition to the GSEs' affordable housing goal purchase requirements, the top tier of the nation's CRA-covered institutions should have a similar duty to serve as beacons of innovation and creativity with regard to serving their underserved markets. Such an obligation could be discharged in a variety of ways (such as supporting an independent R&D facility that would conduct random-controlled trials of innovative products and services, and evaluating their costs and benefits to providers and society), and evaluated by regulators separately from their performance assessment on the existing lending, service and investment tests.

Whatever forms an enhanced CRA might take it goes without saying that the bedrock principle should be retained that no community reinvestment mandate should impair an institution's safety and soundness. Nevertheless, I would also argue that there is an important difference between requiring covered institutions to offer financial services or credit products that are unprofitable over the long-term—which the CRA does not do--versus encouraging them to offer products and services to underserved markets that may be less profitable than some other business lines (which an enhanced CRA should do).

In my many years of working on issues relating to the unbanked and under-banked, I have been told by more than one banker that they know of an innovative financial services product that was developed specifically for this market but was terminated or never brought to scale because, while potentially profitable, it failed to pass their institution's internal hurdle rate. Once again, the Federal Housing Finance Agency has addressed this issue in its proposed GSE Duty to Serve rule currently out for public comment. That rule notes that in discharging their responsibilities relating to the purchase of mortgages on housing for low- and moderate-income families it is appropriate that such activities involve "*a reasonable economic return that may provide less of a return than the Enterprises' other activities)…"*[5] CRA should be no different.

While speaking about GSEs, I would be remiss if I didn't note a problematic feature of many federal low-income housing and community development programs and regulations—their inconsistent and incompatible eligibility requirements, including conflicting income limits. This problem has historically prevented communities and affordable housing providers from creatively integrating federal housing resources such as Community Development Block grants, HOME funds, and Low Income Housing Tax Credits, with CRA-lending programs. In the GSE case, the income limits used to define affordable housing goal-eligible mortgages is significantly higher than the income threshold used for the CRA. Harmonizing these thresholds across federal programs would not only improve the efficiency and productivity of the affordable housing system, it would also facilitate GSE-purchase of CRA portfolios, thereby dramatically increasing the liquidity of CRA lenders.[6] I mention this to emphasize that in contrast to previous reform efforts, the next generation of CRA enhancements should be considered in the broader context of affordable housing finance, financial services, and asset-building policies.

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[5] FEDERAL HOUSING FINANCE AGENCY, 12 CFR Part 1282; RIN 2590–AA27 Duty to Serve Underserved Markets. for Enterprises Federal Register / Vol. 74, No. 148 / Tuesday, August 4, 2009 / Proposed Rules

[6]Statement of Judith A. Kennedy, President and CEO, National Association of Affordable Housing Lenders, on The Community Reinvestment Act , House Committee on Financial Services, U.S. House of Representatives, February 13, 2008. http://financialservices.house.gov/hearing110/kennedy021308.pdf

This need is more important today because the inevitable return to lower leverage and more conservative mortgage underwriting standards will widen the gap between housing prices and the incomes of American families well beyond that which existed during the first two decades of the CRA. This is likely to be the case even as the average housing price-to-family income ratio recedes in the post-bubble market. The average price-to-income ratio for the $4.5 billion CRA portfolio my colleagues and I started tracking in the late 1990s was about 2.6:1 at origination (an average house price of around $88,000 and an average income of about $34,000). This is about the same historical relationship between home prices and family incomes that existed when the CRA was enacted.

Nationally, this ratio remained pretty stable for more than twenty years, drifting up into the 3.5-4.0 range in some higher cost markets at the beginning of this decade. From 2005-2008, however, the ratio soared to double digits in several overheated markets, and since the bubble burst, the ratio has significantly receded toward, but not down to the historical mean.

These market dynamics are important for CRA reform because sustainable mortgage programs designed to serve even the most well-qualified low and moderate income families is likely to leave a sizable affordability gap that may only be filled with some form of subsidy. Because the CRA does not and should not require financial institutions to be the providers of gap financing or the subsidizer of last resort, modernization must be synchronized with government affordable housing programs, preferably in the form of new savings incentives, matched down-payment accounts, and other asset building programs that financial institutions can initiate or participate through partnerships with community-based organizations.

I conclude my testimony with some comments about the current three-test regime. While I acknowledge the concerns of those who argue that the Clinton-era reforms are too quantitative and restrictive to enable institutional creativity, my own research suggests that the least measurable and quantitative of the tests, the Services test, is the weakest link in the examination process. My analysis of almost 2000 CRA examinations conducted between 1996 and 2002 revealed that only 11 of 1,500 banks reviewed received a *Needs to Improve* and none earned a *Substantial Noncompliance* rating.[7] My study also found inconsistencies across regulatory agencies. The analysis suggested that the service Test was often used as a "grade inflator" to boost an institution's overall CRA rating. Underperforming banks—those on the border between a *Needs to Improve* and a *Satisfactory* rating overall—were more likely to receive higher Service Test scores than other institutions. The higher than expected Service Test scores often gave banks just enough cumulative points to eke out a *Satisfactory* rating overall. Not only is it evaluated more subjectively than the other tests, 2005 changes in the CRA which increased the asset threshold of exempt institutions means that today 88 percent of all OTS-regulated institutions and 96 percent of all FDIC-regulated institutions are now exempt from the Service Test."[8]

This makes no sense when millions of American families must replenish their savings and repair their credit records—in 2008 alone American families lost an estimated $6 trillion of housing wealth in real terms[9]. And to add insult to injury, those unfortunate enough to have lost their home in a foreclosure, also saw their credit scores fall by about 35 percent in the first year alone", making it even more difficult for them to qualify for affordable credit. "[10]

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[7] See, Michael A. Stegman, Kelly Cochran and Robert Faris, Creating a Scorecard for the CRA Service Test, Policy Brief No. 96, The Brookings Institution, Washington, DC, March 2002; p. 5.
[8] Roberto Quercia, Janneke Ratcliffe, and Michael A. Stegman, The Community Reinvestment Act: Outstanding: and Needs to Improve, Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, February 2009, p. 54.
[9] The rapidly changing landscape of the real estate market in Los Angeles and beyond, LA Land, Disappearing now: $6 trillion in housing wealth. *Los Angeles Times*, April 30, 2008.
[10] Loan.com, The Effect of a Home Foreclosure on Your Credit Report, www.loan.com/home-loans/the-effect-of-a-home-foreclosure-on-your-credit-report.htm.

This is no time to relax requirements on product development and financial services innovation. An enhanced CRA should demand performance and hold institutions accountable. They should encourage and reward financial institutions for entering into meaningful community development partnerships that deliver services at scale. It is time to drive up the volume and institutional participation in the FDIC's small dollar loan program[11]; it is no longer acceptable for a handful of credit unions to outshine major CRA-covered institutions as centers of financial services innovation.

Courtesy overdraft protection programs—which have become major profit centers for commercial banks—is not the way for mainstream banks to compete with payday lenders in the unsecured small loan market. It is time for the country's biggest banks to emulate the Salary Advance Program of the North Carolina State Employees Credit Union (SECU) which, for the past nine years has been delivering a profitable low-cost salary advance loans to its members at an annual percentage rate of 12 percent--about one-fortieth of the cost of a typical commercial payday loan or overdraft fee. This is no pilot program striving to achieve proof of concept. This is a scaled-up program for which cumulative advances of up to $500 each have been made to 110,000 members of the nation's second largest credit union, totaling more than $1.4 billion, with annual charge-offs averaging just two-tenths of one percent of dollars loaned. Unlike any other payday loan product, this one requires customers to set aside 5 percent of every advance in a separate member-owned special savings account in an effort to help reduce their future reliance on the receipt of serial short term loans. As of

[11]The FDIC's Small-Dollar Loan Pilot Program: A Case Study after One Year, FDIC: Feature Article, www.fdic.gov/bank/analytical/quarterly/2009_vol3_2/smalldollar.html.

June 2009, these account balances totaled in excess of $17 million, with more than 1600 members having each accumulated savings of over $1000.[12]

Mr. Chairman, there is no reason why this program and many others that have been pioneered by non-CRA institutions cannot be replicated by mainstream banks. A strengthened Services Test under an enhanced CRA should provide an appropriate mix of carrots and sticks that would encourage such copycat behavior.

Thank you.

[12]For more discussion of the salary advance product, see, Michael A. Stegman, Payday Lending, *Journal of Economic Perspectives*, Volume 21, No. 1, winter 2007; and, State Employees Credit Union, Salary Advance Loans, An Overview, updated through June 2009.