

20670
128318



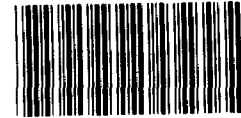
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICE OF THE CHIEF ECONOMIST

NOVEMBER 4, 1985

B-220525

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate



128318

Dear Mr. Chairman:

Subject: Difficulties in Evaluating the Effectiveness of the
Community Reinvestment Act of 1977 (GAO/OCE-86-1)

We are responding to your request that GAO perform an independent and objective evaluation of the effectiveness, economic efficiency, and equity of the Community Reinvestment Act of 1977 (CRA). After completing our survey work, we met with representatives of your office to explain the extent to which we could assess the impact of CRA on lending patterns in low- to moderate-income neighborhoods. We were able to obtain some information on CRA-related regulatory actions by those financial regulatory agencies responsible for the act's implementation and enforcement. However, we found major obstacles that we believe make it impossible to conduct a reliable evaluation of the act's economic impact. This report discusses the information that we obtained on the extent of CRA-related regulatory actions and the factors that prevented us from completing the study you requested.

COMMUNITY REINVESTMENT ACT OF 1977

CRA's primary purpose is to encourage federally regulated financial institutions to help meet the credit needs of the local communities in which they are chartered, consistent with safe and sound business operations. The act is designed to deter potentially discriminatory lending practices by these institutions. Although the act addresses the full range of credit needs in local communities, legislative hearings preceding the enactment of CRA focused on the specific issue of mortgage availability in low-and moderate-income neighborhoods.

(972121)

033675

The Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the Federal Home Loan Bank Board (FHLBB) are designated by the act as the federal financial agencies charged with implementing CRA. These agencies are required to review the records of those financial institutions they regulate to assess how well they meet local credit needs; the agencies must also consider such records when evaluating applications for deposit facilities¹ submitted by the institutions. CRA also requires these regulatory agencies to include a section in their annual reports to the Congress outlining the actions taken to carry out their responsibilities under the act.

SURVEY APPROACH AND RESULTS IN BRIEF

To obtain information on the extent of CRA-related regulatory actions, we reviewed the available annual reports of each of the four regulatory agencies responsible for implementing CRA. We did not verify the data contained in these annual reports. We also reviewed existing studies and analyses of the nature and causes of differential lending patterns by location, surveyed available data sources, and assessed factors other than CRA that may have concurrently affected the lending patterns of the financial institutions subject to CRA's provisions.

Our survey indicated the following:

- o Several analytical studies have attempted to determine whether lending institutions discriminate against certain urban neighborhoods or socioeconomic groups, particularly with respect to mortgages. The results of these studies are mixed.
- o Available data are not sufficient to determine how aggregate lending patterns have changed since the enactment of CRA. Although some limited data exist for certain types of lenders or loans, there is no consistent time series available that is comprehensive enough to conduct a reliable evaluation of CRA's impact. And measures now used to assess the extent of institutions' compliance with CRA are not available for periods of time before CRA was enacted.

¹Applications for deposit facilities are defined by CRA to include those applications otherwise required by federal law or regulations for (1) federal charters, (2) federal deposit insurance, (3) establishment of domestic branches or relocation of home or branch offices by regulated financial institutions, and (4) merger, consolidation, acquisition of assets or shares, or assumption of liabilities of financial institutions requiring regulatory approval.

- o Several factors, such as the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, have significantly affected financial institutions in the years since enactment of CRA. These factors make it impossible to establish the extent to which changes in lending patterns by location are the result of CRA, as distinct from being the result of these other factors.
- o Information reported by regulatory agencies on CRA regulatory actions indicates that relatively few CRA-related protests have been filed since CRA was enacted. Only rarely have such protests resulted in agency denials of applications for deposit facilities. In many of the protested cases, the regulatory agency and depository institution negotiated changes in lending behavior. In addition, institutions may have altered their lending behavior in response to the act in order to avoid regulatory problems.

RESULTS OF STUDIES

Since the passage of CRA, several analytical studies by community-based organizations and academic researchers have attempted to identify the extent to which lending institutions have discriminated against particular urban neighborhoods or socioeconomic groups, particularly with respect to mortgage lending. A comprehensive summary of these research results appears in a report sponsored by the National Science Foundation and the Federal Reserve Bank of Boston.² The results of these research studies are far from conclusive. With respect to mortgage loans (a major focus of CRA), the literature indicates that locational differences in mortgage availability, terms, and rates are associated with differences in several economic factors, such as default rates, loan-to-value ratios, and property appreciation rates. Thus, the literature indicates that differences in credit availability among neighborhoods or socioeconomic groups are not necessarily evidence that noneconomic bias or discriminatory lending practices exist. In addition, CRA specifically requires that its implementation be consistent with the safe and sound operation of those financial institutions subject to its provisions, yet the literature demonstrates that there are differences in many economic factors by location that affect sound business practices in a highly competitive market.

²George Benston, "Mortgage Redlining Research: A Review and Critical Analysis," Journal of Bank Research, 12(1), spring 1981, pp. 144-195. A more recent discussion of the issue can be found in James R. Ostas, "Reduced Form Coefficients, Structural Coefficients and Mortgage Redlining," Journal of the American Real Estate and Urban Economics Association, 13(1), spring 1985, pp. 76-87.

MAJOR CHANGES IN FINANCIAL MARKETS
HINDER MEASUREMENT OF CRA IMPACT

A major obstacle to measuring the impact of CRA stems from the rapidly changing environment in which financial institutions operate. Some of the major changes follow:

- o Mortgage interest rates have risen dramatically and have remained at double-digit levels since 1978. The higher level and greater volatility of rates have generated changes in the competitive behavior and lending patterns of most financial institutions.
- o The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 generated significant changes in the investment behavior of depository institutions. These acts allowed commercial banks and savings institutions to adopt a much broader variety of investment strategies and alternatives.
- o The volume of mortgages insured by the Federal Housing Administration has increased substantially since the mid-1970's as a result of the growing acceptance of mortgage-backed securities. Mortgages insured by the Federal Housing Administration or guaranteed by the Veterans Administration are much more prevalent in central-city neighborhoods, and most of these loans are originated by mortgage bankers who are not covered by CRA. The increased availability of these loans has restricted the ability of regulated institutions to market conventional loans in these neighborhoods.

Even if changes in lending behavior by location were detectable, it would be impossible to assess the extent to which they were caused by CRA and the extent to which they were caused by the more fundamental, competitive pressures introduced by the rapidly changing market conditions facing financial institutions. Separating the independent effect of CRA from the vast array of changes buffeting the financial sector of the economy in recent years is an intractable problem.

REGULATORY ACTIONS

Each of the four regulatory agencies responsible for implementing CRA (the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board) has issued regulations and provided information on its CRA-related actions in its annual report. The information available from these reports indicates that, when viewed in the context of the whole range of regulatory complaints and challenges concerning financial institutions, relatively few matters involve CRA issues.

According to the regulatory agencies, very few CRA-related complaints have been filed, and only a few requests by financial institutions for new branches, mergers, insurance, or other actions have been denied because of noncompliance with CRA. However, changes were negotiated in the lending practices of several other institutions before approvals for mergers and other actions were granted.

While the volume of specific cases that generated CRA-related regulatory actions has been small, the effects of these cases may have influenced the lending practices of other financial institutions. If so, the actual volume of regulatory actions may be a poor indicator of the impact of CRA since there is no way to assess the extent to which the existence of regulations, and even a few test cases, might have affected the operations of institutions not directly challenged on CRA grounds. Shortly after passage of CRA, the four regulatory agencies jointly developed a Uniform Interagency Community Reinvestment Act rating system that rates the extent to which financial institutions comply with CRA. The Federal Reserve Board and the Comptroller of the Currency provide ratings that show that the vast majority of banks are in compliance. However, since data needed to construct similar measures of bank activity were not gathered prior to passage of CRA, it is not possible to use these measures to assess whether compliance is better now than it was before the act. Appendix I contains a further discussion of the available data on CRA regulatory actions.

AGENCY COMMENTS AND OUR RESPONSE

We requested that the Federal Reserve Board of Governors, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board review and comment on a draft of this report. The Federal Reserve provided verbal comments; the other agencies provided written comments, which are attached as Appendix II. The comments either focused on specific technical corrections to our draft report or provided additional information on agency regulatory activity. We revised our report to incorporate these comments as appropriate.

* * * * *

In summary, we believe that it is not possible to conduct a quantitative evaluation of CRA's economic impact for the following reasons: the lack of a consistent time series on the distribution of credit with which to measure the changes since CRA's enactment, the fundamental changes affecting the nation's financial institutions that have occurred since passage of CRA, and the mortgage-lending activities of institutions not covered by CRA. We present more detailed information on CRA-related regulatory actions in Appendix I.

B-220525

We hope that the information conveyed in this report is useful to the Committee. Copies of this report will be sent to other interested parties and will be made available to others upon request.

Sincerely yours,

Lawrence H. Thompson

Lawrence H. Thompson
Chief Economist

Attachments

CRA REGULATORY ACTIONS

Although we believe it is not possible to measure the specific effects of CRA on the flow of credit into low- to moderate-income areas, it is possible to examine the extent to which regulatory agencies actually invoked CRA sanctions. Information reported by the four regulatory agencies shows few instances of consumer complaints or formal protests specifically related to CRA, and only rarely did a consumer complaint or formal protest result in an adverse regulatory action. However, in several cases, a financial institution applying for a deposit facility agreed to modify its behavior in meeting community credit needs.

Whether there are additional effects that go beyond the specific regulatory actions is a more difficult question to answer. Moral suasion or the actions involving a few financial institutions may have set a tone that materially affected the behavior of other institutions.

We discuss below the specific information on CRA-related actions reported by each of the regulatory agencies. The agency data are not consistent in terms of details of coverage or time period involved.

THE FEDERAL RESERVE

CRA designates the Board of Governors of the Federal Reserve System as the supervisory agency for state-chartered banks that are members of the Federal Reserve and bank holding companies. According to the Federal Reserve, the annual number of CRA compliance complaints from consumers or consumer groups to the Federal Reserve ranged from one to five between 1978 and 1984. To put the magnitude of formally lodged CRA complaints in perspective, table 1 lists the frequency of consumer complaints to the Federal Reserve by subject area in 1984. CRA complaints were clearly not the dominant consumer concern; they represent only one of the 2,337 complaints received that year. In 1979, there were five CRA complaints out of a total of 4,067 consumer complaints.

In addition to reporting data on consumer complaints, the Federal Reserve also reports the number of formal protests related to applications for deposit facilities lodged by either community groups or competing institutions. Of the 546 bank holding company applications subject to CRA in 1979, only seven were protested on CRA grounds. Five of those protests were lodged by consumer groups, the other two by competing institutions. After a lengthy processing period, all seven applications were approved. In two cases, the protests were withdrawn following negotiations between the applicants and the protesting organizations. In all but one of the cases the bank modified or agreed to modify its lending behavior in the future. In 1984, one consumer group complaint and two institutional complaints related to CRA were filed. In all three cases, the Federal Reserve Board approved the application after reviewing the available facts.

The Federal Reserve Board indicated that, since neither the applicant nor the community gained from a lengthy period of settlement, they streamlined their procedures over the next several years. One change introduced was a revised rating system for member banks. In 1982, the Federal Reserve examined 854 member banks for CRA compliance using the Uniform Interagency Community Reinvestment Act system. The system ranks financial institutions on a scale of 1 through 5, with 5 representing the lowest level of performance and 3 representing less than satisfactory performance. In 1982, 91 percent of the banks rated received satisfactory scores of 1 or 2. Most of those banks rated "unsatisfactory" received a rating of 3. By 1984, fewer than 2 percent of member banks failed to reach a satisfactory performance level, according to the Federal Reserve.

While CRA has resulted in very few denials of applications by the Federal Reserve, it has generated a number of informal agreements to alter lending behavior. The net effect of these agreements is summarized in a recent Federal Reserve Board staff study:

"Although the System's actions appear to have been consistent with congressional intent, the response of many applicants to pressure from community organizations and regulatory agencies has been to allocate housing-related credit to specific geographic areas. To date, this credit allocation has not been of such magnitude nor has it imposed such severe constraints that it has threatened an institution's basic safety and soundness. Inasmuch as the geographic area's allocation of funds is often the primary goal of community-based protesters, negotiated CRA settlements in the future are likely to continue to involve some elements of geographic credit allocation."¹

¹Glenn Canner, The Community Reinvestment Act and Credit Allocation, Board of Governors of the Federal Reserve, June 1982, p. 8.

Table 1

Consumer Complaints Received by the Federal Reserve System,
by Subject, 1984

Subject	Number
CRA Complaints:	
Regulation BB (Community reinvestment).....	1
Non-CRA Complaints:	
Regulation B (Equal credit opportunity).....	166
Regulation C (Home mortgage disclosure).....	18
Regulation E (Electronic fund transfer).....	80
Regulation M (Consumer leasing).....	2
Regulation Q (Interest on deposits).....	118
Regulation X (Borrowers of securities credit)....	0
Regulation Z (Truth in lending).....	461
Fair Credit Reporting Act.....	65
Fair Debt Collection Practices Act.....	10
Fair Housing Act.....	3
Holder in due course.....	3
Real Estate Settlement Procedures Act.....	2
Transfer agents.....	3
Municipal securities dealer regulation.....	2
Unregulated bank practices.....	1,351
Other.....	52
Total.....	<u>2,337</u>

Source: Federal Reserve Board of Governors

COMPTROLLER OF THE CURRENCY

The Comptroller of the Currency has the responsibility for ensuring that the approximately 4,900 national banks meet the purpose of CRA. According to data reported in its 1980 and 1981 annual reports, the Comptroller of the Currency denied very few applications for mergers or other corporate activities on the basis of poor CRA performance. When CRA violations were alleged, the Comptroller usually granted approvals after reaching an agreement with the affected banks on conditions regarding their future lending policies. In 1979, only one application was disapproved solely as a result of CRA concerns, but several others were approved with conditions designed to ensure satisfactory compliance with CRA.

Of 25 applications with potential CRA problems in 1980, none were denied. However, five conditional approvals were granted directing banks to develop plans to better meet community credit needs. In 1981, 22 cases had CRA problems; two of the applications were ultimately disapproved in whole or in part on the basis of unsatisfactory CRA performance, and four were conditionally approved.

FEDERAL DEPOSIT INSURANCE CORPORATION

The FDIC has CRA responsibility for FDIC-insured state-chartered banks and savings banks that are not members of the Federal Reserve System. CRA performance is one of several factors FDIC considers in evaluating applications for merger, branching, and deposit insurance. The competitive market structure, financial and managerial resources, and convenience and needs of the community to be served are all part of the decision process. CRA compliance is part of the evaluation of how well the depository institution serves the convenience and needs of the community.

As seen in table 2, less than 1 percent of all such applications were denied by FDIC between 1979 and 1983. In only a fraction of these cases was CRA compliance the cause of the denial. For 1979 and 1980, specific data were available in FDIC's annual reports on CRA-related denials. In 1979, 25 challenges were filed on CRA grounds, and in that year the first denial of an application on CRA grounds occurred. In 1980, six community organizations filed CRA protests involving branch applications of seven banks. Two of these applications were denied because of unsatisfactory CRA performance. From 1981 to 1983, no FDIC applications were denied on the basis of CRA performance.

Table 2

Disposition of FDIC Applications

	FDIC Applications				
	1979	1980	1981	1982	1983
Deposit insurance					
Approved	167	148	98	73	101
Denied	2	1	0	2	3
New branches					
Approved	1,434	1,307	1,321	1,171	1,009
Denied	3	5	3	3	9
Mergers					
Approved	52	79	74	108	148
Denied	1	6	1	2	5
Total applications					
Approved	1,653	11,534	1,493	1,352	1,258
Denied	6	12	4	7	17
CRA-related denials ^a	1	2	0	0	0

^aDenied in whole or in part on the basis of CRA performance.

Source: Federal Deposit Insurance Corporation

FEDERAL HOME LOAN BANK BOARD

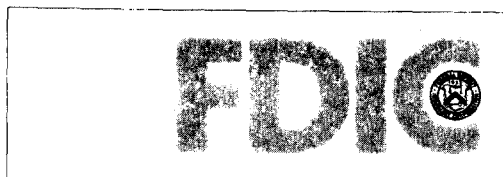
FHLBB has CRA responsibility for savings and loan associations insured by the Federal Savings and Loan Insurance Corporation and savings and loan holding companies. FHLBB considers CRA performance a factor in considering applications for mergers and acquisitions, branches, and insurance, as well as applications for permission to organize, obtain a federal charter, or relocate a home or branch office. The volume of CRA-related protests filed with FHLBB has been relatively modest; the largest number of protested cases occurred in 1980 and 1981 (table 3). In eight of the protested cases, the application was approved contingent on plans for correcting CRA deficiencies. In addition, FHLBB also identified several CRA-related concerns in the course of reviewing applications for deposit facilities. In these instances, plans were formulated to improve CRA performance as a condition for FHLBB approval of the application.

Table 3

Federal Home Loan Bank Board
Activities Related to the
Community Reinvestment Act

	1979	1980	1981	1982	1983	1984
CRA-covered applications	1061	953	474	580	912	850
CRA-related protests	4	13	15	1	7	0
Applications approved with CRA-related conditions						
from protested cases	3	5	0	0	0	0
from CRA issues raised by FHLBB	4	25	17	26	6	2
Total applications approved with CRA-related conditions	7	30	17	26	6	2

Source: Federal Home Loan Bank Board.



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR • DIVISION OF BANK SUPERVISION

September 10, 1985

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter of August 12 submitting for our review and comment a GAO draft report entitled "Evaluating the Effectiveness of the Community Reinvestment Act of 1977." In essence, the report concludes that the GAO is unable to assess the effectiveness of the Community Reinvestment Act ("CRA") because of the lack of consensus on measures of the appropriate distribution of credit consistent with the safe and sound operation of a financial institution, fundamental changes affecting the nation's financial institutions that have occurred since passage of the CRA, and the potential effects of mortgage lending activities by institutions not covered by the CRA.

We have reviewed the draft report and have no substantive comment to offer.

Sincerely,

A handwritten signature in cursive script, appearing to read "Robert V. Shumway".

Robert V. Shumway
Director



Comptroller of the Currency
Administrator of National Banks

Washington, D. C. 20219

September 11, 1985

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Receipt is acknowledged of your draft report entitled, "Evaluating the Effectiveness of the Community Reinvestment Act of 1977." We understand that the purpose of the underlying audit was to perform an objective evaluation of the effectiveness, economic efficiency and equity of the Community Reinvestment Act.

We appreciate and concur with you in the difficulties you encountered in attempting to measure the impact of the Act. However, we strongly disagree with your conclusion expressed on page 6, that "CRA has not been all that important." As your report continues, you indicate there have been relatively few CRA-related complaints from the public and denials by regulators of corporate applications on the basis of noncompliance with CRA. While this is a fair statement, it is also true, as you indicate, that compliance can be achieved by an institution's desire for approval of corporate applications. Such would argue, instead, that the statute is important, both to banks and to regulators. The number of complaints or enforcement actions might be a better indicator of the level of compliance with a statute than the importance of it.

Following are some suggested technical adjustments to the draft to increase its clarity and/or factual accuracy:

- o Page 1 indicates that the primary purpose of CRA is to encourage federally regulated financial institutions "to meet" the credit needs of local communities. The purpose instead is "to help meet."
- o Pages 3 and 6 refer to inconsistent and sporadic reporting of enforcement activities. Elaboration would be helpful to enable the regulators to determine, analyze, and correct deficiencies.

- 2 -

- o Page 7 concludes that there is a lack of consensus on measures of the appropriate distribution of credit consistent with the safe and sound operation of a financial institution. The meaning of this is unclear, as CRA does not require credit allocation or measurement thereof. Further, the regulatory agencies have agreed on a rating system used to evaluate CRA performance.
- o Appendix I, page 8 reports that you were unable to gauge credit flows into urban areas, but the report is silent as to gauging credit flows into rural areas.
- o Appendix I, page 11 should be adjusted to reflect Comptroller of the Currency supervision of approximately 4,900 national banks at the present time.

Thank you for the opportunity to comment.

Sincerely,


H. Joe Selby
Acting Comptroller of the Currency

¹ We believe that the statement referred to here may have been misinterpreted. To assure that other readers of this report do not misinterpret this statement as a GAO conclusion, the section on page 6 of the draft report (pp. 4-5 of the final report) has been rewritten.

Federal Home Loan Bank Board

OFFICE OF COMMUNITY INVESTMENT

1700 G Street, N.W.
Washington, D.C. 20552Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 5, 1985

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Thank you for the opportunity to comment on your recent report explaining why the General Accounting Office (GAO) concluded it is unable to evaluate the effectiveness of the Community Reinvestment Act (CRA). I do not believe it is appropriate for the Federal Home Loan Bank Board (FHLBB) to comment on the feasibility of the GAO carrying out a substantive evaluation of the CRA. Since this is not intended to be a substantive report, we are limiting our comments to technical corrections.

CRA requires that federal financial regulatory agencies encourage the depository institutions they regulate to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. CRA does not ask any institution to meet all the credit needs of its community, only to make a good faith effort to assist in meeting those needs, consistent with its own safety and soundness. Therefore, I suggest the first page of your report be revised to make it clear CRA addresses helping to meet credit needs, and that CRA itself does not address deposit services.

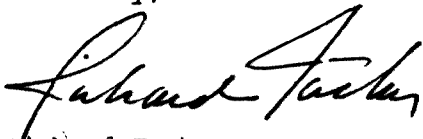
Under this Act, the FHLBB continues to consider CRA performance when evaluating certain applications. Your section on the FHLBB mentions applications for mergers and acquisitions, branches of federally-chartered institutions, and insurance of accounts. Applications to the FHLBB for permission to organize, obtain a federal charter, or relocate a home or branch office, are also covered by CRA.

-2-

Enclosed for your information is a summary of CRA-related actions in connection with such applications. The data are drawn primarily from our annual reports to Congress. There are also many other sources of pertinent information about the impact of CRA.

Please let me know if you have any other questions. Although I have limited my comments to the scope you established for this report, I will be glad to provide additional information if you decide to broaden your review of CRA.

Sincerely,



Richard Tucker
Director

Enclosure