

The Performance and Profitability of CRA-Related Lending

Report by the Board of Governors of the Federal Reserve System,
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Gramm-Leach-Bliley Act of 1999

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Introduction

Many government programs have been established to address concerns about the availability of credit to low- and moderate-income communities and borrowers and to small businesses and farms. In some cases, these programs provide subsidies or other inducements to creditors or borrowers in order to enhance lending opportunities. Other programs seek to improve consumer knowledge about the use and availability of credit. Government regulation of private-sector activities also relates to bolster such lending. Most prominently, the Community Reinvestment Act of 1977 (CRA) directs the federal regulators of federally-insured commercial banks and savings associations (banking institutions) to encourage their regulated institutions to help meet community credit needs consistent with safe and sound operations. Regulators assess each institution's record of meeting the credit needs of their entire communities, including low- and moderate-income neighborhoods, and take an institution's record in serving their community into account in evaluating applications for mergers and other transactions.¹ The CRA was enacted in response to concerns that banking institutions were, in some instances, failing to adequately seek out and help meet the credit needs of viable lending prospects in all sections of their communities.

The CRA regulations jointly issued by four federal banking agencies--the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision--place particular emphasis on an institution's record of serving the credit needs of low- and

¹12 U.S.C. §§ 2901(b), 2903.

moderate-income populations within its CRA assessment area.² For this reason, the term "CRA-related lending" as used in this report, refers to lending by banking institutions to low- and moderate-income populations, low- and moderate-income areas, and small businesses within their CRA assessment area and to lending for the purpose of community development.

Each banking institution's record of performance under the CRA is examined by the institution's appropriate federal banking supervisory agency, and its CRA performance rating is made available to the public. In addition, the CRA performance record of an institution is considered by the appropriate federal banking agency in acting on certain applications by the banking institution, including those for mergers and acquisitions of banking institutions.

Over the past decade or so, there has been a substantial increase in lending to lower-income populations and neighborhoods, populations and areas that are a main focus of the CRA.³ The increased lending likely reflects the confluence of a number of factors including changes in banking regulation and supervision; increased competition among providers of financial services; favorable general economic conditions and the growing demand for, and supply of, credit; and advances in information technology allowing more precise and less-costly evaluations of borrower creditworthiness.⁴

²See 12 CFR 228.41. See also the discussion in "Definition of a CRA-Related Loan" below.

³See FFIEC press release, July 29, 1999 and report by the U.S. Department of the Treasury, "The Community Reinvestment Act After Financial Modernization: a Baseline Report" (Department of the Treasury, 2000).

⁴Prominent among the changes in banking regulation and supervision were legislative amendments to the CRA contained in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 that required public disclosure of CRA performance ratings; 1995 revisions to the regulations that implement the CRA to make the CRA evaluation criteria more performance oriented and less subjective (see Federal Reserve press release, April 21, 1995); enhanced enforcement of the nation's fair lending laws; a relaxation of regulatory restrictions on the ability of banking organizations to establish branch offices; and a relaxation of restrictions on interstate bank acquisitions. The easing of these latter restrictions has resulted in increased opportunities for more large bank mergers and acquisitions, which have
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Banking institutions have been centrally involved in a variety of ways in much of this lending to low- and moderate-income populations and areas, as well as in lending to small businesses and small farms. Many of these institutions, particularly the larger ones, have created special units and programs to foster CRA-related lending; have developed new credit products that feature underwriting guidelines that are generally more flexible than those for other products; have established or helped sponsor programs that educate and counsel prospective borrowers; have tapped into government and other lending programs targeted to low- and moderate-income populations and small firms; and have coordinated their activities with a wide range of third parties, both private and public. In addition, many banking institutions have offered pricing incentives for these targeted loans and have instituted special procedures to mitigate the credit risk associated with such loans, including enhanced monitoring of the repayment patterns of borrowers and early intervention procedures for borrowers who fail to make timely payments.

In spite of this wealth of experience, little systematic information is publicly available about the delinquency and default (performance) and profitability of CRA-related lending activities. Developing estimates of the performance and profitability of CRA-related lending can be difficult for several reasons. First, to evaluate the performance of such loans, one must be able to identify CRA-related loans, not only at the time of origination or purchase, but also up to the point when they are paid off or default. Banking institutions often do the former but may not do the latter. Second, in determining the profitability of these loans, institutions must properly allocate all costs and revenues, including overhead. These calculations are often complex.

⁴(...continued)
drawn considerable public attention and scrutiny regarding their effect on local communities.

Further, those banking institutions that are able to make such estimates often may view these data as proprietary. As a consequence, in previous research, information on the performance and profitability of CRA-related lending has had to be cobbled together from many indirect sources, significantly complicating analyses and making it difficult to draw firm conclusions.

To learn more about the performance and profitability of CRA-related lending activities, in November of 1999 the Congress directed the Board to conduct a comprehensive study that focused (1) on the delinquency and default rates of loans made in conformity with the CRA and (2) on the profitability of such lending.⁵ The Board was further directed to make available to the public the data used as the basis of the study.

Because relatively little systematic information is available on the performance and profitability of CRA-related lending, the Board determined that a study would be most informative if it collected new and systematic data on the experiences of banking institutions with CRA-related lending, both on an absolute and relative basis. To this end, the Board conducted a special survey of the largest banking institutions that focuses on their CRA-related lending experiences. These institutions were selected primarily because they extend a majority of the CRA-related loans originated by all banking institutions.

This report presents the findings of the Board's survey. The first section provides background on why the performance and profitability of CRA-related lending might differ from that of other lending and reviews the previous research on this topic. Section two describes the survey of banking institutions that the Board conducted to gather information on the performance and profitability of CRA-related lending activities. Section three describes the process the Board

⁵Section 713 of the Gramm-Leach-Bliley Act of 1999 (Pub. L. 106-95).

undertook in conducting the survey. In the fourth section, results regarding the nature of responses and other presentation issues are discussed. The main results of the survey are presented in sections five and six. Section seven explores the robustness of these results. A concluding section discusses several analytical issues that readers should bear in mind in considering survey results.

1. The Performance and Profitability of CRA-Related Lending: Issues and Evidence

A key objective of the study is to determine if, on average, there are significant differences between the performance and profitability of CRA-related lending and other lending for a given product type. If they exist, such differences would manifest themselves along one or more of the following dimensions: costs of origination, costs of servicing, pricing, or credit risk.

Differences in performance and profitability may arise if a banking institution makes special efforts to respond to the CRA. Banking institutions can respond to the CRA in a variety of ways. Institutions, for example, may take steps to identify more households with low and moderate incomes and in low- and moderate-income neighborhoods that would qualify for loans under their traditional underwriting guidelines. Measures institutions can take in this regard include increased training of staff to better recognize viable lending opportunities, more intensive marketing and other outreach activities, and consumer education. Lenders may also seek to increase lending to low- and moderate-income populations and neighborhoods by modifying their underwriting guidelines. Lenders may change the standards for their entire lending program or establish more narrowly targeted special lending programs--which might involve the application of flexible underwriting standards, enhanced risk mitigation activities, reduced interest rates or waivers, or reduced fees--in order to serve these populations.

Loans originated as a result of these efforts may differ from other loans in terms of the components of profitability and performance mentioned above. For example, compared with other loans, those extended as a result of activities such as intensive marketing and consumer

education may have different origination and servicing costs and may also have a different credit-risk profile. Price subsidies, if offered by a banking institution, are likely to make CRA-related loans less profitable; however, if the price subsidies are provided by third parties, they may make CRA-related loans more profitable for the originating institution. Similarly, if a banking institution lowers its underwriting standards for CRA-related loans, the credit risk it faces is likely to increase. If, however, third parties provide credit-risk guarantees, the institution may actually be exposed to less credit risk for these loans.

Importantly, even if a banking institution makes no special efforts to respond to the CRA, the performance and profitability of CRA-related loans may differ from that of other loans for a variety of reasons. Differences in performance and profitability can arise simply from differences between the characteristics of CRA-related and those of other loans. For example, if CRA-related loans are smaller than other loans on average, they may be less profitable on a per-dollar basis because of the fixed costs associated with many origination and servicing activities. Similarly, the profile of loan-to-value ratios of CRA-related loans may differ systematically from that of other loans, which would imply differences in credit risk. In addition, differences in prepayment propensities could also affect the relative performance and profitability of CRA-related and other lending. It is important to note that differences along any of these dimensions does not necessarily imply that there will be differences in profitability if the loans are priced to reflect the differences in risk or if the risks are shared with third parties.

Summary of Previous Research

The previous research on the performance and profitability of lending does not provide definitive

conclusions regarding the absolute and relative performance and profitability of CRA-related lending activities. Almost no research *directly* assesses the performance and profitability of CRA-related lending. Very few studies use a definition of CRA lending that focuses on the types of loans given particular emphasis in the evaluation of an institution's record of CRA performance under the current CRA regulations. Nearly all of the publicly available research in this area focuses on residential one- to four-family mortgage lending. In large part because of a lack of available data, very little is known about the performance and profitability of non-mortgage CRA-related lending activities such as small business and community development lending. Even within the mortgage lending category, almost all of the available evidence pertains to loans originated for the purchase of a home or the refinancing of such loans. Very little is known about the performance of CRA-related home equity and home improvement loans.

In addition, researchers have not distinguished between loans originated by institutions covered by the CRA and those that are not, such as independent finance and mortgage companies. The research also has not distinguished between loans originated by CRA-covered institutions within and outside their CRA assessment area.

The existing research provides, at best, only indirect inferences regarding CRA-related lending activities. A number of researchers have used large pools of loans that make no direct distinctions between CRA-related loans and other loans. Some inferences may be drawn from this research regarding differences in the performance and profitability of CRA-related lending and other lending based on specific characteristics of individual loans. For example, observed relationships between delinquency, default, and prepayment rates and the income level of the borrower have been viewed as indicators of the relative performance of CRA-related lending and

other lending (see Appendix A).⁶ The evidence indicates that borrower income is generally negatively related to delinquency and default, which implies that CRA-related loans--many of which are to low- and moderate-income borrowers--would become delinquent and enter default more often than non-CRA-related loans.⁷

Other researchers have used the performance and profitability of other loan classifications as proxies in evaluating CRA-related lending. The most common proxy has been the performance of loans originated under affordable home mortgage lending programs, which are targeted lending programs that often involve the application of nontraditional and more flexible underwriting standards (see Appendix B). Although this group of loans does not include the full range of CRA-related mortgage loans--for example, many CRA-related mortgage loans are originated under traditional lending programs--many affordable home loans are CRA-related.⁸ As a result,

⁶Nearly all publicly available information on differences in delinquency, default, and prepayment rates among CRA-related and other loans includes relative differences in rates (the ratio of one rate to another rate) rather than actual levels. Some research has focused explicitly on differences in the credit risk of CRA-related loans and other loans, but in many cases the results have been proprietary and not released to the public. The research that has been made public typically has been done in such a way that proprietary information has not been released.

⁷For example, see James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel, and Timothy H. Hannan, "Discrimination, Competition, and Loan Performance in FHA Mortgage Lending," *The Review of Economics and Statistics*, vol. 2 (1998), pp. 241-50; George M. von Furstenberg and Jeffery R. Green, "Home Mortgage Delinquency," *Journal of Finance*, vol. 29 (1974), pp. 1545-48; George M. von Furstenberg and Jeffery R. Green, "The Effects of Race and Age of Housing on Mortgage Delinquency Risk," *Urban Studies*, vol. 12 (1975), pp. 85-89.

More generally, research has consistently found that the level of equity in a home is a key determinant of whether a borrower will default on a mortgage. However, evidence suggests that negative equity alone is not sufficient for a default to occur, as only a small proportion of borrowers with negative equity in their homes in any given year actually default. Factors that cause disruptions in income or reductions in wealth, also known as "trigger events," seem to play an important role as well, particularly regarding the incidence of delinquency. See, for example, Chester Foster and Robert Van Order, "An Option-based Model of Mortgage Default," *Housing Finance Review*, vol. 3(4) (1984), pp. 351-72; Kerry D. Vandell and Thomas Thibodeau, "Estimation of Mortgage Defaults Using Disaggregate Loan History Data," *Journal of the American Real Estate and Urban Economics Association*, vol. 2 (1985), pp. 292-316.

⁸Every loan extended under affordable home mortgage lending programs may not be a CRA-related loan. For example, many mortgages extended under such programs are originated by institutions, such as independent mortgage companies, that are not covered by the CRA or by banking institutions that are lending outside their CRA assessment area. Thus, it is important to keep in mind that affordable home mortgage programs are only a rough proxy for CRA-
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the performance of loans originated under these programs can provide some useful insights about the performance and profitability of CRA-related mortgage lending.

Most research on the performance of affordable home mortgage lending programs has focused on credit risk.⁹ Evidence on the performance of these programs comes from many different sources. Much of the literature comes from larger banking institutions and from those institutions that buy or insure loans. In particular, Fannie Mae, Freddie Mac, and a number of private mortgage insurance (PMI) companies have all done studies of the performance of their affordable home loan portfolios.¹⁰

Evidence on the delinquency, default, and prepayment experiences that mortgage market participants have had with affordable home loans has been fairly consistent. Affordable home loans tend to have higher delinquency and default rates than loans extended using traditional underwriting criteria. Freddie Mac, the Mortgage Guarantee Insurance Company (MGIC), the

⁸(...continued)
related mortgage lending.

⁹A few studies have focused on profitability (discussed below), but almost no information is publicly available regarding differences in origination and servicing costs and pricing between CRA-related loans and other loans. Publicly available data provide some information about origination and servicing costs generally, but these data do not distinguish between CRA-related loans and others. Similarly, general information about loan prices is available, but the volume of loans originated at different prices is generally not known. Most important in this regard is the absence of information on the relative pricing of CRA-related and other lending. Finally, to the extent that banking institutions track such information, the results of internal analyses of differences in costs and pricing across groups of loans are typically proprietary and are not available to the public.

¹⁰Fannie Mae and Freddie Mac are secondary market institutions that purchase conventional mortgages almost exclusively, accepting all or part of the credit risk of the mortgages they purchase. Many of the mortgages they purchase are securitized, while others are held directly in their portfolios. PMI companies provide credit enhancements on conventional mortgages that have lower downpayment amounts. Private mortgage insurance reduces a lender's credit risk by insuring against losses associated with default on a loan up to a contractually established percentage of a claim. Both the secondary market institutions and the PMI companies have developed and offer affordable lending programs. Because of the size and nature of these organizations, they have extensive experience with such loans.

For a more extensive discussion of the experiences of these organizations, see Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, vol. 82 (July 1996), pp. 621-48.

United Guaranty Corporation, GE Capital Mortgage Corporation, and the Consumer Bankers Association all have reported that delinquency rates for affordable home loans have been higher than those for other home loans that are purchased or insured. For example, MGIC reported that the delinquency rate on the affordable home loans it insured in 1994 and 1995 was 2.3 times higher than on standard conventional loans with a 5 percent downpayment.¹¹ However, the evidence also suggests that the vast majority of borrowers relying on MGIC's affordable home loan products are current on their mortgage payments.¹²

Reports by individual banking institutions suggest that there is considerable variation in experiences with affordable home lending products.¹³ For example, both NatWest and Bank of America have reported that the delinquency rate was lower for loans made under their affordable home loan programs than for loans made under their conventional lending programs.¹⁴ By contrast, other lenders have had experiences more similar to those of the secondary market

¹¹Snigdha Prakash, "Freddie Sounds a Delinquency Alarm on Popular Lower-Income Mortgage," *American Banker* (July 21, 1995), pp. 1 and 8; Robert S. England, "A Cloud Over the Business," *Mortgage Banking* (October 1996), pp. 86-101; Gordon H. Steinbach, "Ready to Make the Grade," *Mortgage Banking* (June 1995), pp. 36-42; Avery, Bostic, Calem, and Canner (1996); and Fritz Elmendorf and Karin C. Brough, "Consumer Bankers Association Affordable Mortgage Survey," Consumer Bankers Association, Arlington, Virginia (1995). For results of analyses done by Freddie Mac, see Michael K. Stamper, "Revisiting Targeted Affordable Lending: Fresh Evidence Finds Far Lower Default Rate," *Secondary Mortgage Markets*, vol. 14 (October 1997), pp. 16-21.

¹²For an analysis by Freddie Mac, see Prakash, "Freddie Sounds a Delinquency Alarm." The same point was conveyed by former Comptroller of the Currency Eugene A. Ludwig in a discussion of the results of a 1997 survey by the Office of the Comptroller of the Currency (OCC) of the performance of affordable home loans extended by national banks. That survey found that loss rates were about the same for affordable home loans as for other real estate loans, but that delinquency rates were higher for affordable home loans. Eugene A. Ludwig, "The Quiet Revolution," *Mortgage Banking* (September 1997), pp. 24-30.

¹³Participants in the NeighborWorks network--a regional lending consortia organized by the Neighborhood Reinvestment Corporation (NRC)--have also had varied experiences regarding the performance of their affordable home lending programs. Some have experienced delinquency rates close to those experienced industry-wide; others report that their delinquency rates exceed industry averages. See George Knight, "A Solid Foundation for Affordable Lending," *Mortgage Banking* (1996), pp. 69-76.

¹⁴See Avery, Bostic, Calem, and Canner (1996).

institutions and PMI companies. For example, both Countrywide and NationsBank (now merged with Bank of America) have reported that their affordable home loan portfolios have had higher delinquency rates than their other conventional home loans.¹⁵

Researchers have found that an important determinant of relative delinquency rates between loans in affordable home lending programs and those in traditional lending programs has been whether the affordable home loans featured a “layering of risk.” Layering of risk occurs when several criteria that are used to judge the creditworthiness of a loan applicant are jointly eased in order to qualify the applicant for credit. Using a pool of loans from Freddie Mac’s affordable home loan programs, researchers at Freddie Mac found that most of the difference in performance between affordable home loans and other loans could be attributed to the layering of risk.¹⁶ Affordable home loans that did not feature layering of risk performed similarly to loans in the rest of Freddie Mac’s portfolio. Mortgage market participants have taken steps to address this issue by clarifying the circumstances under which multiple underwriting flexibilities may be combined when evaluating the creditworthiness of prospective borrowers.

Aside from research on affordable home mortgage lending programs, there are additional studies that provide indirect evidence on the performance of CRA-related lending. In 1992, the Congress asked the Board to prepare a study comparing the risks and returns to federally-insured depository institutions of lending in low-income, minority, and distressed neighborhoods with the

¹⁵Snigdha Prakash, “Delinquencies May Jeopardize Future of Low-Income Lending,” *American Banker* (September 19, 1996), pp. 1-2. Research conducted by an economist at CitiMortgage produced similar results regarding default. See Michael LaCour-Little, “Does the Community Reinvestment Act Make Mortgage Credit More Widely Available? Some New Evidence Based on the Performance of CRA Mortgage Credits,” paper presented at the mid-year meetings of the *American Real Estate and Urban Economics Association*, June 1998.

¹⁶Stamper, 1997.

risks and returns of lending in other neighborhoods.¹⁷ In preparing the study, the Board sponsored roundtable discussions with banking institutions and other lenders active in extending credit to low- and moderate-income populations and areas. Overall, roundtable participants generally held the view that the costs of originating and servicing loans made under CRA-related and affordable home loan programs were greater than those incurred on other loans of a similar product type and that delinquency rates, but not necessarily default rates, were higher.

Along similar lines, Freddie Mac conducted a broad-based analysis that focused on the effect of borrower and neighborhood income on lending performance. The study found that both borrower income and neighborhood income were inversely related to the probability of loan default, and that the neighborhood income relationship was more negative and more stable. In both cases, however, the magnitude of the relationship was relatively small. In addition, neither income measure was found to have large effects on the costs of credit risk. The most important predictor of loan default and loss severity was the contemporaneous loan-to-value ratio.¹⁸

Prepayment propensity can be an important factor affecting the profitability of lending. The limited research to date on prepayment propensities for CRA-related mortgage lending indicates that CRA-related mortgage loans prepay at a slower rate than other loans.¹⁹

¹⁷Board of Governors of the Federal Reserve System, “Report to the Congress on Community Development Lending by Depository Institutions” (Board of Governors, 1993). Prior to this report, most of the information on the performance of CRA-related loans and on affordable home lending experiences was largely anecdotal. For example, individual lenders would, on occasion, discuss their experiences at various forums and conferences. Such exchanges, while useful, provided only limited information.

¹⁸Robert Van Order and Peter Zorn, “Income, Location and Default: Implications for Community Lending,” *Real Estate Economics* (forthcoming).

¹⁹In examining loan repayment patterns in the mid-1990s, a recent study found that the prepayment rate of seasoned CRA loans was significantly lower than that of other seasoned conventional mortgage loans. The analysts suggest a number of potential reasons for the lower propensity for prepayment of CRA loans: (1) favorable loan terms
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Consequently, these loans may have enhanced value to lenders in an environment of declining interest rates, but less value in an environment of rising rates.

Research on the profitability of CRA-related lending has followed two approaches. First, some researchers have focused on overall institutional profitability.²⁰ These studies have generally found that banking institutions that are relatively more active in CRA-related lending activities have levels of profitability that are not significantly different from those of other institutions. The second approach has been to survey banking institutions directly to obtain information about the profitability of their CRA-related and other lending activities. The results of this approach in *previous* research suggest that CRA-related mortgage lending is profitable for most institutions, but not as profitable as other traditional mortgage lending.²¹

¹⁹(...continued)

associated with reduced interest rates for these loans when they are originated make refinancing less attractive to borrowers; (2) the small balances and high loan-to-value ratios for most CRA loans limit the potential gains from refinancing; (3) lower-income borrowers appear to be more sensitive to payment amounts than to interest rate levels; (4) lower-income borrowers are less mobile than high-income borrowers; and (5) borrowers with relatively small amounts of equity in their homes are less likely to “trade up” to another property. See Ned Brown and Dale Westoff, “Packaging CRA Loans into Securities,” *Mortgage Banking* (May 1998), pp. 32-41.

²⁰The earliest analysis of this type was undertaken by the Federal Reserve for its 1993 “Report to the Congress on Community Development Lending by Depository Institutions.” This research was followed by two later studies. Two Federal Reserve economists compared the profitability of commercial banks that specialize in mortgage lending to lower-income borrowers and neighborhoods with the profitability of other commercial banks. For the details of this research, see Glenn Canner and Wayne Passmore, “The Community Reinvestment Act and the Profitability of Mortgage-Oriented Banks,” *Finance and Economics Discussion Series*, 1997-7 (Board of Governors of the Federal Reserve System, July 1997), pp. 1-31. Researchers at the Office of Thrift Supervision and the Federal Home Loan Mortgage Corporation conducted a similar analysis for savings associations. For the details of this research, see David Malmquist, Fred Phillips-Patrick, and Clifford Rossi, “The Economics of Low-Income Mortgage Lending,” *Journal of Financial Services Research*, vol. 11 (1997), pp. 169-88.

²¹The Federal Reserve Bank of Kansas City took this approach to evaluate the relative profitability of seasoned CRA mortgage lending programs and identify possible sources for any observed differences in profitability. In 1995, surveys were sent to 600 large banking institutions, of which 97 responded. The survey found that 98 percent of the respondents reported that their CRA-related lending was profitable. There was substantial variation, however, in the degree of profitability. Of these, about three-quarters reported that their CRA lending was less profitable than their traditional lending. Twenty-four percent indicated that their CRA lending was as profitable as, or more profitable than, their traditional mortgage lending.

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2. A Survey of the Performance and Profitability of CRA-Related Lending

Section 713 of the Gramm-Leach-Bliley Act directs the Board to “conduct a comprehensive study . . . of the Community Reinvestment Act of 1977, which shall focus on (1) the default rates; (2) the delinquency rates; and (3) the profitability; of loans made in conformity with such Act.” In response to this directive, the Board decided to conduct a special survey of banking institutions to obtain new and systematic data on lender experiences with such lending.

The Board determined that a survey of banking institutions would provide the best and most reliable information on the performance and profitability of CRA-related lending. Such a survey could potentially overcome many of the limitations of previous research. First, the survey structure allows for the gathering of information on a broader range of CRA-related lending activities by including activities other than just residential mortgage lending. Second, because the survey can target banking organizations, the survey can *directly* assess the performance and profitability of CRA-related lending. Banking organizations can identify those loans that are CRA-related and are the only organizations that potentially have information on the performance

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Survey responses suggest that those institutions with more profitable CRA lending programs were more likely to manage and service their CRA loans the same as they managed and serviced loans originated under traditional mortgage lending programs. Survey responses also suggest that differences in profitability across institutions were driven more by the level of delinquency in their CRA lending portfolio, which affected management and servicing costs, than by credit losses arising from CRA-related lending activities. Nearly all respondents reported that the easing of credit standards associated with CRA program lending did not lead to appreciable increases in loan losses.

and profitability of those loans.²²

Further, the Board believed that learning about the underlying sources of observed performance and profitability differences, if they exist, could lead to a greater understanding of the relevant issues. A survey approach allows for the gathering of detailed information on these sources, including information on credit risk, origination and servicing costs, and pricing (interest rates and fees). Such a comprehensive approach would not be possible using other research methods.

Survey Sample

The sample was restricted to roughly the largest 500 retail banking institutions because these institutions account for most CRA-related lending nationwide. These institutions are estimated to account for over 70 percent of one- to four-family home lending and community development lending. To obtain a representative sample for the roughly 9,600 remaining banking institutions would have required at least doubling the size of the sample but would not have substantially increased the proportion of CRA-related lending covered by the survey.

Sample selection was based on the dollar amount of projected total assets as of December

²² The Home Mortgage Disclosure Act of 1975 (HMDA) generally requires banking institutions (and certain other mortgage lenders) that have or are deemed to have offices in metropolitan areas to annually report and disclose to the public data for each housing-related loan originated or purchased during the year, including information on loan location and borrower income. This information, coupled with information on the institution's CRA assessment area, is sufficient to estimate the institution's volume of CRA-related mortgage lending. Similarly, the regulations that implement the CRA require all large banking institutions and smaller institutions in large organizations to report information on small business, small farm, and community development loans originated or purchased during the year, which is sufficient to estimate the institution's volume of CRA-related small business, small farm, and community development lending. However, in none of these cases is information collected on performance or profitability.

31, 1999.²³ Banking institutions were selected based on the projected total assets of the institution, and not on the projected asset size of their parent holding company or other affiliates, if any. Because selection criteria focused on individual banking institutions, multiple affiliated insured commercial banks and savings associations within certain holding companies were requested to participate in the survey. In such an event, the banking institutions were asked to provide separate responses for each sampled institution rather than a consolidated response for all institutions within the holding company. Note that, because of the asset size restriction, not all insured commercial banks or savings associations affiliated with a given bank or thrift holding company were necessarily selected to participate in the survey.

Special purpose banks, such as credit card banks, and banks that do not have significant retail business were not included in the sample. Although insured institutions within these categories are subject to the CRA and many were large enough to meet the sample's asset size requirement, they are often evaluated on a different basis than other banking institutions under the CRA. Institutions headquartered outside the fifty states and the District of Columbia also were excluded due to potential difficulties in distinguishing between domestic and foreign operations. In addition, institutions that were acquired between December 31, 1999 and the survey mailing were excluded, because of the impracticality of collecting a response for the institution from the acquiring entity. The institutions remaining after these exclusions were ranked by asset size and the largest 500 were selected for the survey mailing. The mail sample consisted of 400

²³Projections of total assets for December 31, 1999, were based on the September 30, 1999, Bank Call and Thrift Financial Reports (adjusted for mergers between September and December) because the sample of banking institutions for the survey needed to be selected before the availability of the actual end-of-year Call and Thrift Financial Report data.

commercial banks and 100 savings institutions, ranging in size from about \$870 million to more than \$500 billion in assets.

Survey Instrument

The survey instrument was developed by Board staff and incorporated comments and suggestions from the Congress, banking institutions, community-based organizations, nonprofit organizations involved in CRA-related lending activities, and other government agencies. It was designed primarily to collect information on the performance and profitability of CRA-related and *overall* lending for different types of loan products from a sample of banking institutions covered by the act. A limited number of questions were also included regarding other benefits banking institutions receive from their CRA-related lending activities. However, the survey did not seek to assess the effect of CRA-related lending on local communities. The Gramm-Leach-Bliley Act directed that the U.S. Department of the Treasury report on this aspect of the CRA.

In developing the survey, the Board was guided by language in the congressional directive to focus on “loans made in conformity with [the CRA].” Accordingly, the survey focused on the *lending* activities of banking institutions that are given particular emphasis in analyzing CRA performance, and did not address *nonlending* activities that may be considered in a CRA performance evaluation, such as making CRA-qualified investments or providing retail banking services. This directive also implies that the current regulations implementing the CRA should be used as the appropriate way to identify loans “made in conformity” with the Act.

In light of the directive to “conduct a comprehensive study,” the Board determined it would be appropriate for the survey to include a number of features. First, because the

circumstances of individual banking institutions vary, the Board determined that the survey should seek information on both absolute and relative measures of the performance and profitability of CRA-related lending. Relative measures were likely to provide a more complete assessment of the performance and profitability of CRA-related lending activities.

Second, the Board determined that the survey should collect information separately for specific loan product lines, since banking institutions differ in the mix of products they offer. Without disaggregated information, performance and profitability are difficult to compare across banking institutions because they can vary significantly across product lines. Third, the Board determined that the survey should collect both quantitative and qualitative information on performance and profitability, because of a concern that some banking institutions may not maintain sufficient quantitative data to complete the survey or may use different methods to quantify performance and profitability.

Fourth, the Board determined that the survey should gather contextual information on CRA-related and overall lending activities--such as loan volumes and the distribution of loans within product types along various dimensions. Such information can be useful in interpreting any observed differences in performance and profitability between CRA-related and other lending and across banking institutions. In this spirit, the Board also decided to gather information on differences between CRA-related and other lending regarding the major components of profitability, such as origination and servicing costs, and pricing.

Finally, although most CRA-related loans are originated under traditional lending programs, some banking institutions also have established special lending programs designed to enhance their CRA performance. Special lending programs may involve the application of flexible

underwriting standards, enhanced risk mitigation activities, consumer education, and, in some cases, reduced interest rates or waivers or reductions in fees.²⁴ For some banking institutions, special lending programs are used to evaluate new approaches to serving populations that banking institutions find more difficult to serve, either because of lack of information or special borrower circumstances. These programs may also be part of a competitive strategy that banking institutions employ to gain or maintain market share and compete effectively for CRA-related loans.

Because special lending programs may constitute an important element of an institution's overall CRA-related lending program, the Board determined that a comprehensive survey on the performance and profitability of CRA-related lending should gather information on such programs. To understand the effect that special lending programs have on the activities of banking institutions, more information than just the performance and profitability of these programs should be collected, including details about their size and operation, the role of third parties in implementing them, the reasons they were originally established, and the benefits the banking institution currently receives from them.

The basic structure of the survey reflects these features. The survey questionnaire has two parts: Part A, entitled "Survey of CRA Lending," and Part B, entitled "Survey of CRA Special Lending Programs." Part A requests information on lending in four loan product categories: (1) one- to four-family home purchase and refinance mortgage lending; (2) other one- to four-family residential lending, including home improvement and home equity lending but excluding home

²⁴A special lending program may or may not have been established primarily to originate CRA-related loans. Some programs are set up simply to evaluate the performance and profitability implications of allowing variations from traditional underwriting standards or other approaches for identifying potentially profitable markets.

equity lines of credit; (3) small business lending; and (4) community development lending. The primary objective of this part of the survey was to obtain both absolute and relative information on the performance and profitability of CRA-related loans in these product categories. Part B requests information on special lending programs that banking institutions have developed or participate in and use to specifically enhance the banking institution's CRA performance (referred to as "CRA special lending programs").

In developing the survey instrument, the principles just outlined were used to provide guidance on a number of specific decisions related to the survey content. The following sections highlight the details underlying the most important of these decisions.

Selection of Loan Products

As noted above, the Board was directed to study experiences regarding "loans made in conformity with" the CRA. The CRA regulations jointly issued by the four federal banking agencies currently set forth the types of lending activities that may be considered by the agencies in evaluating the CRA performance of a banking institution (see Appendix C). These regulations place special emphasis on the review of an institution's home mortgage, small business, and small farm lending in its assessment area in addition to any community development lending the institution may engage in.²⁵

Because of this regulatory focus, Part A of the survey was limited to the following four loan product categories: (1) one- to four-family home purchase and refinance mortgage lending;

²⁵Under certain circumstances, a banking institution's consumer lending activities are also considered in CRA performance evaluations. For most institutions, however, consumer lending is not a major element of their performance evaluation.

(2) other one- to four-family residential lending, including home improvement and home equity lending but excluding home equity lines of credit; (3) small business lending; and (4) community development lending.²⁶

An advantage of collecting information on these four loan categories is that banking institutions are required to regularly collect and report information on loan originations and purchases in these categories with sufficient borrower and geographic information to estimate the *volume* of CRA-related and non-CRA lending.²⁷ Because banking institutions have the ability to identify these CRA-related loans at the time of origination or purchase, it was hoped that they might also be able to provide information on the performance and profitability of CRA-related loans over time.

Definition of a CRA-Related Loan

²⁶The CRA regulations were used as the basis for defining “small business loans” and “community development lending.” Those regulations generally define a “small business loan” to mean any loan to a business in an original amount of \$1 million or less. A “community development loan” is any loan or loan commitment that has as its primary purpose community development.

Part A of the survey did not collect information about the performance and profitability of small farm lending, consumer lending, or home equity lines of credit, even though small farm lending and, in some cases, consumer lending are components of a CRA evaluation. Although small farm lending may be important to some institutions, particularly smaller rural institutions, it does not constitute a significant component of overall CRA-related lending. In addition, the survey did not collect information on consumer loans because they are not universally considered in CRA performance evaluations. Finally, the reporting of home equity lines of credit is optional under the HMDA. To better ensure the uniformity of responses across banking institutions, institutions were asked to exclude home equity lines of credit in their responses to the survey.

²⁷These are the reports filed under the HMDA and the regulations that implement the CRA. Because the HMDA and CRA reporting requirements do not cover all banking institutions and because of specific reporting exceptions in these regulations, information is not available to classify all loans banking institutions originate or purchase as CRA or non-CRA-related.

To conduct a study of the performance and profitability of loans made in conformity with the CRA, one must first define such loans, referred to as “CRA-related loans” in this report. The current CRA regulations again were used as a guide in establishing such a definition. Such a guide minimizes the potential for confusion about what is meant by the term “CRA-related loan.”

The CRA regulations require the banking agencies to evaluate the geographic distribution of a banking institution’s home mortgage and small business lending activities, including (1) the proportion of loans extended within the institution's assessment area, as distinct from its lending outside of its assessment area, and (2) the distribution of loans within the institution's assessment area across neighborhoods of differing incomes.²⁸ Lending in low- and moderate-income neighborhoods is weighed heavily for the latter in CRA performance evaluations.²⁹

Regarding home mortgage and small business lending, the CRA regulations also require the banking agencies to evaluate the distribution of a banking institution's lending within its assessment area across borrowers of different economic standing. The exact definition of economic standing varies with the loan product being examined. For mortgage and home improvement lending products, CRA assessments consider the distribution of loans across low-,

²⁸For purposes of evaluating CRA performance, each institution must delineate the geographic areas that constitute its CRA assessment area. For a retail-oriented banking institution, the institution’s CRA assessment area must include the areas in which the institution operates branches and deposit-taking ATMs and any surrounding areas in which it originated or purchased a substantial portion of its loans. In addition, an institution’s assessment area may not reflect illegal discrimination or arbitrarily exclude low- and moderate-income areas (taking into account the institution's size and financial condition) and must consist of whole census tracts or block numbering areas. For a more complete description of these issues, see 12 CFR 228.41.

²⁹For assessing the distribution of loans by neighborhood income, neighborhoods are grouped as low-, moderate-, middle-, or upper-income. A low-income area (typically a census tract) is defined as an area in which the median family income is less than 50 percent of the median family income for the broader area (such as a metropolitan statistical area or the nonmetropolitan portion of a state). In a moderate-income area, the median family income is at least 50 percent and less than 80 percent of that for the broader area. In a middle-income area, the percentage ranges from at least 80 percent to less than 120 percent. And in an upper-income area, the percentage is at least 120 percent.

moderate-, middle-, and upper-income borrowers, with a special focus on lending to low- and moderate-income borrowers.³⁰ For small business lending products, assessments consider the distribution of small loans (loans of \$1 million or less) across businesses with differing levels of revenue, with a particular focus on loans to firms with annual revenues of \$1 million or less.

In light of these provisions, a CRA-related loan was defined in a manner consistent with the geographic and borrower characteristics emphasized by the CRA regulations for each loan product. For one- to four-family residential mortgage lending, a CRA-related loan was defined to mean any loan made *within* the banking institution's CRA assessment area to a low- or moderate-income borrower (regardless of neighborhood income) *or* in a low- or moderate-income neighborhood (regardless of borrower income).³¹ For small business lending, a CRA-related loan was defined as any small business loan (as defined in the CRA regulations) made *within* the banking institution's CRA assessment area to a firm with annual revenues of \$1 million or less (regardless of neighborhood income) *or* in a low- and moderate-income neighborhood (regardless of firm size).

These definitions also determine the set of loans that comprise the comparison groups used for the relative performance and profitability assessments. For home purchase and refinance and home improvement lending, the comparison group of loans is the set of loans that is either

³⁰Borrower income categories follow the same groupings as those for neighborhoods, but rely on the borrower's income relative to that of the median family income of his or her MSA or nonmetropolitan portion of the state depending upon the location of the borrower.

³¹The focus on lending to low- and moderate-income populations and areas *within* an institution's CRA assessment area recognizes the weight given to such lending by the regulatory agencies when conducting certain CRA performance evaluations. Non-community development lending to low- and moderate-income populations, small businesses, and small farms located lending to areas *outside* an institution's CRA assessment area also are considered by regulators under certain circumstances, but carry significantly less importance in performance evaluations. Community development lending is treated differently.

made *outside* the banking institution's CRA assessment area *or* to a middle- or upper-income borrower in a middle- or upper-income neighborhood within the banking institution's CRA assessment area. The comparison group for small business lending consists of any small business loan made outside the banking institution's CRA assessment area or made in a middle- or upper-income neighborhood to a firm with revenues exceeding \$1 million.

The CRA regulations treat community development lending differently. Community development lending generally must have a primary purpose of benefitting low- and moderate-income neighborhoods, low- and moderate-income individuals, or small businesses and farms. Accordingly, the CRA regulations do not require the agencies to separately consider the distribution of an institution's community development lending across neighborhoods of different income levels or borrowers of different economic standing. For these reasons, in the community development lending portion of the survey, a CRA-related community development loan was defined as any community development loan (as defined in the CRA regulations) considered in an institution's CRA performance evaluation. Since the CRA regulations permit a community development loan to benefit the institution's assessment area or a broader geographic area in which the assessment area is located, community development lending can include loans outside the institution's CRA assessment area.

Definition of Performance and Profitability

In studying CRA-related lending, the Gramm-Leach-Bliley Act directed the Board to focus on delinquency and default rates, which are collectively referred to here as performance. The survey uses two measures of delinquency--30-89 days past due and 90 days or more past due or non-

accruing--which are commonly used in the industry and are regularly tracked and disclosed in regulatory reports filed by lending institutions.³² The survey gathers information on the percentage of loans that were delinquent on December 31, 1999. Measuring delinquency is complicated by the fact that banking institutions often sell a portion of the loans they originate and thus may have little information on their performance. Consequently, the survey collected information about the delinquency experiences for loans held in the banking institution's portfolio, and for those that were originated, later sold, but still serviced by the originating institution.³³

Unlike the case of delinquency, there is no commonly held definition of default. For the survey, information was collected on a closely related measure--an institution's net charge-off rate. For a given loan, the net charge-off is the total dollars owed at default minus any recoveries. An institution's net charge-off rate is calculated by summing its loan-level net charge-offs over a period of time (for the survey, calendar year 1999) and dividing this amount by the average outstanding loan balances over the period.

For both the delinquency and charge-off rates, quantitative data were collected separately for overall lending and CRA-related lending for each loan product. In addition, qualitative information was collected on the relative credit losses of CRA-related and other lending. Institutions were asked whether the credit losses associated with their CRA-related lending were

³²These reports are the Report of Condition and Income (Bank Call Report) for commercial banks and some savings associations and the Thrift Financial Report for the remaining savings associations.

³³If the performance of the loans that are sold differs systematically from the performance of the loans the institution holds in portfolio, then responses about the performance of lending based only on portfolio loans would be biased.

“higher,” “somewhat higher,” “about the same,” “somewhat lower,” or “lower” than the credit losses associated with their other lending.

Measuring profitability offered special challenges. First, there are various ways to calculate dollars of profit for a loan or program. For the survey, profit from a lending activity was measured using a comprehensive definition that included all “revenues and costs associated with origination, servicing, pricing, delinquency, default and losses, prepayment, loan sales and purchases, and related customer account business.” Although not stated explicitly, overhead was intended to include the costs of permanent and working capital (sometimes referred to as a hurdle rate). Under this definition, a positive profit would imply a profitable program.

Dollars of profit may not be a meaningful measure of profitability, as programs may differ in size, for example. Therefore, profitability is typically expressed as a rate. Because profits are returns to shareholders, the return on equity (ROE) is the appropriate measure to use and thus was selected as the measure used in the survey.³⁴ In determining the ROE, institutions were asked to consider all the components of profitability discussed above. Accordingly, an ROE greater than zero would indicate a profitable program.

Although the ROE is the most appropriate measure of profitability, discussions with

³⁴There is no generally agreed upon measure of profitability, although the ROE and the return on assets (ROA) are both commonly used. Calculating the ROE or the ROA for a program requires the allocation of equity or assets, respectively, to it. The ROA is commonly used because it can often be more easily calculated at a given point in time. However, the ROA cannot be used to compare programs that have varying propensities for selling their loans. For example, a banking institution that sells most of the loans it originates, and thus has few assets, may appear to be extraordinarily profitable when measured using the ROA. Thus, comparing the ROA across programs in which loans are sold at different rates can be misleading.

banking institutions suggested that some banking institutions might have difficulty calculating it for individual loan programs. Consequently, the survey also collected detailed qualitative information on profitability as well. For example, banking institutions were asked if lending was “profitable,” “marginally profitable,” “break even,” “marginally unprofitable,” or “unprofitable.”

Both the quantitative and qualitative questions regarding ROE were asked about overall lending and CRA-related lending for each loan product. In addition, institutions were asked whether the ROE for CRA-related lending was “higher,” “somewhat higher,” “about the same,” “somewhat lower,” or “lower” than the ROE for other lending of a similar product. If their response to this qualitative question indicated that there was an ROE difference, institutions were asked to provide a quantitative estimate of the ROE difference.

Gathering Contextual Information

The context in which banking institutions operate is an important factor that may influence the absolute and relative performance and profitability of CRA-related lending. Contextual information could be useful for fully understanding any differences in performance and profitability that are observed in survey responses. The survey collected three types of contextual information.

First, because differences in profitability across groups of loans could arise from differences in any of the components of profitability--origination and servicing costs, pricing, and credit losses--the survey asks qualitative questions about the relative values for each of these factors for CRA-related and non-CRA lending. Further, for each factor, the survey asks about the

specific sources of cost, price, or credit-loss differences.³⁵

Second, because characteristics of groups of loans can vary greatly and this variation may affect performance and profitability of these groups, institutions were asked to compare the profitability of CRA-related lending and other lending controlling for a variety of loan characteristics. These included loan size, product type (e.g., fixed or adjustable rate), loan seasoning, and purpose.

Third, because the nature and size of loan programs can vary greatly across banking institutions and because this variation may influence performance and profitability, a number of mainly quantitative contextual questions were asked about the nature of each institution's CRA-related and overall lending. Institutions were asked to report the dollar volume of originations and purchases and the dollar volume of outstanding loans for CRA-related loans and all loans within each loan product category. In addition, several contextual questions were also asked about the characteristics of both CRA-related and all loans held in portfolio, such as the distribution of the loans by age, outstanding balance, third-party guarantee status, and type of pricing (fixed versus adjustable interest rate). Each banking institution was also asked to identify whether it relied on a distinct unit or department to originate its CRA-related loans, the role of affiliates in their CRA-related lending activities, and the proportion of loans in each product

³⁵An additional aspect of profitability is the costs incurred to comply with the CRA and other regulatory requirements that are not associated with lending per se, such as costs associated with reporting loan origination and purchase activity. As the objective of this report is to gather information on the performance and profitability of lending rather than the costs to comply with the technical provisions of the CRA or other laws, information on these "regulatory compliance" costs was not collected in the survey. These costs, however, presumably are part of overhead and in principle should be allocated to the appropriate lending activities in the calculation of profitability.

category extended under CRA special lending programs.

Gathering Information on CRA Special Lending Programs

The survey also sought to obtain information that would help provide a better understanding of the nature of special lending programs and the role they play in CRA-related lending. In Part B of the survey, banking institutions were asked to provide detailed information on their 1999 CRA special lending programs, defined as any program that the institution established (or participated in) and uses specifically to enhance its CRA performance.³⁶ CRA special lending programs could involve housing-related, small business, consumer, or other types of lending. In addition, CRA special lending programs could involve loans beyond those considered as CRA-related lending in Part A of the survey, as they could include loans extended outside the institution's CRA assessment area.

For the survey, CRA special lending programs could include special programs offered or developed in conjunction with third parties, such as lending consortia, nonprofit organizations, or government agencies that offer special lending programs in which an institution participates. However, traditional government-backed lending programs, such as those offered by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), or Small Business Administration (SBA), were not considered to be CRA special lending programs for the purposes of the survey, unless an institution provided a special enhancement to the program, such as a

³⁶A program would meet this definition only if one of the program's documented purposes was to enhance the institution's CRA performance.

formal education program or waiver of fees. In addition, community development loan programs were not considered to be CRA special lending programs in the survey.

Because there is great diversity among CRA special lending programs, both within and across banking institutions, the survey gathered information on the characteristics of each program (up to five, ranked by size) that an institution offered. The survey also collected detailed information on the performance and profitability of each of these programs. Finally, because it was recognized that banking institutions may have established these programs for a variety of reasons that go beyond their efforts to enhance their CRA performance, the survey asked respondents to provide information on both the reasons these programs were developed originally and the current benefits the programs provide to institutions.

Using the Most Recent Experiences

The questions in both parts of the survey focused on lending experiences based on 1999 calendar year activity and on an institution's lending portfolio as of December 31, 1999.³⁷ The survey thus collected the most current information available. The focus on the most recent lending experiences was intended to facilitate responses by surveyed institutions, as they already had to collect some of this information for regulatory reporting purposes. In addition, collecting information on the performance and profitability of lending for years earlier than 1999 would have been problematic, as many larger banking institutions have been involved in mergers and

³⁷The survey asks respondents to include the activities of affiliates in their responses to the same extent that these firms' activities were considered in the respondent's CRA performance evaluations.

acquisitions over the past few years. It is highly unlikely that consolidated entities could have provided separate historical information for the individual institutions that now have been combined into one entity.

Determining the Basis for Survey Responses

Because of variation in the nature and extent of recordkeeping across banking institutions and because of the short time frame established for the institutions to respond to the survey, it was recognized that some institutions might not be able to provide exact answers for some questions. To distinguish among responses based on (1) actual tabulations of requested quantities, (2) estimates based on data and reasonable assumptions, or (3) educated guesses, most of the quantitative and some of the qualitative questions in the survey were followed by a question eliciting the basis for the response.

3. Implementing the Survey

Participation by banking institutions in the survey was voluntary. On January 21, 2000, the 500 prospective respondents were mailed a copy of the questionnaire accompanied by a cover letter from Chairman Alan Greenspan explaining the purpose of the survey and seeking their voluntary cooperation in the study. Institutions were informed that responses to the survey would not be used for supervisory purposes and that the information reported would not be made available to the public in a way that permitted the identification of the responses provided by a particular institution. Banking institutions were asked to return their completed surveys by March 1, 2000. To help ensure complete and accurate responses to the survey, the Board established a CRA-survey assistance telephone line and set up a dedicated web site that included an electronic copy of the questionnaire and a collection of questions and answers about the survey.³⁸

Although a March 1 deadline was established for the submission of survey responses, a number of banking institutions submitted responses after this date. In total, responses were received from 143 institutions--114 commercial banks and 29 savings associations (table 1). Upon receipt at the Board, each survey response underwent extensive reviews. An initial review, prior to data entry, focused on completeness and obvious errors and inconsistencies. Board staff contacted institutions by telephone to resolve these problems. After data entry, the responses were reviewed a second time. These computer-based, second-stage reviews focused on a wide range of issues, including response inconsistencies, logical errors, and seemingly implausible

³⁸See www.federalreserve.gov/boarddocs/surveys/CRAloansurvey/.

values for delinquency or charge-off rates, for dollar volumes of loan originations and purchases, or for outstanding balances. For delinquency and charge-off rates and for outstanding balances, information from the Bank Call and Thrift Financial Reports were the basis for the comparison. For loan volumes, data from the 1999 Home Mortgage Disclosure Act (HMDA) and CRA small business loan filings served as the basis for comparison.³⁹ Potential problems identified at this stage were also resolved to the extent possible through telephone contact with the respondents.

Despite their relatively small number, the 143 survey respondents (out of more than 10,000 banking institutions) account for about one-half of the assets of all U.S. banking institutions as of December 31, 1999. They also account for about one-half of the dollars associated with home purchase and refinance mortgage and home improvement originations in the 1999 HMDA filings estimated to satisfy the survey definition of CRA-related lending. Similar estimates using 1999 CRA small business loan filings imply that respondents to this survey account for about 40 percent of the dollars associated with small business loan originations estimated to satisfy the survey definition of CRA-related lending and about 45 percent of the dollars associated with community development loan originations.

Overall, about 29 percent of the 500 banking institutions surveyed provided a response. Commercial banks and savings institutions responded at almost exactly the same rate. However, institutions' response rates varied markedly by asset size. More than 80 percent (27 out of 33

³⁹The 1999 HMDA and CRA small business and community development lending data will be made available to the public in late July 2000 by the Federal Financial Institutions Examination Council. Preliminary versions of this information were used in validating the accuracy of survey responses.

sampled institutions in this asset category) of the surveyed banking institutions with assets of \$30 billion or more as of December 31 returned a survey. In contrast, only about 19 percent (72 out of 363) of the surveyed banking institutions with assets of less than \$5 billion responded. Institutions with assets between \$5 billion and \$30 billion had a response rate of about 40 percent. Because these differences in response rates can potentially distort results, adjustments were made in calculating summary measures. These are discussed in more detail in the next section.

4. Presentation Issues and Results Regarding the Nature of Responses

A series of issues shapes how the results of the survey are presented. These issues involve the ability of respondents to provide answers to the quantitative questions of the survey and variation in the calculation of profitability among respondents. In addition, the different sample response rates by asset size discussed in the previous section also play an important role in the presentation of results.

The Ability to Provide Quantitative Responses

Survey responses and extensive follow-up telephone interviews undertaken to clarify responses suggest that, although banking institutions generally track the number and dollar amount of originations and purchases of CRA-related lending as defined in the survey, few institutions collect information on and track the delinquency and charge-off rates and profitability of such lending separately. As a result, except for community development lending, fewer than half of the banking institutions that responded to the survey provided quantitative information on the performance of CRA-related lending (tables 2a and 2b). Less than a quarter provided responses to quantitative questions on the absolute profitability of CRA-related lending. There is a significant difference in the ability of respondents to provide responses to quantitative questions for the overall lending and CRA-related lending categories. For overall lending, almost twice as many respondents were able to provide responses to the quantitative questions on performance and profitability.

These patterns hold for each of the loan product categories, although response rates for quantitative questions were higher for home purchase and refinance lending than for home improvement, or small business lending.⁴⁰ For example, of the 140 survey respondents that did home purchase and refinance lending, 61 were able to provide an estimate of their 30-89 day delinquency rate for CRA-related lending; 116 were able to provide an estimate of the 30-89 day delinquency rate for overall lending. By comparison, of the 116 respondents that did home improvement lending, only 40 were able to provide an estimate of their 30-89 day delinquency rate for CRA-related lending; 91 were able to provide an estimate of the 30-89 day delinquency rate for overall home improvement lending.

Of the respondents that provided quantitative answers, the proportion that answered questions based on “actual tabulations” as opposed to those that responded on the basis of “estimates based on reasonable assumptions and data” or “educated guesses” varies between measures of performance and measures of profitability and between CRA-related and overall lending. A substantially higher proportion provided quantitative responses based on actual tabulations for measures of performance than for measures of profitability. The number of responses based on actual tabulations for quantitative profitability measures is quite small. For example, fewer than 5 of the survey’s 143 respondents provided quantitative responses based on

⁴⁰The comparative response rates across loan product categories are consistent with their regulatory reporting requirements for performance information. Commercial banks and savings associations are required to report delinquency and charge-off information for closed-end loans secured by one- to four-family residential properties, most of which are one- to four-family home purchase and refinance loans. Performance information is not reported for small business or home improvement loans as defined in this survey. (Thrift institutions report performance information for unsecured closed-end home improvement loans. However, this is only a small part of overall home improvement lending for most banking institutions.)

actual tabulations for the profitability of CRA-related lending for any loan product. A somewhat larger, but still relatively small, number of respondents provided a response based on actual tabulations to the quantitative question on the absolute profitability of overall lending for each product type. For example, 15 respondents provided a response based on actual tabulations in reporting the absolute profitability of their overall one- to four-family home purchase and refinance lending.

Implications. Because relatively few banking institutions report quantitative answers, quantitative estimates of performance and profitability measures provided in the tables presented in this report must be viewed with caution. For example, given the small number of respondents, reported means are potentially susceptible to a few extreme values. Therefore, to permit assessments of the validity of quantities presented in the tables that follow, the tables present tallies of the number of respondents whose information was used to calculate a given quantity. Because so few institutions provided responses to quantitative questions based on actual tabulations, the tallies do not distinguish between quantitative responses that were based on actual tabulations and those that were based on estimates or educated guesses. Finally, along with the means of quantitative variables, the tables report median values for these variables. These median values are less sensitive to extreme values.

In addition, because of significant differences in the frequency of responses to quantitative questions for overall lending and for CRA-related lending, comparisons based on all responses could be misleading. To address this concern, the quantitative figures for performance presented in the tables are based only on those respondents that provided quantitative responses for *both*

overall lending and CRA-related lending. For profitability, the qualitative results presented in the tables are based only on those respondents that provided responses to the question on relative profitability and to the qualitative questions on the profitability of *both* overall lending and CRA-related lending. The quantitative figures for profitability presented in the tables are based only on those respondents that satisfied the conditions for the qualitative portion of the table and further provided a quantitative estimate of the relative difference in ROE between CRA-related and other lending.⁴¹ Although these restrictions reduce the sample sizes used in calculations somewhat, they help to ensure that no biases are introduced because of differences in response rates for overall and CRA-related lending.

Variation in Measuring Profitability (ROE)

In reviewing the responses to the quantitative questions on profitability in the survey, it appears that respondents used at least two different approaches in calculating profitability (ROE). Some banking institutions included the costs of capital (for example, interest) in reporting the ROE, while it appears that others did not. For example, for some respondents an ROE of zero was characterized as “break even,” while for others positive values well above zero were similarly classified. For these latter respondents, the reported ROE presumably does not reflect the costs of capital. Telephone conversations with respondents confirmed these impressions. More

⁴¹Those respondents that indicated that the ROE for CRA-related lending and other lending was “about the same,” and were therefore not asked to quantify the ROE difference, were assigned a quantitative relative difference of zero. These responses were used in calculating the figures in the tables.

generally, it is difficult to verify that all of the many components that are considered in calculating profitability were used by all respondents. It is also possible that qualitative responses regarding absolute profitability in the survey may have been affected by these differing measures of the ROE.

Implications. Because the reported ROE measures may not be fully comparable across banking institutions, numerical data on the absolute levels of the ROE for the different categories of loans are not given in this report. Information is presented on the qualitative responses regarding absolute profitability, but some caution should be exercised in interpreting these results for similar reasons.

However, although consistency in the computation of profitability across institutions is an important issue for making comparisons of absolute profitability across banking institutions, it is important to note that neither the quantitative nor qualitative measures of *relative* profitability for programs within a banking institution would be affected by this issue as long as a banking institution was consistent in how it calculated an ROE within a product category. Such consistency of response seems highly likely, and telephone conversations with respondents confirmed this view. For this reason, prominence is given to relative profitability measures in this report.

A Summary Measure of Survey Responses--Adjustments for Nonresponse

In reporting the results of the survey, a summary measure of survey responses is presented in an “All institutions” column. The figures in this column represent an estimate of what the full survey

responses would have been if all 500 of the sample institutions had participated and all respondents had provided answers to all applicable questions.

The accuracy of this “All institutions” estimate relies upon the validity of the assumptions needed to construct it. Key assumptions are those related to the treatment of sample and question nonresponse. As discussed previously, the proportion of banking institutions that responded to the survey varied significantly by asset-size group. As a consequence, unless behavior is the same for institutions across different asset-size categories, simple averages based on the answers provided by respondents would provide a distorted “All institutions” estimate of the survey responses.

To address this concern, the figures for the “All institutions” columns in the tables are calculated based, in part, using sample response adjustment factors reflecting the relative response rates for respondents in the three asset-size classes (less than \$5 billion, \$5 billion to \$30 billion, and \$30 billion or more). The sample response adjustment factor for respondents with assets of \$30 billion or more is 1.2 (or $33 \div 27$). Similarly, the sample response adjustment factor for respondents with assets between \$5 billion and \$30 billion is 2.4 (or $104 \div 44$) and for respondents with assets of less than \$5 billion, the adjustment factor is 5.0 (or $363 \div 72$).⁴²

An additional adjustment problem in calculating responses for “All institutions” arises from the fact that many questions were not answered by a significant proportion of respondents. For questions that are answered by all or nearly all respondents, this is not a problem. For

⁴²This procedure assumes that the respondents within an asset-size category are representative of all institutions in that asset-size category.

questions with a significant number of nonresponses, however, it was decided to adjust for different propensities to answer questions by incorporating an additional question response adjustment factor also based on asset size.

The general procedure used to calculate question response adjustment factors was to assume that respondents within an asset-size category that did not provide an answer to a question would have the same response pattern as those that did. Thus, respondents who answered each question were “blown up” to represent those who were asked the question but did not answer. Respondents for whom a question is not applicable are not used in calculating “All institutions” figures. For example, if 24 respondents were asked a question and 12 provided an answer, these 12 were “blown up” to represent 24 institutions (i.e., each of the 12 was “blown up” by a factor of 2). Question response adjustment factors were calculated separately for each asset-size category because the responses varied by asset size.

Figures in the “All institutions” column are computed using these question response adjustments in conjunction with the sample response adjustment factors discussed earlier. For example, if the 24 respondents in the example above were large institutions, the total response adjustment for each of the 12 institutions that provided an answer would be $2 \times (33 \div 27)$ or 2.44.

5. Results of Part A--The Survey of CRA Lending

Part A of the survey gathers information on the experiences of banking institutions in four broad lending categories: home purchase and refinance lending, home improvement lending, small business lending, and community development lending. For each product category, the survey collects performance and profitability information for both CRA-related and overall lending, as well as contextual information that allows for a greater understanding of any differences in performance and profitability that may be revealed by survey responses. The results for each of the four loan product categories are discussed in the sections that follow.

Results are first presented on a “per institution” basis. As noted earlier, information is presented separately for institutions in the three asset-size categories and for “All institutions.” The latter is calculated using the total response adjustment factors discussed in the previous section and represents an estimate of what responses would have been if all surveyed institutions had participated in the survey and all respondents had answered all applicable questions.

The results for performance and profitability are also presented on a “per CRA dollar” basis. These figures are calculated using weights based on the dollar volume of CRA-related loans that each institution reported they originated in each product area in 1999.⁴³ Figures in the “All institutions” column of the per CRA dollar tables were calculated using total response

⁴³If an institution did not provide the dollars of CRA-related loans it originated in its survey response, this quantity was estimated using information provided in its 1999 HMDA or CRA data filing. The proportion of respondents that did not report the dollar amount of their CRA-related loan originations varies somewhat by product type: 15 percent for home purchase and refinance lending, 27 percent for home improvement lending, 11 percent for small business lending, and 2 percent for community development lending.

adjustment factors that were recalculated using CRA dollar-weighted sample and question response adjustments. The “All institutions” figures in the CRA dollar-weighted tables represent an estimate of what the distribution of CRA-related loan dollars originated across responses would have been if all surveyed institutions had participated in the survey and all respondents had answered all applicable questions.⁴⁴

Home Purchase and Refinance Lending

Among the loan products that receive primary attention in most CRA performance examinations, home purchase and refinance lending has by far the largest origination volume (table 2c). It is estimated that the 500 banking institutions sampled in the survey originated over \$570 billion in home purchase and refinance loans in 1999. This amount far exceeds the amount of lending in the other loan product categories. These 500 institutions are estimated to have originated \$117 billion in small business loans, \$12 billion in home improvement loans, and \$13 billion in community development loans. This relative scale across loan product categories holds for CRA-related

⁴⁴The choice of this particular weighting scheme was motivated by practical considerations. First, most respondents provided quantitative data on the volume of CRA-related lending originated for all product areas. Second, for those institutions that did not provide such information and for which imputations were necessary, external data were available from the 1999 HMDA and CRA data filings that permitted reliable and reasonably accurate imputations. Another advantage is that a single loan will not contribute to the weight of more than one institution, as only one institution can have originated each loan.

There are other dollar-weighting schemes that could have been implemented. However, each suffers from shortcomings. For example, weights based upon dollars associated with CRA-related lending each institution held in portfolio could have been used. However, these values would have had to be imputed for more than half of the respondents and no external hard data source that could be used for these imputations exists. As a second example, a weight based upon loans originated and purchased could also have been used. However, this weight can lead to a double-counting of loan dollars, as a single loan could be counted as an origination for one banking institution and a purchase by another.

lending as well, although the differences in volume across loan products is less extreme for home improvement and small business lending because a higher proportion of these loans are CRA-related. About 10 percent of all home purchase and refinance lending is CRA-related compared with about 18 percent for home improvement lending and about 50 percent for small business lending.

Profitability

Per institution analysis. Survey responses indicate that CRA-related home purchase and refinance lending is either profitable or marginally profitable for most respondents (82 percent, table 3a). About one-sixth of the respondents report that such lending is either marginally unprofitable or unprofitable. This pattern holds generally across banking institutions of different asset size, although a greater proportion of large banking institutions (assets of \$30 billion or more) report that their CRA-related home purchase and refinance lending is either marginally unprofitable or unprofitable than medium- (assets between \$5 billion and \$30 billion) or smaller-sized (assets between \$950 million and \$5 billion) institutions.

Although CRA-related home purchase and refinance lending is reported to be at least marginally profitable for most of the survey respondents, *overall* home purchase and refinance lending is reported to be at least marginally profitable for an even larger proportion of these institutions (94 percent). Moreover, for slightly less than half (44 percent) of the respondents, the profitability of CRA-related home purchase and refinance lending is reported to be either lower or somewhat lower than that of *other* home purchase and refinance lending. However, the remaining 56 percent report that the profitability of their CRA-related and other home purchase and refinance

lending is about the same as the profitability of their other home purchase and refinance lending. None report that it is more profitable. Consistent with the pattern noted above, large banking institutions are more likely than smaller institutions to report that the profitability of their CRA-related home purchase and refinance lending is lower than the profitability of their other lending in this product category. For example, while 39 percent of the smallest banking institutions in the sample report that the profitability of their CRA-related home purchase and refinance lending is either somewhat lower or lower than the profitability of their non-CRA-related lending, 69 percent of the largest banking institutions report this experience.

Respondents report that the ROE for CRA-related home purchase and refinance lending is on average 1.8 percentage points lower than the ROE for other home purchase and refinance lending. However, most respondents report the same ROE for CRA-related and overall home purchase and refinance lending. This similarity of experience is further reflected in the median ROE difference, which is zero.

Per CRA dollar analysis. Weighting the responses by the amount of CRA dollars an institution originated in 1999 produces results that differ somewhat from those computed on a per institution basis (table 3b).⁴⁵ Regarding the profitability of CRA-related lending, the implications for the profitability of home purchase and refinance lending are similar when viewed on a per CRA-dollar basis as compared to a per institution basis. For example, 84 percent of CRA-related

⁴⁵Large institutions are estimated to account for 57 percent of the dollars of CRA-related home purchase and refinance loans originated in 1999 by surveyed institutions but constituted only about 7 percent of surveyed institutions. In contrast, small institutions in the sample, which made up 72 percent of surveyed institutions, are estimated to account for 17 percent of the dollars of CRA-related home purchase and refinance lending in 1999.

loan dollars originated were originated by institutions that report that their CRA-related home purchase or refinance lending was profitable; survey responses indicate that CRA-related home purchase and refinance lending is profitable or marginally profitable for 82 percent of respondents on a per institution basis. However, a substantially higher percentage of the CRA dollars originated in 1999 were originated by respondents that report that CRA-related one- to four-family home purchase and refinance lending is less profitable than other lending than the percentage of institutions that report that CRA-related lending is less profitable on a per institution basis (63 percent of CRA dollars versus 44 percent of institutions).

Performance

Per institution analysis. Many institutions report no difference in performance between CRA-related and other home purchase and refinance lending (tables 3c and 3d).⁴⁶ However, when there is a difference in performance, respondents tend to report that CRA-related home purchase and refinance lending performs less well than other home purchase and refinance lending. For example, about half of the survey respondents have higher rates for both measures of delinquency for CRA-related home purchase and refinance loans than for overall home purchase and refinance loans; about one-third report no difference in rates and one-sixth report lower delinquency rates for CRA-related loans.

When performance is measured by charge-off rates, a smaller percentage of respondents

⁴⁶Qualitative differences in performance are inferred from the quantitative responses provided by respondents. If the reported quantitative delinquency or charge-off rate for CRA-related lending was greater (less) than the rate for overall lending, the response was treated as indicating that the rate for CRA-related lending was higher (lower) than the rate for overall lending. If the quantitative delinquency or charge-off rate was identical for CRA-related and overall lending, the response was treated as indicating that the rate for CRA-related and overall lending was the same.

report that their CRA-related home purchase and refinance loans do not perform as well as their home purchase and refinance loans considered in the aggregate. Nearly 70 percent of the respondents report either no difference in charge-off rates for CRA-related and for other home purchase and refinance lending or lower charge-off rates for CRA-related loans. When asked a qualitative question about credit losses, 65 percent of respondents report that credit losses were about the same for CRA-related and for other home purchase and refinance lending in 1999.

Twenty-eight percent report that the credit losses associated with CRA-related home purchase and refinance lending were higher or somewhat higher than credit losses associated with other lending, and 6 percent report that credit losses associated with CRA-related home purchase and refinance lending were lower or somewhat lower than credit losses associated with other lending.

Quantitative data also reflect this pattern. On average, although experience varies, survey responses indicate that CRA-related home purchase and refinance loans do not perform as well as home purchase and refinance loans in the aggregate.⁴⁷ For example, the *mean* charge-off rate for CRA-related home purchase and refinance loans (23 basis points) is about 50 percent higher than that for all home purchase and refinance loans (15 basis points). However, the difference in median charge-off rates is zero. This general pattern holds for the absolute and relative means and medians for all three measures of performance.

⁴⁷The delinquency figures that appear in the tables and are discussed in the text pertain to the performance of loans that banking institutions held in portfolio as of December 31, 1999. Information on delinquency rates was also obtained for the composite of loans held in portfolio as of December 31, 1999, and those loans sold by the institution for which the institution retained servicing rights. For both CRA-related loans and all loans considered together, these latter rates are generally lower than those reported in the text, but only marginally so. The relative relationship between the performance of CRA-related and all home purchase and refinance loans is unchanged.

There is considerable variation in the performance of CRA-related lending across banking institutions of different asset sizes, with large- and medium-sized institutions reporting higher delinquency and charge-off rates than smaller institutions for both CRA-related and overall home purchase and refinance lending. For example, the mean and median 30-89 day delinquency rates for both the CRA-related and overall lending of large banking institutions are more than two times the mean and median 30-89 day delinquency rates for smaller institutions in the sample. Differences for other measures of performance are about the same.

Patterns of relative performance also vary by asset-size category, with larger institutions more likely to report that CRA-related home purchase and refinance loans do not perform as well as other loans. For example, nearly 90 percent of large banking institutions report higher 30-89 day delinquency rates for CRA-related home purchase and refinance lending than for overall home purchase and refinance lending. By comparison, 41 percent of smaller banking institutions in the sample report this kind of relative experience. Similarly, half of the large institutions report that credit losses are higher for CRA-related home purchase and refinance lending, while only 22 percent of smaller institutions in the sample report a similar experience.

Per CRA dollar analysis. CRA-related home purchase and refinance loans do not appear to perform as well as other home purchase and refinance loans when the analysis is conducted on a per CRA-dollar basis (tables 3e and 3f). Moreover, the differences appear to be larger than when measured on a per institution basis. For example, 46 percent of the dollars associated with CRA-related loans were originated by institutions that report that credit losses are higher or somewhat higher for CRA-related home purchase and refinance loans than for other home purchase and

refinance loans, whereas only 28 percent of institutions report such an experience on a per institution basis. Similar patterns are observed when performance is measured by delinquency and charge-off rates.

Context

As described earlier, the survey includes a number of questions designed to improve the understanding of the sources of any differences in the performance and profitability of CRA-related lending and other lending to the extent that such differences exist. Among these are qualitative questions that seek information on potential differences in origination and servicing costs and the pricing of loans.

A large proportion of respondents on a per institution basis report that origination and servicing costs are about the same for CRA-related and other home purchase and refinance loans (table 3g). For example, about 47 percent of the respondents report that origination costs for the two groups of loans are about the same. The proportion reporting that costs are the same is greater when servicing costs are considered. However, for those respondents that do report differences, the difference almost always indicates higher costs for CRA-related home purchase and refinance loans. For example, nearly all respondents that report differences in origination costs indicate that these costs are higher for CRA-related loans.

As with costs, a large proportion of respondents report that the pricing for CRA-related and other home purchase and refinance lending is similar. However, about 40 percent of respondents report that their CRA-related home purchase and refinance loans have lower prices than other home purchase and refinance loans. Only about 10 percent of the respondents report

higher prices for CRA-related loans.

Experience varies by size of institution, with large and medium-sized institutions more likely to report relatively higher costs for CRA-related loans. With respect to pricing, large institutions in particular are more likely to report that they have lower prices for their CRA-related home purchase and refinance loans.

When calculated on a per CRA dollar basis, CRA-related home purchase and refinance loans appear to have higher origination and servicing costs than other home purchase and refinance loans (table 3h). Moreover, the percentages with higher costs are larger than when measured on a per institution basis. For example, 78 percent of the dollars associated with CRA-related home purchase and refinance loans were originated by institutions that report that origination costs are higher or somewhat higher for CRA-related loans, while only 52 percent of respondents on a per institution basis report a similar experience. By contrast, the relationship for pricing is little changed.

Home Improvement Lending

Home improvement lending is a substantially smaller component of total bank lending than either home purchase and refinance or small business lending. It is estimated that the banking institutions sampled in the survey originated about \$12 billion in home improvement loans in 1999, about 18 percent of which is CRA-related. This volume equals less than 1 percent of the estimated dollar amount of home purchase and refinance lending originated in 1999.

Profitability

Per institution analysis. Most banking institutions providing responses (86 percent) report that their CRA-related home improvement lending is either profitable or marginally profitable (table 4a). Ten percent of the institutions indicate that CRA-related home improvement lending is either marginally unprofitable or unprofitable. This pattern holds generally across banking institutions of different asset sizes, although a somewhat smaller proportion of small banking institutions in the sample report that their CRA-related home improvement lending is either marginally unprofitable or unprofitable than medium- or large-sized institutions.

As with CRA-related home improvement lending, most respondents (94 percent) report that their overall home improvement lending is at least marginally profitable. Nearly three-quarters of respondents report that the profitability of their CRA-related and other home improvement lending is about the same. Of those reporting a difference, all report that profitability of CRA-related home improvement lending is either lower or somewhat lower than the profitability of other home improvement lending. Consistent with the pattern noted above, larger banking institutions are more likely than smaller ones in the sample to report that the profitability of their CRA-related home improvement lending is lower than that of their other home improvement lending. About 47 percent of the large-and medium-sized banking institutions report this experience, compared with 21 percent of the smaller institutions in the sample.

Among institutions that provided quantitative responses on differences in the profitability of CRA-related and overall home improvement lending, the ROE for CRA-related home improvement lending is reported to be 1.3 percentage points lower, on average, than the ROE for

other home improvement lending. However, as is the case for home purchase and refinance lending, most respondents report the same ROE for CRA-related and overall home improvement lending. Once again, as with home purchase and refinance lending, the median ROE difference for home improvement lending is zero.

Per CRA dollar analysis. Nearly 80 percent of the dollars of CRA-related home improvement lending were originated by institutions that report that their CRA-related home improvement lending is either profitable or marginally profitable, a percentage similar to that reported on a per institution basis. However, weighting the responses by the amount of CRA dollars originated produces results for relative profitability that differ somewhat from those computed on a per institution basis and more closely track the per institution results for large banking institutions (table 4b).⁴⁸ Fifty percent of the dollars of CRA-related home improvement were originated by institutions that report that the profitability of CRA-related home improvement lending is lower or somewhat lower than the profitability of other home improvement lending. This percentage tracks the 47 percent of large banking institutions on a per institution basis that report that their CRA-related home improvement lending is less profitable than their other home improvement lending, but is higher than the percentage of all institutions on a per institution basis that report such an experience (28 percent).

⁴⁸Large institutions are estimated to account for 45 percent of the dollars of CRA-related home improvement loans originated in 1999 by surveyed institutions but constituted only about 7 percent of surveyed institutions. In contrast, small institutions in the sample, which made up 72 percent of surveyed institutions, are estimated to account for 27 percent of the dollars of CRA-related home improvement lending in 1999.

Performance

Per institution analysis. For three measures of performance, a majority of respondents report that the performance of CRA-related and overall or other home improvement lending is about the same (tables 4c and 4d). Moreover, for those institutions that do report a difference, the proportion that report that CRA-related home improvement lending performs better than overall or other lending is about equal to the proportion that report that CRA-related home improvement lending performs worse than overall or other lending. For example, 78 percent of respondents report that the credit losses associated with CRA-related home improvement loans are about the same as the credit losses associated with other home improvement loans. About as many respondents (10 percent) report that losses associated with CRA-related home improvement loans were lower or somewhat lower than those associated with other home improvement loans as those that report that losses on CRA-related loans were higher or somewhat higher (11 percent).

The exception to this pattern is the 30-89 day delinquency rate measure. By this measure, CRA-related home improvement loans do not perform as well as home improvement loans in the aggregate. Nearly half of the respondents (46 percent) report higher 30-89 day delinquency rates for CRA-related home improvement lending than for overall home improvement lending. Only 17 percent of respondents report that CRA-related home improvement lending had a lower 30-89 day delinquency rate.

As with home purchase and refinance lending, experience varies by size of institution. For example, roughly 21 percent of large banking institutions report higher credit losses for CRA-related home improvement lending than for overall home improvement lending. In comparison

only 7 percent of small banking institutions in the sample report this kind of relative experience. This relationship between relative loan performance and the size of the banking institution also holds for the other performance measures.

Per CRA dollar analysis. On a per CRA dollar basis, the results are more consistent across the performance measures, but differ somewhat from the results of the per institution analysis (tables 4e and 4f). By all four measures of performance, CRA-related home improvement loans perform relatively less well. For example, 59 percent on per CRA dollar basis report that the charge-off rate is higher for CRA-related home improvement loans than for other home improvement loans whereas 28 percent on a per institution basis report such an experience. Similar patterns are observed when performance is measured by delinquency rates and credit losses, although 70 percent of the CRA-related home improvement loan dollars are originated by institutions that report that credit losses are about the same for CRA-related and other home improvement lending on a per CRA dollar basis.

Context

Only 15 percent of respondents report that their origination costs for CRA-related home improvement loans are higher (including somewhat higher) than for other home improvement loans (table 4g). The majority of respondents of all size classes report that origination costs of CRA-related and other home improvement lending are similar. There is a similar pattern for servicing costs. There is also relatively little evidence of pricing differences between CRA-related and other home improvement lending.

When calculated on a per CRA dollar basis rather than on a per institution basis, a

somewhat larger percentage report that origination and servicing costs are higher for CRA-related home improvement loans than for other home improvement loans (table 4h). However, as in the per institution analysis, most CRA-related dollars are originated by institutions that report that origination and servicing costs and pricing are about the same for CRA-related and other home improvement lending.

Small Business Lending

The estimated total dollar volume of small business lending originations for 1999 for the 500 banking institutions that were surveyed is \$117 billion. This is about 20 percent of the estimated total dollar volume of home purchase and refinance lending (derived from table 2c).

Small business lending differs from mortgage-related lending in a number of ways that may have implications for the interpretation of results. First, the proportion of all small business lending that is CRA-related is quite a bit higher than the proportion of home purchase and refinance lending that is CRA-related (about 50 percent for small business and about 10 percent for home purchase and refinance), so that the total dollar volume of CRA-related small business lending nearly equals the total dollar volume of CRA-related home purchase and refinance lending.

This disparity has implications for evaluating survey responses regarding relative performance and profitability. For small business lending, the dollar volume of lending is about the same size for CRA-related and other small business lending. The significant proportion of overall small business lending that is CRA-related implies that measures of performance and profitability for CRA-related and overall lending will tend to converge more than would be the case if CRA-

related lending were only a small fraction of overall lending. The comparison of CRA-related small business lending and *other* small business lending will not necessarily be affected by this.

Further, there may be greater diversity in the characteristics of small business loans compared with mortgage-related loans. Therefore, in assessing the relative measures of profitability and performance for CRA-related small business lending, one must carefully consider the comparability of CRA-related small business loans and non-CRA small business loans. The survey defined a CRA-related small business loan as any small business loan made *within* the banking institution's CRA assessment area to (1) a firm with revenues of \$1 million or less (regardless of neighborhood income) *or* (2) in a low- or moderate-income neighborhood (regardless of firm size). A non-CRA small business loan is any small business loan made (1) outside the banking institution's CRA assessment area or (2) to a firm with revenues exceeding \$1 million in a middle- or upper-income neighborhood within the institution's CRA assessment area.⁴⁹

Along these lines, it is important to note that the composition of the group of loans that are not CRA-related differs for small business and home purchase and refinance lending. For example, for small business lending, about 25 percent of these loans were originated outside the institution's assessment area; by contrast, more than 55 percent of the home purchase and refinance loans that were not CRA-related were originated outside the institution's assessment area. The implications of these differences for relative measures of performance and profitability are unclear.

⁴⁹In principle, this issue is also relevant for home mortgage lending. However, it is believed that home mortgage lending is significantly more "commoditized" and homogeneous than small business lending. As a result, comparison groups are more likely to have similar characteristics.

Profitability

Per institution analysis. Virtually all banking institutions providing responses (96 percent) report that their CRA-related small business lending is either profitable or marginally profitable (table 5a). This is true for banking institutions in all asset-size categories. There is relatively little difference in the profitability of CRA-related and other small business lending; more than 80 percent of respondents report that the profitability of CRA-related and other small business lending is about the same. Only 13 percent of respondents report that the profitability of their CRA-related lending is lower than their other small business lending; 4 percent report that it is higher. This pattern is similar for banking institutions in all asset-size classes.

Per CRA dollar analysis. Weighting responses by the amount of CRA loan dollars originated produces virtually the same results (table 5b).⁵⁰ The vast majority of CRA-related small business loan dollars were originated by respondents that report that their CRA-related small business lending is profitable (94 percent). As above, this is true for banking institutions in all asset-size categories. In addition, most CRA-related loan dollars were originated by respondents that report the profitability of CRA-related and other small business lending is about the same.

Performance

Per institution analysis. There is relatively little evidence that performance differs systematically between CRA-related and overall small business lending (tables 5c and 5d). For

⁵⁰Large institutions are estimated to account for 41 percent of the dollars of CRA-related small business loans originated in 1999 by surveyed institutions but constituted only about 7 percent of surveyed institutions. In contrast, small institutions in the sample, which made up 72 percent of surveyed institutions, are estimated to account for 33 percent of the dollars of CRA-related small business lending in 1999.

example, the proportion of respondents (about 10 percent) reporting higher 30-89 day delinquency rates for their CRA-related lending is similar to the proportion reporting lower delinquency rates (13 percent). Moreover, the mean and median delinquency rates and charge-off rates for CRA-related and overall small business loans are similar. In terms of credit losses, 88 percent of respondents report that losses were the same for CRA-related small business loans as for other loans. Banking institutions in each asset-size category report roughly the same delinquency and charge-off rate experience for CRA-related and overall small business lending, although large institutions generally experience poorer performance than smaller institutions in the sample for both groups of loans.

Per CRA dollar analysis. Unlike the results for profitability, weighting responses by CRA-related loan dollars originated tends to produce results for performance that differ somewhat from those in the per institution analysis (tables 5e and 5f). Generally, compared to the per institution analysis, CRA-related small business loans perform less well than other small business loans in terms of delinquency and charge-off rates when measured on a per CRA dollar basis. However, credit loss experience is similar for CRA-related and other lending using both types of analysis.

Context

Reported differences are also small for the components of profitability (table 5g). For origination and account maintenance and monitoring costs, about 87 percent of respondents report no difference between CRA-related and other small business lending. A comparable percentage report similar pricing. Some differences across respondents grouped by asset size are found. As

before, large banking institutions are more likely than smaller institutions in the sample to report that their costs are higher for CRA-related small business loans than for other small business loans. However, unlike the case for home-related lending, those larger institutions that report differences in pricing indicate that CRA-related small business loans have *higher* prices than other small business loans.

When calculated on a per CRA dollar basis, the results differ only slightly from the results obtained from the per institution analysis (table 5h). Most of the CRA-related loan dollars are originated by institutions that report that their origination and account maintenance and monitoring costs and pricing are about the same for CRA-related and other small business lending. However, the percentage of CRA-related small business loans dollars that is originated by institutions that report that costs and prices are higher or somewhat higher for CRA-related small business lending is slightly higher than the percentage of respondents on a per institution basis that report higher costs or prices.

Community Development Lending

Community development lending is a highly heterogeneous product category that includes many different types of loans, such as multifamily residential and commercial development lending and lending to community development organizations. Because of this heterogeneity, it is unlikely that banking institutions could construct valid comparison groups from other portions of their loan

portfolios.

First, the mix of products (in dollar volume) that make up a banking institution's community development lending portfolio may differ substantially from the mix of products (in dollar volume) that make up other portions of that institution's loan portfolio. Second, some loans in a banking institution's community development loan portfolio may not have an appropriate set of comparable loans. For example, a loan to a nonprofit community development organization often has unique features and, thus, lacks a comparable loan product. Consequently, the survey collected information only on quantitative and qualitative measures of the performance and profitability for the community development loans themselves. No information comparing the performance and profitability of community development loans with a comparison group of loans was collected.

Of the loan products that were the focus of the survey, community development lending had a relatively small dollar volume of 1999 originations, estimated to be about \$13 billion for survey respondents. This total equaled slightly more than 2 percent of the dollar amount of the CRA-related home purchase and refinance lending reported by survey respondents. However, while the dollar volume of community development lending extended by survey respondents is small when compared with the volume of reported home purchase and refinance lending, it constitutes about 45 percent of all the community development lending reported by banking institutions covered by the CRA data reporting requirements.

Community development lending can be a highly specialized activity that often requires special training of staff and the expenditure of considerable time and effort to extend many of these

loans. To help facilitate community development lending, banking institutions sometimes establish distinct units or departments to focus on this type of lending. Roughly 27 percent of all survey respondents report that they have a distinct unit or department that specializes in community development lending (table 6). Large banking institutions in particular are likely to have staff dedicated to community development lending; nearly 70 percent of these institutions report having a distinct unit or department that specializes in such lending.

Community development lending offers a variety of benefits to banking institutions. Virtually all survey respondents report that they benefit from their community development lending because it promotes community growth and stability and responds to the credit needs of the local community, although some differences in perceptions of benefits appear across banking institutions grouped by asset size. Large banking institutions are more likely than smaller institutions in the sample to believe that community development lending (1) is necessary to achieve an outstanding CRA performance rating, (2) is a source of additional profits, (3) provides a means of maintaining their market share, and (4) minimizes the likelihood of adverse public comment on their CRA record. Nonetheless, virtually no respondents report that they undertake community development lending solely to obtain a satisfactory or outstanding CRA performance rating.

Performance and Profitability

Per institution analysis. Nearly all (93 percent) banking institutions that provided responses report that their community development lending is either profitable or marginally profitable (table 7a). This is true for banking institutions in all asset-size categories. The performance of community development lending, however, differs across banking institutions grouped by size

(table 7c). As was generally the case for the other product categories, larger banking institutions are more likely than smaller institutions in the sample to report poorer loan performance, whether measured by delinquency or charge-off rates.

Per CRA dollar analysis.⁵¹ As in the per institution analysis, virtually all community development dollars were originated by respondents that report that community development lending is profitable or marginally profitable on a per CRA dollar basis (table 7b).⁵² Regarding performance, the results of the per CRA dollar analysis differ somewhat from those of the per institution analysis, although the differences are not consistent across the three measures of performance (table 7d). For example, the average 30-89 day delinquency rate for the per CRA dollar analysis is greater than the average 30-89 day delinquency rate in the per institution analysis, while the charge-off rate for the per CRA dollar analysis is less than the charge-off rate in the per institution analysis.

New Opportunities from CRA-Related Lending

CRA-related lending can potentially lead to new and profitable business opportunities for banking institutions, and the survey gathered information on whether such opportunities exist and, if they exist, the sources of these opportunities. Nearly two-thirds of respondents report that their CRA-

⁵¹Because all community development loans are considered to be CRA-related, the weights for this section are the dollar volumes of total community development loan originations in 1999 for an institution.

⁵²Large institutions are estimated to account for 47 percent of the dollars of community development loans originated in 1999 by surveyed institutions but constituted only about 7 percent of surveyed institutions. In contrast, small institutions in the sample, which made up 72 percent of surveyed institutions, are estimated to account for 26 percent of the dollars of community development lending in 1999.

related home purchase and refinance lending has led to such opportunities (table 8). The proportions are even higher for CRA-related home improvement and small business lending. Regardless of the type of CRA-related lending, virtually all banking institutions report that such lending has led to new customers and additional loans. The opportunity to cross-market products to CRA loan customers is also mentioned as a benefit by a large proportion of respondents.

Other than items related to profitability, about two-thirds of the survey respondents report some other benefit that they receive from CRA-related lending, such as promoting a good image in the community. At the same time, about one-quarter of the institutions report that they incur some costs other than items related to profitability because of their CRA-related lending activities.

6. Results of Part B--Survey of CRA Special Lending Programs

The main focus of Part B of the survey was CRA special lending programs. Banking institutions were asked to report detailed information on the characteristics, performance, and profitability of each of their five largest CRA special lending programs and summary information on performance and profitability for all of their programs combined. In total, Part B of the survey includes detailed information on 341 CRA special lending programs (table 9).⁵³ About 73 percent of the banking institutions participating in the survey report offering at least one CRA special lending program and, on average, institutions report that they offer about four programs. Many banking institutions establish distinct units or departments within the institution to run their CRA special lending programs. About 63 percent of the programs are operated by a distinct unit or department.

In the tables that follow, results are generally presented on a per program basis. As in Part A, information is presented separately for the CRA special lending programs of institutions grouped into the three asset-size categories and for “All institutions.” Figures in the “All institutions” column are adjusted for sample nonresponse and, for questions with substantial nonresponse, question nonresponse. The “All institutions” column represents an estimate of what the per program responses would have been if all 500 institutions had responded to the survey and provided answers to all applicable questions.

For performance and profitability, results are also presented on a per program dollar basis. These figures are calculated using program-based weights based on the reported dollars originated

⁵³Respondents also report that they are involved in an additional 281 CRA special lending programs. The discussion in the text focuses on those programs for which respondents provided detailed information.

under each CRA special lending program in 1999. The “All institutions” column in this case represents an estimate of what the distribution of CRA special lending program dollars would have been if all 500 institutions had responded to the survey and provided answers to all applicable questions.

The Size of Individual Programs

Evidence suggests that loans originated under CRA special lending programs make up a relatively small portion of the total CRA-related loans originated for most respondents. For example, it is estimated that only about 3 percent of the total dollars of home purchase and refinance originations and about 17 percent of the total dollars of CRA-related home purchase and refinance originations were extended under CRA special lending programs.⁵⁴ Along similar lines, for the median banking institution, the proportion of CRA-related home purchase and refinance lending that was extended under CRA lending programs was only 4 percent. However, about 16 percent of institutions report that more than 40 percent of their CRA-related home purchase and refinance lending is originated under CRA special lending programs. The proportions for home improvement and small business lending were much lower.

Information reported for individual programs also suggests that they are generally small. For 1999, an estimated 39 percent of the CRA special lending programs reported in the survey had originations of \$500,000 or less and about 24 percent of programs had originations between

⁵⁴Estimates are derived from responses to questions in Part A of the survey.

\$500,000 and \$2 million (not shown in tables). Only 15 percent of CRA special lending programs had 1999 originations of more than \$15 million. However, the size of CRA special lending programs varies with the asset size of the banking institution, as CRA special lending programs tend to be larger for the largest banks in the sample. The median size of CRA special lending programs for banks with assets greater than \$30 billion was about \$23 million; for the smallest banks in the sample the median CRA special lending program size was about \$460,000.

Reasons for Establishing CRA Special Lending Programs and Current Benefits

Banking institutions cite many reasons for *originally* establishing or participating in CRA special lending programs (table 10). Responding to the credit needs of the local community, promoting community growth and stability, and improving the public image of the institution are the most frequently cited reasons. For about 74 percent of the programs, institutions indicate that they believed the program was needed to obtain a satisfactory or outstanding CRA rating. However, only 1 percent of CRA special lending programs are reported to be established *only* to obtain a satisfactory or outstanding CRA rating.

Banking institutions report receiving a variety of *current* benefits from offering or participating in CRA special lending programs. Obtaining either a satisfactory or outstanding CRA rating is a benefit mentioned for 76 percent of the programs, but for only 1 percent of programs was this cited as the only current benefit. Responding to the credit needs of the local community, promoting community growth and stability, and improving the public image of the institution are other frequently cited current benefits of CRA special lending programs.

That only about 75 percent of the CRA special lending programs reportedly were established in order to achieve a satisfactory or outstanding CRA rating may be somewhat puzzling, given that the survey explicitly asked institutions to report only on special lending programs that had as one of their documented purposes to enhance the institution's CRA performance. One possibility is that some of the programs that support the CRA-related lending activities of institutions are not considered by the institutions to be "needed" to obtain a particular CRA rating. A second possibility is that the support of CRA-related activities is a documented purpose, but relatively minor feature, of some programs.

Features of CRA Special Lending Programs

CRA special lending programs target a number of populations and involve a range of credit products (table 11). The most frequently noted target populations for these programs in the survey are lower-income borrowers and lower-income neighborhoods. Home purchase and refinance lending is the focus of most (76 percent) of the programs reported in the survey. Other credit products, including home improvement and small business lending, are cited as the primary focus of a much smaller percentage of programs.

Third parties often play a role in CRA special lending programs. About three-quarters of the programs involve the activities of third parties (table 12). Third parties involved in CRA special lending programs include public entities at all levels of government and a range of for-profit and nonprofit private-sector firms and organizations. Although their role varies across programs, these entities offer a wide range of services that contribute to the implementation of CRA special

lending programs, including activities that reduce the costs that banking institutions might otherwise incur in extending credit to the populations served by the special programs. For example, third parties help lenders identify prospective borrowers (mentioned for 54 percent of the programs in which they are involved), provide pre-loan education or counseling to loan applicants (51 percent), provide grants for downpayments or other purposes (46 percent), provide interest rate subsidies (31 percent), and provide subsidies to offset loan fees (23 percent).

Although third parties provide services and contribute to the implementation of many CRA special lending programs, banking institutions also offer a wide range of special features or services in connection with these programs (table 13). For example, respondents report that they offer reduced interest rates on 46 percent of programs; waive or reduce fees for a similar proportion of programs; and provide pre-loan education or counseling to loan applicants in connection with 36 percent of the programs. Banking institutions also report that they alter their customary underwriting standards for a large majority of their special lending programs (82 percent). The most frequently cited underwriting variances are lower downpayments, higher debt-to-income ratios, and the acceptance of alternative measures of credit quality, such as rent and utility payment histories, in lieu of more traditional measures of credit risk.

Performance and Profitability of CRA Special Lending Programs

According to respondents, the majority (61 percent) of CRA special lending programs are either profitable or marginally profitable (table 14a). About 25 percent of the programs are considered either marginally unprofitable or unprofitable. Experience varies across banking institutions

grouped by asset size. Compared to smaller institutions in the sample, large- and medium-sized institutions report a higher percentage of programs that are either marginally unprofitable or unprofitable.

When measured on a per program dollar basis, the results indicate that, within asset-size categories, CRA special lending programs with larger dollar volumes are more likely to be profitable (table 14b).⁵⁵ However, the responses also show that large banking institutions, whose CRA special lending programs tend to have larger origination volumes, are more likely than smaller institutions to report that their CRA special lending programs are unprofitable. These two effects interact in the “All institutions” column. A comparison of the “All institutions” results on a per program basis and on a per program dollar basis suggests that they are largely offsetting, as the results on a per program dollar basis differ only slightly from the results on a per program basis. Slightly more than 55 percent of the program dollars are reported to be in profitable or marginally profitable programs; 31 percent of the program dollars are reported to be in programs that are either marginally unprofitable or unprofitable.

Regarding performance, on a per program basis, respondents report that a majority of CRA special lending programs have low delinquency and charge-off rates (table 14c). For example, the median charge-off rate is reported to be zero. The performance of these programs appears to vary with the asset size of the banking institution operating the program. Compared with smaller

⁵⁵Large institutions are estimated to account for 62 percent of the loan dollars originated in 1999 under CRA special lending programs by surveyed institutions but are estimated to account for only about 10 percent of the programs. In contrast, small institutions in the sample accounted for only about 11 percent of the loan dollars originated in 1999 under CRA special lending programs despite being estimated to account for about 65 percent of the programs.

banking institutions in the sample, larger banking institutions report that their CRA special lending programs have higher delinquency and charge-off rates on average.

Performance results on a per program dollar basis are mixed (table 14d). Responses show that delinquency rates tend to be higher on a per program dollar basis than on a per program basis, suggesting that larger programs have higher delinquency rates. By contrast, responses indicate that charge-off rates are lower on a per program dollar basis than on a per program basis, which suggests that larger programs have fewer charge-offs associated with them.

7. Robustness of Results

To evaluate the robustness of the per institution and per CRA dollar summary results, the results in the “All institutions” column were recalculated in several ways. Three recalculations were made for each loan product: (1) where all banking institutions in a holding company that are not the lead (that is, largest) institution in the holding company are dropped, (2) where a complicated model-based adjustment to account for sample nonresponse was substituted for the simple asset-based sample adjustment factor, and (3) where a complicated model-based adjustment to account for question nonresponse was substituted for the simple asset-based question nonresponse adjustment factor.

Each of these factors was selected out of a concern that they might potentially affect the results presented in the previous sections. The lead bank analysis reduces the influence of those holding companies that had more than one affiliated banking institution included in the sample, a feature of the sample that could potentially bias results to the extent that respondents lacked information on the experience of individual affiliated institutions and could only provide information on the overall experience of the holding company as a whole.⁵⁶ The other two recalculations provide alternative adjustments for sample and question nonresponse as a validation of the results in the baseline analysis using the simple adjustment factors.⁵⁷

⁵⁶The lead bank sample consists of 110 observations.

⁵⁷The model-based sample nonresponse adjustments were estimated using logistic regressions where the probability of response was modeled as a function of institution size, region, whether the institution had been acquired in the past year, the institution’s overall profit level, and the institution’s CRA rating. The model-based question
(continued...)

Results are presented for absolute and relative profitability, although the patterns are similar for measures of performance (tables 15, 16, 17, and 18). None of the recalculations appears to have any appreciable effect on results.

An additional robustness issue concerns the consistency of the responses to quantitative and qualitative questions. There is some evidence that respondents that were able to provide answers to quantitative questions may have had different experiences regarding the performance and profitability of CRA-related lending than those respondents that did not provide quantitative information. For example, 38 percent of the respondents that provided quantitative charge-off data for CRA-related lending report that credit losses were higher or marginally higher for CRA-related home purchase and refinance lending than for other home purchase and refinance lending. In contrast, only 17 percent of the respondents that did not provide quantitative charge-off data for CRA-related lending report a similar experience. Interestingly, about 13 percent of the respondents that provided quantitative charge-off data for CRA-related lending report that credit losses were *lower or marginally lower* for CRA-related home purchase and refinance lending than for other home purchase and refinance lending. In contrast, less than 1 percent of the respondents that did not provide quantitative charge-off data for CRA-related lending report that credit losses were lower for CRA-related home purchase and refinance lending.

There are at least two possible explanations for this inconsistency. One is that the

⁵⁷(...continued)

nonresponse adjustments were estimated using logistic regressions where the probability of response was modeled as a function of institution size, region, the institution's overall profit level, the percentage of originations the institution retained in portfolio, the use of affiliates, the ratio of CRA-related to other lending, the percentage of loans the institution retained for servicing, and whether the institution was a savings association.

experiences of respondents that can provide quantitative answers are not representative of the total sample. A second potential explanation is that those respondents that did not quantify performance tend to report that performance is the same in the absence of hard evidence that performance differs, even in cases in which performance might not be the same.

As a further robustness issue, comparisons of the performance and profitability of CRA-related and other lending of a product type may be influenced by differences in the characteristics of the loans in each group. The full implications of these differences for relative measures of performance and profitability are unclear. However, some evidence on this issue is available from responses to a question for each product category (except community development lending) asking respondents to indicate whether the relative profitability of CRA-related and other lending differed after controlling for major loan characteristics, such as loan size and product type.

For home purchase and refinance lending, responses to this question were virtually the same as for the question on relative profitability that did not ask respondents to control for any characteristics. This suggests that differences in the characteristics of CRA-related and other home purchase and refinance loans are not an important element of differences in performance and profitability. In contrast, for home improvement and small business lending, responses to these additional profitability questions indicate that CRA-related lending is less profitable than other lending for a smaller percentage of respondents (between 6 and 10 percent) than when the question on relative profitability that did not ask respondents to control for any characteristics question was asked. For small business lending, when differences in loan characteristics are controlled for, the percentage of respondents that report that CRA-related small business lending is less profitable

than other small business lending was identical to the percentage that report that CRA-related small business lending is more profitable than other small business lending. This suggests that, for home improvement and small business lending, an important proportion of the reported differences in profitability between CRA-related and other lending arises from differences in the characteristics of the loans in each group.

8. Analytical Issues

The survey and resulting data provide new information about the experiences of banking institutions with CRA-related and other lending. This information provides opportunities to better understand and measure the effect of the CRA on lending markets. However, the survey data do not allow researchers to answer all questions regarding the effects of CRA on the performance and profitability of banking institutions.

In previous sections, a number of limitations and analytical concerns were highlighted. Sample sizes are relatively small, which leaves some statistics vulnerable to extreme values. Most respondents were unable to provide quantitative answers regarding the performance and profitability of CRA-related lending because they do not explicitly track such information. Thus, assessments based on quantitative estimates of profitability and delinquency and charge-off rates should be viewed with considerable caution; qualitative assessments of profitability and performance may be more reliable. In addition, there is some evidence that respondents providing answers to quantitative questions had somewhat different responses to qualitative questions than respondents that did not provide answers to qualitative questions, which raises questions regarding response consistency. Further, it appears that banking institutions used at least two different approaches to calculate the ROE measure of profitability. Therefore, the extent to which one should rely on reported ROE figures in making comparisons of absolute levels of profitability between CRA-related and overall lending is limited. Finally, the proportion of banking institutions that responded to the survey varied significantly by asset-size group, suggesting that unadjusted

statistics are inappropriate for characterizing the experiences of respondents as a whole. This latter issue, as well as the issues of question nonresponse and controlling for differences in the characteristics of CRA-related and other loans, was explored more fully in the robustness section.

This section highlights several additional important limitations of the survey and the resulting data. These limitations pertain to (1) the scope of the survey, (2) the representativeness of the survey responses, (3) the completeness of the survey responses, and (4) the potential for response bias.

Because of these and other issues, results presented here using the survey data may not provide a complete picture of the performance and profitability of CRA-related lending. In addition, the broad patterns observed in the survey results may not reflect the experiences of particular institutions or specific markets. For example, the experiences of individual banking institutions might vary significantly from those of the average survey respondent.

Scope of the Survey

The first broad limitation of the survey pertains to its scope along several dimensions. First, the survey focuses on only one aspect of the CRA--the performance and profitability of CRA-related lending. Because it does not examine activities such as investment and service activities, data from this survey do not allow researchers to answer broader questions regarding the overall effects of the CRA on the performance and profitability of banking institutions. Nor do the data speak to the effect of the CRA on local communities, the stated purpose of the law. Some information was collected in the survey about the benefits banking institutions receive from their CRA-related

lending activities, but this information is insufficient to document the benefits of CRA-related lending to the larger community. Any comprehensive assessment of the CRA would require a more thorough treatment of benefits than that included in this survey. A recent study by the U.S. Department of the Treasury, also mandated by the Gramm-Leach-Bliley Act, addresses these issues.

Second, as noted above, the regulations that implement the CRA set forth three sets of activities by which the performance of most large covered institutions are evaluated: lending, investment, and service activities. The survey was designed to obtain information pertinent *only* to lending. No information was collected that could be used to assess the costs, revenues, or profitability of the investment and service activities conducted by banking institutions that also are evaluated under the CRA. This design reflects the congressional directive, which emphasizes only CRA-related lending activities and not CRA-related investment and service activities.

In addition, within the wide range of lending activities that banking institutions undertake, only a subset, albeit a significant one for most institutions, is considered. In particular, the survey collected information only on home purchase and refinance lending, home improvement lending, small business lending, community development lending, and lending associated with CRA special lending programs. The survey was not designed to gather information regarding the experiences of banking institutions with small farm, non-housing consumer, or other types of lending, including large commercial and industrial lending, except to the extent that these activities fall into one of the covered lending categories. Small farm lending, which was not covered in the survey, may constitute an important portion of CRA-related and overall lending for some banking institutions,

although these tend to be smaller and rural institutions. For the institutions included in the survey, small farm lending is not a significant portion of total lending activity.

Representativeness of Responses

A second limitation of the survey pertains to the representativeness of the data collected and to the specific banking institutions that responded to the survey. As noted, the survey collected data on the experiences of banking institutions during 1999. Consequently, the survey provides data on the most current experiences of banking institutions with respect to both their CRA-related and aggregate lending activities. However, calendar year 1999 may not be representative of banking institution lending experiences in other years. Activities during 1999 occurred in the context of an on-going economic expansion characterized by strong employment growth and low and relatively stable inflation and interest rates. Thus, experiences during this time might differ from those during periods with different economic conditions. For example, weaker general economic conditions would likely result in poorer loan performance, measured either by delinquency rates or defaults. Whether weaker economic conditions would differentially affect CRA-related lending and other lending is a matter of speculation and cannot be evaluated using the data collected in the survey. Another issue is the restriction of the survey to the experiences of respondents in just one calendar year. Institutions with new programs or expanding operations may not have had ample time to fully realize the profitability of their lending.

The survey is restricted to large retail banking institutions because these institutions extend a large proportion of all CRA-related loans. As a result, analytical results using survey data may

not necessarily reflect the experiences of the banking industry as a whole. In particular, the experiences of small banking institutions could differ from those of larger institutions.

Nonetheless, the banking institutions that were included in the survey sample and the responding institutions extended significant percentages of all the CRA-related loans originated nationwide during 1999. For example, the banking institutions included in the survey sample are estimated to have extended 79 percent of all CRA-related one- to four-family mortgage loans reported in 1999 HMDA filings, and those that provided responses to the survey are estimated to have extended 53 percent of such loans (table 1). The data therefore represent the experiences of a substantial portion of the CRA-related lending markets.

Completeness of Responses

A third limitation of the survey pertains to the completeness and accuracy of the reported data. Survey responses by banking institutions reflect only data available through their record-keeping activities. For example, if an institution originated a loan and then sold but no longer serviced it, then the institution may be able to provide only partial information regarding the performance and profitability of that loan. This institution may be able to report on the costs associated with originating the loan but may have no information regarding the delinquency and default history of the loan once it is sold. If these “off-book” experiences differ from those of loans for which information is available, then responses may not fully portray the overall experiences institutions have had with CRA-related loans.

Potential for Biased Responses

The approach in this analysis attempts to correct for response biases that may have arisen as a result of many factors, such as those discussed during the exploration of robustness. There is, however, a separate issue of whether the answers reported by banking institutions might be influenced by individual biases. Neither the patterns of responses nor the contacts with respondents suggest that this is the case. However, there is no way to definitively determine whether such potential biases had a significant effect on survey results.

Appendix A: Delinquency, Default, and Prepayment Risks

Delinquency, default and prepayment risk characterize all lending activities. Delinquency occurs when a borrower fails to make a scheduled payment on a loan in a timely manner and in full.

Because loan payments are typically due monthly, the lending industry customarily categorizes delinquent loans as either 30, 60, 90, or 120 or more days late depending on the length of time the oldest unpaid loan payment has been overdue. For purposes of reporting on delinquency experience in the Report of Condition and Income for commercial banks and the Thrift Institution Financial Report for savings associations, institutions typically group delinquent loans into three broad categories: 30-89 days past due and still accruing, 90 days or more delinquent and still accruing, and non-accruing.

Default occurs, technically, at the same time as delinquency; that is, a loan is in default as soon as the borrower misses a scheduled payment. However, in the research literature, the term “default” has been used for each of the following four situations:

- ! A lender has been forced to foreclose on the loan to gain title to the asset securing the loan.
- ! The borrower chooses to give the lender title to the asset securing the loan “in lieu of foreclosure.”
- ! The borrower sells the asset securing and makes less than full payment on the loan obligation.
- ! The lender agrees to renegotiate or modify the terms of the loan and forgives some or all of the delinquent principal and interest payments. Loan modifications may take many forms, including a change in the interest rate on the loan, an extension of the length of the loan, and an adjustment of the principal balance due.

Because practices differ in the lending industry, not all of the situations listed above are consistently recorded as defaults by lenders. Moreover, the length of the foreclosure process may

vary considerably, affecting the measured default rate. For these reasons, analyses of default experiences can be difficult and are often based on only a subset of actual defaults. Delinquencies, on the other hand, are recorded contemporaneously and generally on a more consistent basis. Therefore, delinquency data may provide a good source of information for analysis, particularly for evaluating the performance of newly originated loans and for identifying underperforming loans that require greater attention.

While delinquency and default risks arise from the borrower falling behind on their payment obligations, prepayment risk arises when a borrower decides to repay a loan in full before the term of the loan is reached. Borrowers prepay their loans for many reasons but tend to do so in large numbers when market interest rates fall, because they can substitute a loan with a lower rate of interest for one with a higher rate. Lenders expect a certain proportion of borrowers to prepay their loans and can price their loans accordingly. However, if interest rates fall more than anticipated, lenders may fail to achieve targeted rates of return.

Delinquency and default propensities have been the focus of most of the research on the performance of CRA-related and affordable home lending. Prepayment risk has received less attention, although it has been widely assumed that borrowers receiving such loans would either tend to have more difficulty qualifying for a new loan or would be less likely to change residence and hence would be less likely to prepay.

The economic literature has developed two major theories of the determinants of delinquency and default. “Option-based” theories of default focus on the role of the borrower’s equity in the home in the decision of whether to default on a mortgage. Under this approach, as

long as the market value of the home (net of sales expenses) exceeds the market value of the mortgage, the borrower has a financial incentive to sell the property to extract the equity rather than to default on the loan. Option-based theories of default emphasize equity-related factors, such as the initial loan-to-value ratio on a mortgage, current and expected house price appreciation, and the age of a loan as key determinants of default.

While option-based theories of default emphasize the role of equity in determining loan performance, “triggering-event” theories emphasize the role of factors that may adversely affect the financial well-being of the borrower and ultimately the borrower’s ability to meet mortgage payment obligations as scheduled. In this view, both negative equity and a triggering event, such as a loss of income due to a disruption in employment, would be associated with most defaults. Hence, researchers who emphasize the role of triggering events in loan performance focus on the borrower’s vulnerability to income disruptions.

These theories have provided a framework for empirically evaluating default and its causes. The evidence supports the notion that equity in the house is an important factor in default decisions.⁵⁸ Evidence on the importance of triggering events has been less definitive, although recent evidence suggests that they are an important consideration and influence borrower

⁵⁸For a review of the many studies that demonstrate the importance of equity in the home as a factor in default decisions, see Roberto G. Quercia and Michael A. Stegman, “Residential Mortgage Default: A Review of the Literature,” *Journal of Housing Research*, vol. 3(2) (1992), pp. 341-79. More recent studies have corroborated this result. See, for example, Dennis R. Capozza, Dickran Kazarian, and Thomas A. Thomson, “Mortgage Default in Local Markets,” *Real Estate Economics*, vol. 25(4) (1997), pp. 631-55.

repayment decisions.⁵⁹

⁵⁹Examples include Capozza, Kazarian, and Thomson, "Mortgage Default;" and Yongheng Deng, Robert Van Order, and John M. Quigley, "Mortgage Default and Low Downpayment Loans: The Costs of Public Subsidy," *Journal of Regional Science and Urban Economics*, vol. 26(3-4) (1996), pp. 263-85.

Appendix B: Affordable Mortgage Lending Programs

In recent years, mortgage originators, secondary mortgage market institutions (Fannie Mae and Freddie Mac, in particular) and private mortgage insurance (PMI) companies have initiated a wide variety of affordable mortgage lending programs. The details vary widely, but affordable home loan programs generally involve four distinct elements: targeted groups, special marketing, the application of nontraditional and more flexible underwriting standards, and the proactive use of risk-mitigation activities. Targeted groups are usually defined with eligibility criteria tied to borrower or neighborhood income, loan-to-value ratios, location, homebuyer status (for example, first-time homebuyers), and other factors.

Most important among these criteria are the income eligibility restrictions, which normally require a prospective borrower to have a low or moderate income or to purchase a home in a low- or moderate-income neighborhood. Special marketing activities commonly include homebuyer education seminars and outreach to religious and community organizations active in targeted neighborhoods. Flexible underwriting policies usually have the following characteristics: relatively low-down-payment requirements; higher acceptable ratios of debt payment to income; the use of alternative credit history information, such as records of payments for rent and utilities; flexible employment standards; and reduced cash-reserve requirements. In addition, some lenders offer reduced interest rates, waive private mortgage insurance requirements, or reduce or waive points or fees associated with originating the loan.

To reduce the potential for higher losses on these flexibly underwritten loans, lenders

customarily require the borrowers to complete a homebuyer education program and to undergo credit counseling when needed. Lenders also use enhanced servicing techniques on these loans, contacting borrowers by phone, for example, as soon as they are thirty days delinquent to determine the cause of the delinquency and to establish a plan to rectify the situation. Lenders also mitigate their potential exposure to losses by sharing risks with third parties, including local or state public authorities or private revolving loan funds.

Appendix C: Legislative and Regulatory History of the CRA

The CRA encourages insured commercial banks and savings associations to help meet the credit needs of their communities, including low- and moderate-income neighborhoods, consistent with their safe and sound operation. In adopting the CRA, the Congress reaffirmed the principle that banking institutions have an obligation under their charters to serve "the convenience and needs" of their communities by extending credit to all parts of those communities.⁶⁰

The mandates of the CRA are directed primarily at the four federal banking supervisory agencies--the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The act calls upon the agencies to use their supervisory authority to encourage each banking institution to help meet local credit needs in a manner consistent with safe and sound operation, by (1) assessing the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, and (2) considering the institution's CRA performance when assessing an application for a charter, deposit insurance, branch or other deposit facility, office relocation, or merger or acquisition.

Legislative History

The legislative history of the CRA indicates that members of Congress were concerned primarily

⁶⁰The CRA does not cover credit unions and other types of financial institutions. For a more expansive overview of the history of the CRA and of the issues associated with it, see Griffith L. Garwood and Dolores S. Smith, "The Community Reinvestment Act: Evolution and Current Issues," *Federal Reserve Bulletin*, vol. 79 (April 1993), pp. 251-67.

with conditions in inner-city neighborhoods, particularly economically distressed and blighted areas. Proponents of the CRA argued that banking institutions were accepting deposits from households and businesses in those areas while lending elsewhere and overlooking qualified loan applicants from the local community. They believed that the failure of banking institutions to take advantage of sound lending opportunities in those neighborhoods accelerated the process of economic decay and inhibited private revitalization efforts.

The legislative debate indicates that the Congress did not support nonmarket methods of credit allocation, such as lending quotas established through government regulation, to meet the credit needs of local communities. Rather, the CRA seeks to promote banking institution search for and service of qualified borrowing prospects in their communities and even-handed treatment of creditworthy applicants. In keeping with this view, the CRA does not require excessive risk-taking or lending that would undermine the safety and soundness of covered institutions.

Although the broad concerns of the Congress were well known, there was little congressional guidance provided to the agencies responsible for promulgating the regulations that implement the law. For example, the Act did not provide the regulatory agencies with any guidance in defining a "low- or moderate-income neighborhood," a bank's "community," or the criteria for determining how well a particular institution is meeting its community's credit needs.

Implementing the CRA

To implement the CRA, the supervisory agencies solicited public comment and in 1978 adopted joint regulations that reflected two principles that continue today to mark the administration of the CRA. First, the regulation should not require covered institutions to allocate credit according to

government-issued edicts. Second, banking institutions should be free to meet their CRA obligations in different ways to reflect the specific needs of their communities and their own capabilities.

To apply the CRA, the regulatory agencies identified twelve factors against which the agencies would assess the performance of banking institutions, and these were codified in the regulations. They also adopted uniform examination procedures. Like the regulations, these procedures stressed that covered institutions could use various means to learn about and help meet the credit needs of their local communities. As required by the law, the regulatory agencies conduct periodic CRA examinations of banking institutions and evaluate and consider CRA performance during the application process for bank acquisitions, mergers, and other actions.

Over the years, the regulatory agencies provided additional guidance to regulated institutions to help clarify their responsibilities under the CRA and the procedures the agencies would follow in assessing performance.⁶¹ In August 1989, the Congress amended the CRA to require the public release of examination assessments and corresponding CRA performance ratings.⁶²

Concerns about the evaluation process for the CRA continued over the years, despite the agencies' efforts to clarify policies and procedures. Some community advocacy groups believed,

⁶¹The Federal Financial Institutions Examination Council (FFIEC) issued a policy statement in September 1980. The regulatory agencies issued an interagency policy statement in April 1989.

⁶²Guidelines were also published in April 1990 to detail expected performance requirements and provide information about how examiners would evaluate institutions. See FFIEC announcement, "Guidelines for Disclosure of Written Evaluations and Revised Assessment Rating System."

for example, that the examination process failed to make meaningful distinctions between banking institutions that performed well under the CRA and those that performed poorly. On the other hand, some banking institutions were concerned that CRA enforcement was too focused on process and paperwork and that the examination standards were unclear and inconsistently applied.

The Current CRA Regulations

Believing that the implementation of the CRA could be improved, President Clinton in July 1993 requested that the regulatory agencies reform the CRA examination and enforcement system. The President asked the agencies to refocus the CRA examination system on more objective, performance-based assessment standards to further the goals of minimizing the burden of compliance, promoting consistency and even-handedness, and providing more effective sanctions against institutions with consistently poor performance.

Following a period of review and public comment, the agencies issued revised regulations in April 1995.⁶³ The new regulations provide distinct performance evaluation tests for three categories of banking institutions--large retail, small retail, and wholesale or limited-purpose institutions. Each institution may also choose, as an alternative, to be evaluated under a “strategic plan” option in which the institution identifies and seeks to meet measurable objectives. Like the earlier regulations, the new regulations do not establish specific lending thresholds for obtaining a particular CRA performance rating. While large retail and small retail institutions are evaluated

⁶³See Federal Reserve press release, "Community Reinvestment Act Regulations," April 24, 1995.

primarily based on their performance in their assessment areas, wholesale and limited purpose institutions may be evaluated based on their performance nationwide, so long as they have adequately addressed the needs of their assessment areas.

To further promote consistency of assessments, the regulations establish a uniform set of ratings criteria. Specifically, the agencies assign ratings of outstanding, satisfactory, needs to improve, and substantial noncompliance to an institution's CRA performance.

For large retail banking institutions, the new regulations substitute three performance tests--lending, investment, and service--for the twelve assessment factors contained in the original regulation. (See box "The Three CRA Performance Tests") Under this scheme, lending is more heavily weighted than investments or services, so that an institution may not receive a satisfactory or outstanding rating unless it is rated at least low satisfactory on lending. To facilitate the CRA assessment process, and to increase public awareness of the activities of banking institutions, the new regulation requires large banking institutions to report to the supervisory agencies the number, the dollar amount, and the geographic distribution of all small business and small farm loans and any community development loans.⁶⁴

⁶⁴Under the regulation, a "large" banking institution is generally defined to be an independent institution with assets of \$250 million or more or an institution of any size if owned by a banking institution holding company with assets of \$1 billion or more.

For the reporting of business loans, the maximum loan size reported is \$1 million; for the reporting of farm loans, the maximum loan size reported is \$500,000.

The regulation defines a community development loan as any loan whose primary purpose is community development and includes such loans as those for affordable housing, multifamily residential housing for low- and moderate- income households and other loans that promote economic development by financing small businesses or stabilizing low- or moderate-income areas.

Box: The Three CRA Performance Tests

The regulations that implement the CRA set forth three tests by which the performance of most large retail banking institutions is evaluated: a lending test, an investment test, and a service test.

The lending test involves the measurement of lending activity for a variety of loan types, including home mortgage, small business and small farm loans. Among the assessment criteria are the geographic distribution of lending, the distribution of lending across different types of borrowers, the extent of community development lending, and the use of innovative or flexible lending practices to address the credit needs of low- or moderate-income individuals or areas.

The investment test considers a banking institution's qualified investments that benefit the institution's assessment area or a broader statewide or regional area that includes its assessment area. A qualified investment is a lawful investment, deposit, membership share, or grant that has community development as its primary purpose.

The service test considers the availability of an institution's system for delivering retail banking services and judges the extent of its community development services and their degree of innovativeness and responsiveness. Among the assessment criteria for retail banking services are the geographic distribution of an institution's branches and the availability and effectiveness of alternative systems for delivering retail banking services, such as automated teller machines, in low- and moderate-income areas and to low- and moderate-income persons.

A large banking institution's performance under the three performance tests is evaluated by examiners in the context of information about the institution and its community, competitors, and peers (broadly referred to as the "performance context"). Assessments of a banking institution's record under the CRA consider many factors, including the economic and demographic characteristics of the institution's local community; lending, investment, and service opportunities in the local community; the institution's product offerings and business strategy; and its capacity and constraints. According to the regulatory agencies, a principal benefit of the new regulation is that it lowers the costs of compliance and makes CRA performance ratings more meaningful by

spelling out in greater detail the process and indicators regulators use to make CRA evaluations.

Assessments of the CRA performance of small banking institutions are streamlined relative to those for larger institutions. For small institutions, lending is the primary consideration; a small institution may opt to be evaluated under the investment and service tests for large institutions. Consideration is also given to investment and service activities when an improvement of a small institution's CRA rating from "satisfactory" to "outstanding" is sought by the institution. By contrast, wholesale banks, which typically do little retail lending, and limited-purpose institutions, such as credit card banks, may elect to be evaluated using a community development test that primarily considers community development lending, investments, and services. For these banks, the only lending considered is community development lending.

The CRA legislation refers specifically to the importance of the geographic distribution of an institution's lending across all sections of its community. The revised regulation implements this legislative intent with respect to large banking institutions primarily through the "lending test" in which lending activities are measured by (1) the portion of loans extended within an institution's local community, as distinct from its lending outside the community, and (2) the distribution of loans across neighborhoods of differing incomes. For assessing the distribution of loans by neighborhood income, neighborhoods are grouped as low-, moderate-, middle-, or upper-income.⁶⁵

The revised regulations also extend the evaluation of a bank's lending to encompass the distribution of loans across borrowers of different economic standing. The definition of economic

⁶⁵For most institutions, these income divisions divide the population and the number of census tracts into groups of unequal size whether measured by number, residents, housing units, or businesses.

standing varies with the product being examined. For retail products, such as mortgage and, in some cases, consumer lending, CRA assessments consider the distribution of loans across low-, moderate-, middle-, and upper-income borrowers. Borrower income categories follow the same groupings as those for neighborhoods but rely on the borrower's income relative to that of the median family income of the metropolitan statistical area or nonmetropolitan portion of the state in which the borrower is located. For small business and small farm lending, assessments consider the distribution of small loans (loans of \$1 million or less to businesses and \$50,000 or less to farms) across businesses and farms with differing levels of revenue and focus particularly on loans to businesses or farms with revenues of \$1 million or less.

An additional provision of the new regulations was the requirement that banking regulators make public a list of those institutions that are scheduled to undergo a CRA performance examination in the forthcoming quarter. This provision was added to enhance the public's opportunity to provide comments on the CRA performance of banking institutions. Each institution must also maintain a public file including such comments as well as other pertinent materials, such as its most recent performance evaluation.

Summary

The legislative history indicates that the Congress did not intend for the CRA to result in government-imposed credit allocation. The expectation, rather, was that banking institutions would be proactive in seeking out and serving viable lending opportunities in all sections of their communities. At the same time, it was expected that lending activities would be undertaken in a

manner consistent with the safe and sound operation of banking institutions. The regulations that implement the CRA reflect these goals. They provide for flexibility and direct that performance be evaluated in the context of the specific circumstances faced by each institution.