SECTION 8

THE EFFECT OF CRA ON MORTGAGE LENDING OPERATIONS

This section presents a qualitative assessment of the impact of CRA on the operation of mortgage lenders, and thus serves as a complement to the earlier discussion of the impact of CRA on mortgage lending patterns. Material for the section comes primarily from interviews with CRA-regulated, and in some cases non-regulated, lenders in our five case study sites. Some of the material also comes from interviews with other interested observers of the community reinvestment process in these areas (and is noted as such) and some is drawn from discussion groups conducted with regulators, lenders, and advocates as part of this project (Belsky *et al*., 2000). The lenders interviewed spanned all sizes, from institutions with national reach to those with only a handful of branches operating in a single market. Specific personnel interviewed were generally at the CEO/senior management level for small banks. At larger lenders, interviewees were typically the person or persons responsible for CRA compliance activities. Responses here are consensus views unless otherwise noted and represent an effort to distill reactions and opinions on a range of issues related to the past, present and future of CRA, compliance activities, community reinvestment more broadly, mortgage lending, and banking in general**.**

CRA AND BUSINESS STRATEGY

While obviously a component of the competitive environment in which both CRA-regulated and unregulated lenders operate, CRA generally surfaces as a second-tier consideration in the business plans of regulated lenders. Said another way, CRA compliance strategies are typically formulated taking business strategy as a given. For example, one regulator in the San Francisco focus groups pointed out that in lender decision-making regarding merger or expansion activities, CRA considerations are swamped by tax-related concerns. At the margin, however, CRA can influence some business decisions. And, some activities, such as operating an affiliated mortgage company or pursuing a strategy of cross-selling mortgage and small business products through branch networks, are more compatible with CRA obligations than others.

A. Reputational Risk and Impact on Services and Product Lines

Over the past 15 years CRA has entered the strategic considerations of lending industry decision-makers in ways linked both to opportunities for new business lines and to potential reputational and regulatory concerns. Along with HMDA, CRA's impact on transparency and data quality clearly helped lower-income area and borrower markets develop into their current robust condition. The effect of CRA and HMDA in combination with enhanced technology and industry competition since the late 1980s has been to demonstrate the viability of these markets, and open up this lending as standard lines of business. The transformation of lending to parts of the lower-income area and borrower markets has been so complete that it is currently difficult to apportion motivation for depositories' ongoing lending to some lower-income borrowers and areas between CRA obligations and standard business considerations.

CRA and related concerns may also influence business activities on the positive side when combined with a leadership role in the community. One large lender in Chicago that has expanded in part by purchasing several smaller depositories, reported fierce loyalty among the clients of one of the acquired institutions that was widely perceived as being a champion of the interests of lower-income, particularly immigrant, customers. While it would seem possible for a

lender to market itself based on its success at reaching underserved borrowers and areas (as evidenced by a grade of outstanding on a CRA exam) no one interviewed for this study reported doing so. Several lenders did, however, mention using the value of being known as a concerned corporate citizen more generally. The chairman of one bank, in a letter to the *Chicago Tribune*, denounced predatory lending at a time when doing so constituted breaking ranks with many in the lending community. He did so on the theory that, in addition to ethical considerations, predatory lending can harm legitimate lenders in targeted neighborhoods by weakening markets there. Weeding out those engaging in predatory lending is therefore good for legitimate lenders.[1]

Small lenders may experience the link between performance that is commendable on CRA grounds and business strategy most viscerally because they are situated in relatively few areas, with limited options for expansion, and consequently dependent on the viability of these areas for their own survival. Particularly in lower-income areas, CRA-eligible activities help keep markets sufficiently liquid and communities sufficiently robust to prevent the deterioration of assets held by lenders in these areas. A medium sized lender in Chicago expressed this point, saying "leaving CRA aside, the [bank's] board feels that the community has to do well for the bank to do well." A small lender in the same market referred to itself as "located in and invested in low- and moderate-income areas" to the extent that absent CRA they would have little choice but to continue serving lower-income markets. And, in an extreme example of this kind of commitment, a small commercial lender in Birmingham considers the bank, while intended to be a profitable concern, as "an extension of the other empowerment activities" of its founders.

To the extent that it is possible to isolate a CRA effect on business decisions today, however, it is in some cases easier to find it in the practices and business lines that regulated lenders avoid on account of CRA rather than in the markets they are serving because of it. Several lenders mentioned that specific practices and lines of business are associated with negative attention from regulators and advocates during exams and with undesirable effects on their community reputation. Two areas of particular concern were methods of reaching the unbanked population and mortgage lending practices that could be construed as predatory. One small lender in Baltimore, for example, reported getting out of the check cashing business, despite its profitability, in response to concerns from community advocates. Similarly, CitiGroup and Household Finance Corporation recently made unilateral commitments to drop mortgage products that include single premium credit insurance (a practice many consider predatory), again in spite of their profitability.

Several national lenders interviewed for this study reported specific interventions designed to ensure that their pricing does not enter realms that may be considered predatory and hence attract negative attention from advocates and regulators. Such efforts are in large measure a belated response to the uproar about loan packages securitized by the GSEs and Wall Street that were revealed to contain loans made using predatory practices and through which lower-income people were defrauded out of home equity and/or cheated into losing their homes altogether by being tricked into securing a loan they were unable to repay. Some lenders' self-police using absolute point caps, independent of risk, for all of their 'B' and 'C' market activities. One reported monitoring pricing differentials by race/ethnicity and gender on both its retail and wholesale operations, a move that may reflect lenders' particular sensitivity to Fair Lending legislation. A third national lender has taken advantage of technological advances to insulate itself from decisions by its brokers that might reflect poorly on the institution, by designing an automated

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[1] Any benefits of this kind of action must be weighed against the negative impact it has on a bank's relationship with mortgage brokers, who are wary that legislative efforts intended to ameliorate "predatory lending" may affect their livelihoods in unintended ways by proscribing classes of activities.

underwriting system that automatically gives the client the best pricing for which he/she qualifies. Further indicating the attention paid to ethically questionable practices, this lender takes the additional step of running background checks on brokers and approving them to originate some product lines and not others, based on the results of this check.

These steps reflect the intersection between CRA and related legislation, including the Fair Housing Act and the Equal Credit Opportunity Act (ECOA) and the reputational risk considerations that lenders face. Lenders are extremely concerned with reputational risk because the impression that a lender's practices are unfair with respect to income and race can be extremely costly and difficult to overcome, and may be widely publicized. In California, for example, the Greenlining Institute compiles and distributes a 'watch list' of lenders whose practices it considers suspect, that is monitored by advocates, consumers, and potentially by regulators.

Regulators clearly pay attention to community groups with clout. One lender in Chicago reported facing a particularly tough exam because of a campaign against the bank by ACORN that coincided with its CRA exam. And in a prominent early example of the importance of reputational risk, Decatur Federal Savings and Loan Association (Atlanta) not only paid a $1 million settlement to 48 African-American families that had been turned down for mortgage loans, it also agreed to expand its CRA assessment area, target minorities in its marketing, modify its commission structure to reward loan officers for making loans to African-Americans, open a branch in South Fulton County, and hire minority loan officers, all to appease the Department of Justice for violations of ECOA and the Fair Housing Act associated with its mortgage lending practices (Schill unpubl).

B. Consolidation and Branch Banking

Another area where CRA interfaces with depositors' business strategies is in decisions about consolidation, and expansion or contraction of branch networks. Though contained in the initial legislation, CRA's provision that an institution's CRA performance be considered when regulators consider its application for mergers and branch openings was ineffectual until 1989, when the Federal Reserve denied the Continental Bank Corporation's attempt to take over Grand Canyon Bank of Scottsdale on the basis of Continental's poor CRA record. This made it clear that lenders must have their CRA house in order if proposed consolidation activities are going to meet regulatory approval. To this end, actively and potentially consolidating banks seek to maintain ratings no less than 'satisfactory' to ease their ability to consolidate, an ability that is increasingly important in the current highly competitive banking industry. To this end, mergers can be the occasion for reinvigorating and publicizing community reinvestment activities, as was the case in the Chase-Chemical merger of 1996, which resulted in a public $18 billion small business and mortgage lending commitment to lower-income and minority borrowers and areas.

Branching activities also attract regulatory attention during the service test portion of the exam, in which examiners scrutinize the pattern of opening and closing branches to ensure that lower-income areas are not disproportionately targeted for closings. This has, in practice, made it extremely difficult to close branches. One lender described a process of closing a small rural branch that included commissioning and funding a study of the impact of the branch closing, and funding a CDFI to serve the area in place of the closed branch. Several bankers noted that it is nearly impossible to close a branch because of the negative publicity and the leverage that community advocates have in the exam process. Another lender described a meticulous process by which his bank investigated the demographic characteristics of areas in and around locations that they consider for new branch placements in order to "improve their perceived impact" in the

CRA exam. At the same time, branch openings can also pave the way for regulatory approval of merger activities and may to some extent be *quid pro quo* for this approval. In Los Angeles, U.S. Bancorp, at the time it acquired Firstar, agreed to open two branches in the predominantly Latino East Los Angeles and the predominantly African-American South Central neighborhood. The latter branch was the first opened in the area for 20 years.

Overall, the relationship between CRA and business strategy, while operating at the margins, nevertheless exists. In addition to the examples catalogued above, it may enter business considerations in less direct ways. One representative of a mortgage company operating outside of the assessment area of its parent bank, noted that mortgage product development first occurs in bank assessment areas, and is then deployed in other markets served by the mortgage company. Another lender noted that CRA and business strategy are not really at odds when it comes to mortgage lending. Since the homeownership rates of lower-income people and minorities, whom current CRA and related legislation is designed to benefit, are far lower than those of higher-income people and whites, the CRA-eligible market is the growth market going forward, thus aligning business interests and CRA.

INTERNAL ORGANIZATION OF CRA COMPLIANCE

Most covered institutions have responded to CRA by initiating processes and developing personnel to ensure that their activities result in defensible records of community-oriented lending, investments, and other activities. These people and/or departments may track lending patterns, anticipate peer comparisons, engage in and document community outreach, as well as a number of other activities intended to demonstrate that their performance is satisfactory or better when the examiners arrive. While some CRA-relevant activities are undertaken by lenders of all sizes, others are a function of the amount of resources that the institution can devote to compliance-related activities, and hence differ between large and small lenders. This section looks at these activities noting the differences in compliance paths chosen by larger and small institutions.

A. Goal Setting

Many institutions begin structuring a compliance plan by establishing a target for the desired exam score. This decision is typically made by senior management, and is then communicated to compliance staff. Since achieving an outstanding rating is more costly, the expenses incurred must be weighed against the potential benefits of a higher ranking. And, as noted earlier, a grade of outstanding does not necessarily generate leverage or create business in the community. Indeed, the head of compliance at one ‘outstanding’ organization said that the rating “does us no good internally or externally.” Yet focus group and case study participants agreed that a subset of lenders would do what it takes to achieve an outstanding rating.

Institutions that aim for the outstanding rating typically cite indirect reasons for committing the expenditures involved in reaching this goal. In some cases, their motivation derives from an organizational culture where ‘being the best’ is deeply ingrained. One compliance officer mentioned that the “message from the top [is that] we will always be outstanding.” Another lender that aimed for outstanding cited the problem of sustaining employee morale if it sends a mixed message that the institution’s goal is to be the best at everything, except for CRA. Interestingly, the link between organizational goals and strong lower-income lending performance was confirmed by a large non-CRA lender that has a division focused on lending

that would be CRA-eligible if it were a depository, and has made public commitments led by senior management to hit lower-income and minority lending goals.

Other lenders, while recognizing the need to maintain satisfactory performance, do not actively aim for outstanding. Often this is a reaction to the perceived uncertainty of the regulatory environment. One executive at the holding company level pointed out that his institution noticed variation between regulatory agencies reviewing different parts of the organization.[2] As evidence of this variation, one lender mentioned struggling to obtain CRA credit for doing the construction loan for a manufactured housing development under the affordable housing component of the community development lending test, while another lender noted that regulators had "found" such a loan on their books and counted it toward meeting their CRA goals, though the bank had initially not intended to include it in their lending summary. Another CRA compliance officer for a bank that had been rated 'needs to improve' after a series of satisfactory ratings, subsequently examined 200 exam reports from comparable institutions and said that the bank's own performance was not discernibly different from that of its peers, all of whom were rated satisfactory. Comments such as "our goal is not outstanding but to make a difference" and "we want to do outstanding work, which may or may not get us an 'outstanding' grade", all reflect a lack of clarity about the process on the part of some well-intentioned lenders. One lender summarized his bank's approach as "putting up numbers that are high satisfactory and [possibly] letting regulator discretion take us to outstanding."

Uncertainty about the relationship between a certain level of performance and the attendant CRA rating is often located in the subjectivity of the law and regulations, despite the push to quantify the exam since 1995. Two key areas are the provisions to evaluate the bank's activities given the 'performance context' in which it operates, and the 'peers' to which the institution's performance is compared. In focus groups, lenders mentioned these as key areas of uncertainty. They also noted that regulators continually raise the bar for what constitutes acceptable lending levels and 'innovativeness' in investment, service, and community development lending activities.

Lenders also suggest that ratings fluctuate because regulators fail to understand the nature and complexity of the products and business lines they are involved in, and consequently do not give them sufficient credit for some activities or demand unfair levels of achievement for others. One reported being pressured to reach unrealistically high mortgage lending goals, though their business consists of very little mortgage lending. Lenders also cite the role played in the exam process by community groups as a source of uncertainty because regulators tighten standards when they know that advocates have identified a lender as one whose performance should be monitored closely. One lender even reported being told by regulators that they could not receive credit for a particular loan because it would not pass the scrutiny of a specific community group.

Beyond the cost and uncertainty of moving between satisfactory and outstanding, some lenders note that an outstanding rating "sets you up to fail." It raises the bar with regulators, to some extent casting 'outstanding' lenders as institutions that are expected to continue to lead and innovate. It also brings increased attention from community advocates. One lender specifically mentioned the desirability of the "lower public profile" that comes with a satisfactory rating. Lenders believe that both regulators and advocates will perceive the organization's performance as deteriorating if they move from outstanding to high satisfactory, a change that many believe is well within the margin of regulator discretion/variability.

[2] Thomas (1998) has documented fluctuation in the intensity of regulatory scrutiny across regulators and regions.

B. Structure and Staffing of Compliance

Subsequent to goal setting, institutions must devise an internal structure to address, staff, and track compliance activities. Larger lenders typically have entire departments managing compliance activities that in some cases reach across the disparate corporate entities housed within a holding company. In the most straightforward structure, 'CRA Compliance' departments assume responsibility for generating and tracking CRA-eligible activity. In other cases, depending in part on the strengths and focus of the institution, 'Community Development' or 'Affordable Lending' departments bear primary responsibility for CRA-related activities. In some instances these are standard business units that happen to generate CRA-eligible activity. In others, they are targeted more specifically at achieving compliance-oriented goals.

In an example of a hybrid structure, one large lender had a 'Community Investment' division housed in the risk management department. Despite the institution's size, the division consisted of a single person who coordinates all community development activities and who brings CRA-eligible projects to lending officers in the appropriate section of the bank. This approach was similar in some ways to that pursued by several smaller institutions (including some with asset levels low enough to qualify under the small bank exam rules) that had an individual whose primary responsibility was to manage compliance issues. In one case, a small lender hired an individual to a position created specifically to turn the bank's CRA performance around following a disappointing review from regulators.

Lenders' response to the letter and in some cases the spirit of the Act is also evident in the way they go about staffing compliance activities. Several lenders have, in fact, hired community advocates to head up their compliance effort. Hiring someone from 'the other side' can be both a signal to regulators that the institution is serious about CRA, and an effort to use the advocate's skills and knowledge to gain a competitive edge in lending to lower-income borrowers and areas. It can also be a way of capturing advocates' knowledge of which community-based organizations are likely to be effective partners, information that is increasingly important as institutions seek to coordinate their charitable giving with their CRA business strategy. Sending the right messenger to meet potential community partners may help banks secure a relationship with one that has sufficiently effective leadership and institutional capacity to be a useful partner. Some lenders have chosen to hire heads of compliance out of their mortgage lending operations, presumably reflecting the perception that mortgage lending carries disproportionate weight during the exam. A key benefit of this strategy is that it houses CRA-eligible mortgage product development in the same department as compliance.

Following selection of a compliance chief, the bank must structure its internal operations in such a way that they meet CRA compliance obligations. This typically follows one of three approaches: employing specialized teams that do CRA-eligible lines of business; providing incentives or requiring regular business units to do certain shares of CRA-eligible lending; and hybrid approaches. In each of these, a key issue is compensation, because CRA-oriented activities and deals are widely seen as more time-consuming to consummate and hence dilutive of loan officer productivity. Lenders following the 'specialized department' approach often pay higher rates of commission on CRA-eligible business. Alternatively, some community development loan officers are paid a salary rather than commission, reflecting the fact that CRA business often is viewed as being distinct from mainstream business.

Several lenders without special CRA lending teams pay higher commissions on some or all loans that qualify for CRA credit. One bases commissions on the number of loans, rather than dollar volume, to work around the fact that CRA-eligible loans are, on average, smaller than others.

Another lender initially paid higher commissions on CRA mortgage products to loan officers but was later able to abandon these special incentives; once the origination team had gained experience and become convinced of the viability of this segment of the market, they would originate these loans anyway as part of their standard, volume-based commission structure. Other lenders have more complicated commission structures that reward officers for both the number and dollar volume of loans.

As further evidence of the special practices organizations undertake to generate CRA-eligible loan volume, one Birmingham-based lender employs community lending specialists while also setting goals and providing incentives for regular loan officers to do CRA-eligible business. The company also pays loan processors more on community development loans because they are more challenging to process as well as underwrite. Another lender has chosen to start a department that handles more challenging deals, but also pays regular loan officers more when they do a community development deal.

A key aspect of the compliance strategies of both large and small lenders appears to be periodic meetings to track CRA goals. One large California-based lender reported meeting bi-monthly to track community development lending, and a medium-sized lender in Chicago reviews its overall progress on CRA-eligible lending in a quarterly self-exam. Another lender's compliance committee - comprised of the compliance officer plus senior management, including the CEO - meets annually to assess and discuss performance in between exams.

All of these adaptations to the CRA environment are aided by management information systems (MIS). MIS allow formal, CRA-oriented sub-goals to be allocated to departments and tracked at periodic meetings. More technologically oriented lenders integrate the systems that track overall business activities and the subset that are CRA-oriented. These systems have allowed some lenders to define and specifically track profitability goals for CRA-oriented lending.

In sum, the amount of energy devoted to structuring, staffing, and tracking CRA performance leaves little doubt about the fact that lenders expend resources in adapting to the regulatory environment. In today's competitive banking and mortgage lending marketplace the challenge of CRA is to integrate compliance obligations as seamlessly and as profitably as possible into existing business operations.

PRODUCT DEVELOPMENT

Because the lending test portion of the CRA exam is weighted most heavily, product development for the CRA-eligible segment of the market is a key component of lenders' response to the regulatory environment. As the lower-income mortgage market has become demonstrably mainstream and competitive over the last decade, virtually all mortgage lenders now tailor products to this sub-market as part of their standard business practice. Because of market conditions, regulatory or competitive pressure, or good corporate citizenship, lenders in some cases will go further and innovate products that reach deeper than standard lower-income targeted products intended for sale on the secondary market.

Spurred on by CRA activism, the process of mortgage innovation was well established in the 1980s. In part a response to community pressure, in part an effort to develop new market niches, banks in Chicago and elsewhere began to work with community groups in forging new community lending partnerships. Many of these early efforts, codified in the form of CRA agreements, led to a range of new loan products and a new focus on modifying underwriting

standards to better serve lower-income borrowers living in historically underserved communities. The role played by individual banks to create new loan products was complemented in the late 1980s and early 1990s by parallel efforts on the part of Fannie Mae and Freddie Mac. Responding to Congressional pressure that led ultimately in 1992 to the legislation that mandated the creation of specific 'GSE goals,' Fannie Mae and Freddie Mac joined in the effort to develop new products that would better meet the needs of lower-income and otherwise traditionally underserved borrowers.[3]

Recognizing the growing array of affordable lending products on the market, many lender participants in the focus groups and case studies noted that they began their efforts to reach lower-income market segments by entering into partnering arrangements that minimize or eliminate their risk exposure. To the extent that these are available, most lenders are willing to try them. On the mortgage side, many reported working with the GSEs' 97 and 100 percent loan-to-value products. Further, a substantial share of lending that counts for CRA credit comes through FHA and VA. In the economic development arena, many mentioned using Small Business Administration products to serve small business customers.

Several lenders also mentioned working with existing city, county, and state programs - one large lender designs products specifically to complement existing city programs. Another lender considers it part of its competitive advantage in being a client service leader to try harder than competitors to find and facilitate layered financing of their products with available government and non-profit programs to the extent possible. Other tactics include working on product design with community groups, and with their own loan officers, in order to learn why lower-income clients are being rejected and what it takes to get them above the bar.

In some cases, market conditions drive product development. For example, southern California lenders frequently discussed challenges relating to the lack of affordable homeownership opportunities in the region, as well as the difficulty of serving non-native speakers of English. Lenders that are part of national organizations often commented on the additional difficulty of communicating these challenges to headquarters located outside the state. The pervasiveness of affordability and linguistic issues in a large and competitive market like California makes hitting lower-income lending goals particularly challenging and, in many cases, does rely on the development of innovative products, or at a minimum offering products and marketing materials in languages besides English. One lender cited the "need to be realistic" about borrowers' economic situations in discussing a new mortgage product that allows up to 15 percent of the primary borrower's income to come from undocumented sources, a response to the nature of employment among many immigrants in the Los Angeles market. Others mentioned having the language skills on staff to originate a mortgage loan in nine different languages, and having printed materials available in three languages.

Though in many cases their focus on achieving scale economies limits the participation of larger lenders in truly niche areas, large lenders nevertheless have a range of product development options that are not available to smaller entities. One lender reports having a product that is "more competitive than FHA" via a lower interest rate and no private mortgage insurance requirements. Another refuses to buy loans to meet CRA lending goals, designing products with whatever specifications are necessary to meet CRA goals if its lower-income lending is falling short of targets. In particularly challenging markets, another national lender deploys a 95 percent loan-to-value product that is combined with a 5 percent unsecured loan. These loans are seasoned for two years and then sold to the GSEs. A complementary approach is to target mortgage

[3] For an overview of these trends see: Listokin and Wyly (2000); Lea (1996); and Guttentag, (1992).

products to the housing stock lower-income borrowers typically occupy. To this end, one lender designed a product for use on small multi-family properties.

Many smaller lenders also develop products that allow them to pursue idiosyncratic market niches. Several devise and deploy these niche products as part of their general business/survival strategies that are based in many cases on accessing market segments that large organizations overlook or find difficult to serve. In the competitive Chicago market, one mid-sized lender developed a product around '2x4' and '2x6' combined commercial and residential properties.[4] The non-standard architecture makes this a non-standard product, but one that is common enough in many Chicago neighborhoods to make it viable for a lender that is not looking for national reach with its products. Another lender has a product, including a $12,000 grant, designed specifically for physically handicapped borrowers.

COPING STRATEGIES

Beyond developing internal compliance structures and developing CRA-oriented products, lenders subject to CRA have developed a variety of other 'coping mechanisms' intended to ensure their activities are judged compliant amid the uncertainty inherent in the regulatory process. The diversity of these tactics is impressive, and provides clear evidence that lenders continue to respond to CRA. In many cases these efforts are self-evidently outside the scope of the bank's normal activities. In others they complement these activities.

Managing the Exam Process. Most lenders have developed an approach to managing the exam process itself that is designed to minimize uncertainty and control the impression that they present to regulators. Several mentioned trying to make regulators aware of their compliance-oriented activities on an ongoing basis, not merely at the time of the exam. This includes asking regulators for advice on community needs, questioning them about which community groups might be effective partners, and probing for suggestions about activities that might be considered 'innovative.' One lender expressed this as an effort to develop a "non-confrontational relationship with the regulators." Regulators may also be invited to internal intra-exam compliance meetings, presumably to demonstrate the nature of and challenges to the lender's compliance effort. In focus groups, regulators confirmed that lenders were increasingly attempting to work with them on community reinvestment issues and activities.

Managing the exam process also involves making sure the institution puts its best foot forward. This can take the form of policies that limit which employees can speak to the regulators and under what circumstances. One lender that had "done a bad job of telling [its] story" during one exam went as far as to design a procedure, detailing which employees were allowed to interact with regulators, into its protocol for subsequent exams. Other lenders attempt to manage the exam through negotiations with regulators over the coverage and characteristics of assessment areas. One small lender successfully reduced the effective size of its assessment area using detailed maps to convince regulators that a substantial portion of the area that had been labeled a 'lower-income neighborhood,' actually was comprised mostly of hospitals, parks, and cemeteries.

Working with Community Groups. As noted throughout the report, CRA often brings lenders into working relationships with community groups or state and local agencies. In previous years these often took the form of codified 'CRA agreements' between the lender and a community group, and may have specified lending and service goals for the banks, and complementary

[4] These properties have two commercial spaces on the ground floor and four or six residential units above.

activities for advocates as well. These two-way agreements are less common in the current environment where automated underwriting and approval systems often diminish the importance of community groups' specialized knowledge of applicants and neighborhoods. Unilateral lender pledges to meet certain underserved borrower and area goals across multiple markets are more common today, with one compliance officer noting that "to some extent the agreement era is over."

In the present, intensely competitive environment, cooperation between lenders and community-based organizations often works best when community groups provide services that help lenders lower the cost of reaching qualified lower-income borrowers.[5] One common approach, for example, is the effort of many community groups to provide credit and homeownership counseling to buyers, doing outreach to market segments that would be difficult for lenders to access, and generally helping make marginal applicants 'loan-ready' and bringing them to the lender. Since counseling programs are often funded by government or foundation grants, they may generate 'loan-ready borrowers' at little or no cost to the lender. Whether or not partnerships between banks and community groups represent a substantial benefit to a bank's bottom line, of course, will depend on whether any savings the lender realizes in marketing and outreach are offset by lender contributions to support or subsidize other community-based activities.

Illustrating the complex and diverse characteristics of lender relations with community organizations, one smaller lender reported partnering with a local group on business plan writing, with the goal of improving the quality of small business loan applications and increasing approval rates for these loans. Community groups may also help lenders identify the appropriate depth of targeting on mortgage products as several reported asking for community groups' input on the appropriate lower thresholds for credit scores.[6]

The advantages resulting from these cooperative relationships flow in both directions as lenders provide a variety of services to community-based organizations. According to both lenders and advocates, bankers play a key role when they sit on community group boards. One lender noted, however, that as local corporate control recedes in many markets, community groups "are making a lot of bad decisions" in areas such as finance, because they no longer have bankers on their boards. Similarly, in many places bankers are the only corporate leaders sitting on these boards as other businesses have either left lower-income areas for the suburbs or abdicated responsibility for advising local groups, aware that bankers must maintain their involvement because of CRA.[7] Reflecting on this situation generally, one banker lamented that community groups "don't do a good job of finding other partners besides banks."

Beyond sitting on boards, lenders play a variety of other roles in their relationships with community groups. Despite many larger lenders reporting the desirability of working with large-scale advocacy organizations, they were often engaged in efforts to build capacity and enhance sustainability in smaller ones. Such efforts include activities seemingly well removed from banks' core activities, such as helping community groups develop press strategies. One lender

[5] One lender noted that in a particular market, collaboration was made difficult by the fact that community groups there are "just advocates."

[6] Interestingly, one lender reported a community group urging them not to go below 600 FICO scores for fear that borrowers below this level are not ready for loans and that neighborhood deterioration could result from geographically-concentrated defaults.

[7] One Chicago lender noted that insurance company executives participate to a greater extent than other business people (attributing these efforts at least in part as a component of insurance companies' strategy of avoiding having CRA extended to them). In Birmingham, lenders mentioned hospitals as the only other engaged sector.

helped twelve community groups coordinate their real estate acquisitions and development efforts in a distressed part of the city. The groups had previously not realized the extent of each other's holdings, and the bank's involvement helped the groups identify key parcels for acquisition and avoid bidding against each other. Another lender provided seed money for community groups to use in getting community development projects started, with the hope that the money would improve the quality of the projects at the time when the groups applied to the bank's community development lending department for formal financing.

Realtors. Working with real estate agents can also help lenders bolster CRA performance, since many buyers follow their broker's advice about where to seek a mortgage loan. Several lenders emphasized this channel for generating CRA-eligible volume, including efforts to educate realtors about the special provisions of their products that are targeted to lower-income borrowers. One Birmingham lender extends this practice to community development lending, with specialists in this area cultivating relationships with realtors as part of the department's general business development activity. In California, the competitiveness of the market and the fact that realtors can also be mortgage brokers has led one lender to devise a program intended to increase realtor loyalty to its products and capture CRA-eligible loans. Under this scheme, the lender pre-approves potential borrowers and sends them to a realtor/broker who helps them find a home. Acting as a broker as well, the realtor then originates the loan using one of the lenders' products. Though this program is currently unique, the lender expects it to be copied by others in due course given the highly competitive nature of the market and the realtors' ongoing centrality to the mortgage process.

Large Lenders. While many of the coping strategies mentioned thus far are available to all lenders, large lenders can engage in some activities that smaller ones cannot. Large players can, for example, test products in one or a few markets and then deploy successful ones nationally. They can also develop and offer a diverse range of products that makes them competitive in virtually all types of markets and sub-markets. These lenders can also use their portfolios as a safety net to season aggressive CRA-eligible loans that do not initially meet secondary market criteria. And they can also afford to break even or lose money on some CRA-oriented products and deals. Though none of the lenders interviewed for this study reported doing so themselves, several commented that other lenders write off many CRA loans the day they buy or originate them.

Perhaps the greatest advantage enjoyed by some large lenders, however, is their affiliated mortgage company. Because the CRA legislation allows lenders to include the activity of their mortgage company affiliates operating in their CRA assessment areas in their lending totals, organizations with mortgage company affiliates typically take advantage of this option and have little difficulty meeting mortgage lending goals. One compliance officer, who had moved to an institution with a mortgage company from one without, commented that a healthy mortgage company makes the job of a compliance officer easier, allowing him/her to focus on more complex compliance activities associated with community development lending, and the investment and service tests. Because mortgage companies, both independent and affiliated, are often the most cost-effective mortgage originators in their market areas, not having an affiliate basically offers lenders two relatively expensive compliance options for the lending test: operate your own lower-income origination business or buy loans.

One lender reported hitting lower-income mortgage lending goals exclusively by buying loans. While this is rare and results from the lender's business focus outside of mortgage lending, buying loans to reach CRA targets is not. One lender reported selling every loan its mortgage company originates in another lender's assessment area to that lender. Another official at an

independent mortgage company reported selling a high share of its low-income loans to depositories aiming to achieve lending goals. This practice, by which the loans pass through the hands of an additional owner on their way to the secondary market, is clearly uneconomic. Lenders appear to treat it as a cost of doing business and one that is preferable to risking a rating below satisfactory that hurts their competitive standing. While common, the practice is not universal. One lender "never buys loans" to reach CRA targets, preferring to develop products with a deeper subsidy that transfers the lender's additional expenditure to the borrower.

Large lenders may also enjoy an advantage in being able to absorb the costs of producing marketing materials in languages beside English. Because immigrants have relatively low homeownership rates and disproportionately lower incomes, the immigrant market can be a fertile territory for CRA-eligible loans for lenders that can reach it effectively. Outreach includes marketing in non-English language publications and radio and television programs and producing materials in other languages (though this is complicated by regional variation and dialects within a single language). Further compounding the expense of such efforts, non-English marketing channels are highly fragmented. One lender reported doing lots of small-scale activities and "waiting for the message to trickle through." Large lenders are more likely to engage in these efforts because of the scale necessary to recoup the expenses, though some smaller institutions clearly specialize in serving a particular ethnic group. One large lender has a Hispanic marketing department that, in addition to leading the institution's strategy in reaching the Hispanic market, will translate materials from other departments into Spanish. Another prints materials in both Chinese and Spanish and has loan officers that speak a variety of other languages including Vietnamese, Thai, and Lao.

Smaller Lenders. Smaller lenders' lack of resources principally affects their lending test performance. These lenders are generally less competitive in conventional conforming lending and have a limited menu of product offerings. At the same time, they are generally not able to commit reserves to meet goals by buying loans. In order to produce mortgage lending volume they are employing a range of strategies.

Some intend to compete with the lower prices and/or more sophisticated marketing of their competitors by offering superior service. Others have simply ceased originating loans, opting instead to have their own branch-based loan officers serve as correspondents for other mortgage lenders. Such an approach is intended to retain existing customers by offering a full product range and to open opportunities to cross-sell bank products to mortgage clients. Some banks continue to offer mortgages as a loss leader that helps create and maintain 'customers for life.' And one particular lender reported offering unprofitable mortgage products in order to meet goals because they prefer that their expenditures subsidize lower-income borrowers rather than be used to pay the cost of fighting over their exam score in court.

Small lenders also hunt out niches that are profitable and in many cases CRA-eligible that have been overlooked by larger lenders in the consolidation-oriented environment of the previous decade. These efforts often concentrate on small business lending, which is not yet as commodified as the prime mortgage market. One lender reported a highly profitable niche in making business loans under $2,500, a level well below what many larger institutions will handle. Another has a Korean banking unit that generates lots of small business activity. A Los Angeles lender noted that many Asian immigrant groups are, in fact, more eager for small business than mortgage loans, with current immigration patterns suggesting that this should be a good business going forward. Another smaller lender was fortunate that the niche left open by consolidation among larger players is small multifamily construction finance, which can in some cases be counted under the lending test's affordable housing provisions.

In addition to exploiting CRA-eligible niches, smaller lenders often strategically collaborate in meeting CRA obligations in order to share risk, overcome loan limits, and minimize the cost of compliance.[8] These efforts most often occur in activities related to the investment test and community development lending test portions of the exam. One medium-sized lender in Chicago reported advising smaller lenders on CRA-eligible investments. In Los Angeles, smaller lenders have formed an organization called Bankers In Search Of (BISO). BISO members discuss compliance issues and invest together in community development projects presented to the group at monthly meetings during which community-based organizations are invited to present prospective projects to the group. Each of BISO's roughly 20 member banks takes a turn at hosting the meeting and the host invites a community group to present a proposal for funding. Banks that want to participate in the project can offer any level of funding, while others may choose not to participate at all. All participating lenders are listed as funders, regardless of the level of the contribution (though actual dollar amounts are reported to regulators for CRA purposes). This approach ensures that these smaller lenders have a variety of investment activities well beyond what they could achieve individually.

Investment Test. One specific area of adjustment to the regulatory environment concerns actions taken to fulfill the investment test requirements. Guidelines for the investment test generally require CRA-regulated lenders to engage in significant levels of qualified community development investments and grants - preferably in a leadership role - and to be innovative in responding to credit and community development needs in their assessment areas.

An area for further review is the definition of 'innovative.' Some lenders contend that regulators are slow to consider activities 'innovative' that are actually challenging to accomplish. As an example, one lender purchased state housing finance agency bonds backed by mortgages to lower-income borrowers and is unsure whether this purchase arrangement will be considered innovative. Another large lender counts a 25 percent equity position in a small bank operating in a very low-income area of the metropolitan area for investment test credit.[9] Large lenders also have the advantage of being able to make grants that are of sufficient size as to be self-evidently capable of making a positive community impact.

The backbone of investment test compliance for lenders of all sizes, however, is tax credit and mortgage-backed security deals. Just as having an affiliated mortgage company is a compliance advantage on the lending test, some lenders have departments that do financing on tax credit deals, and consequently larger investment portfolios, while others seek investment credits in other areas. However, large lenders who are generally better equipped to evaluate complex deals sometimes take a lead role and then bring smaller lenders on board. This cooperation is not uncommon, as Chicago lenders collaborate on investment test deals to keep costs down because of the potential for bidding wars over these projects. There was suggestion, however, that tax credit deals allow some lenders to comply with minimal effort by 'creaming' the most attractive tax credit deals.

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[8] Under some circumstances larger lenders will also collaborate, an example being among Chicago lenders working on investment deals. Another example mentioned by one large lender was a collaborative approach to warding off negative criticism from an advocacy group. In some cases large and small lenders also work together, as in the Alabama Multifamily Housing Consortium and the Birmingham Business Resource Council, which do multifamily finance and 'micro-lending' respectively. In some cases, however, small players are unwilling and/or suspicious of larger lenders and one large lender reported that such partnerships do not work for them because smaller players believe the bank will "railroad and trample their interests."

[9] The bank's other (non-CRA) regulators force the large institution to take a hands-off approach and they are not allowed to help the institution grow or even purchase mortgages from it.

Providing support to CDFIs is another popular strategy. One large lender mentioned dividing $8 million among three CDFIs in the assessment area surrounding its headquarters and another had recently given $10 million to a local CDFI. CDFIs are also a potential area of collaboration among lenders, as the development of Birmingham's Region 2020 CDFI illustrates. Region 2020, a non-profit group serving northern Alabama, is currently developing a CDFI with contributions (that it hopes will total $100 million) from large and small lending institutions in the area. Lenders interviewed for the study were willing participants, with prospective individual contributions as high as $10 million. Lenders' supportive attitudes toward the project reflect the dilemma CRA presents to large lenders who often have trouble finding viable investments and partnerships at a scale that makes their compliance activities appear commensurate with the volume of their business activites.

Service Test. The service test assesses the accessibility of the bank's delivery channels, branch location changes, reasonableness of hours and services in meeting area needs, and community development service provision. Like the investment test, the service test has produced a range of behaviors and compliance strategies among lenders. Based on regulator assessments expressed in CRA exams, the floor for acceptable performance on this portion of the CRA exam seems to include not closing branches exclusively in lower-income areas, and not having shorter hours, fewer ATMs, or limited product offerings in lower- than in higher-income areas.

Institutions of all sizes also report participating with non-profits, GSEs, faith-based groups, and others to provide homeownership counseling, attend first-time buyer fairs, and improve financial literacy, as part of service test credit generating activities. Participation on the boards of non-profits by an institution's leadership is also counted under the service test component of the exam. One institution expressed its service test strategy as "complying locally." Several others require all employees to volunteer periodically, including one with quarterly mandates for employees of its mortgage division, and another that sets volunteer goals for all staff.

In all cases service test compliance efforts are carefully documented, which forms the basis for many of lenders' complaints about the continuing paperwork burden of CRA in spite of the move in 1995 from 'effort-based' to 'quantitative' assessment methodologies. Lenders, however, take particular care to document activities in less affordable markets such as parts of California where efforts to generate lower-income mortgage lending are crippled by the limited availability of properties in the price range of lower-income prospective buyers. One California lender meticulously documents his institution's counseling efforts in order to be able to demonstrate to regulators the number of loan-ready borrowers coming through their counseling programs that are unable to find homes.

Several lenders discussed reaching the 'unbanked' as part of their service strategies. One lender in California is even attempting to transition customers from its check cashing business into regular accounts. The City of Los Angeles is also initiating a linked-deposit program by which institutions seeking to provide banking services to the city will be graded on their record of serving lower-income clientele in an effort to bring more people into the formal banking system. Participating lenders could apply for service test credit and potentially get additional points for being innovative if they are pioneers in getting the city's program of the ground. Regarding the unbanked generally, however, many lenders noted that the unbanked are expensive to serve and offer limited upstream cross-selling opportunities by graduating to financial services beyond basic checking accounts.

Strategic Plans. In order to manage the uncertainty of the CRA exam, some lenders choose the security of the 'Strategic Plan' option, which one described as appealing given its "static approach." The provision for strategic plans in the 1995 regulations allows lenders to devise a formal three-year plan with annual goals for each section of the test that specify levels that constitute satisfactory, and in some cases outstanding, performance. Emphasizing the appeal of having known numeric goals, one lender attributed the fact that his organization was on a strategic plan to the fact that the bank's CEO was an accountant. Despite the advantages they offer in terms of certainty, strategic plans have, to date, been used by relatively few institutions. In part this is because plans must be revised as institutions change structure, which has happened frequently for many lenders since the 1995 regulations allowing the strategic plan option went into effect. One compliance officer said that his institution would take the strategic plan route if they did not have future growth plans.

Others suggest that lenders have shied away because the plans must be submitted for public comment prior to regulatory approval. Lenders fear that community groups will use this opportunity to ratchet up goals to potentially unreachable levels, and left with the choice of a messier process but one that they know more or less how to manage already, they stick with the standard exam. One community advocate commented that the strategic plan appeals to "weird banks." Supporting this 'hypothesis,' several banks started by the insurance companies have chosen the strategic plan option, as has IndyMac, an 'inverted' mortgage company that also owns a small bank.

In addition to the potentially discouraging aspects of the strategic plan and the fact that its appeal is greater for unconventionally structured institutions, there is general confusion about it. One lender felt that while the OCC considers the plan an agreement between the bank and regulators, the Federal Reserve Board thinks of the agreement as being between the lender and community advocates. One compliance officer of a bank with several entities evaluated for CRA under different strategic plans reported that regulators in one area made them remove numerical targets for 'outstanding' from their plan, while regulators in another area allowed such targets. Other interviewees reported that one regulatory agency encourages use of the strategic plan option, while others discourage it.

In reporting on the outcome of the decision to take the strategic plan route, one lender indicated that some of the strategic plan anecdotes ring true. This lender felt that the plan increased the institution's visibility, and it landed them in a fight with one vocal community group that sought to have regulators raise their target loan-levels. The lender also stated that being on the plan did not reduce documentation. On the plus side, however, they were able to cut CRA compliance staff by distributing numeric goals to regular business divisions. The lender summed up their experience as a mixed one and recommended that the exam for lenders on strategic plans become more impact-based in the future, to take advantage of the plan's inherently longer-run time horizon and its ability to address potential needs in the bank's assessment area 'strategically.'

LENDER CONCERNS ABOUT REGULATORY BURDEN

In spite of the range of adaptations lenders employ to comply with CRA, and the fact that virtually all lenders achieve a rating of 'satisfactory' or better, several issues came up repeatedly as areas in which it was felt that the exam's emphasis was misdirected or that the requirements were excessive. Of course, most banks have only been evaluated once or twice under the 1995 regulations, so part of their concerns simply reflected their uncertainty about the 'new process.' Even so, many comments went beyond the details of the regulations and focused on generic

issues. One common theme, for example, were statements to the effect that "regulators don't understand" certain lines of business. Others related to the challenges of mortgage lending in an unaffordable housing market, and the ability of deep-pocketed players to cream tax credit deals for investment test credit. As mentioned throughout this section, however, the chief concern is the uncertainty inherent in the exam process itself, which raises the cost of compliance and drives lenders into areas outside their expertise.
In addition, several lenders expressed a wish for community development projects made outside their assessment areas to count for CRA credit, because areas most in need of community development are not always within their assessment areas, and/or because viable community development projects are relatively rare. Another issue of contention is the emphasis on quantitative goals since 1995, which ironically was made in response to complaints that the 'effort-based' requirements were too subjective. Many lenders nonetheless expressed the opinion that the new quantitative goals direct lenders' activities away from the "harder work" of "having an actual impact." The quantitative focus can also set up a situation where CRA-eligible loans are effectively "auctioned" late in the year, as institutions that are not going to make goals by originating loans enter the market to purchase loans made by others in their assessment areas.

One lender bemoaned the fact that no distinction is made between loans to borrowers at different points on the income distribution, pointing out that it is far more difficult to get someone at 50 percent of area median income into a loan that someone in the 70-80 percent range. Yet, all loans to people below 80 percent of area median income count as 'low-income' for CRA purposes. Another lender felt that mortgage lending is generally given too much credit in the exam, particularly given the potential spillovers associated with small business lending. Picking up on the small business point, several lenders mentioned that the $1 million cap is far too high to ensure that lenders target the types of businesses that typically have the most trouble getting credit. One lender suggested that rather than having a business size and a loan size standard, the two should be combined to improve targeting of the small business lending requirement, hopefully to reach those borrowers who are now funding business start-ups with consumer debt.

Another set of concerns results from what small lenders feel are implicit comparisons between themselves and larger players. Smaller players claim not to be able to compete with larger ones on pricing for many products, particularly mortgages. One lender that tries to generate CRA-eligible mortgage business by originating loans through its branch network mentioned the difficulty of being compared to another who competes in the same assessment area by buying loans. Small lenders feel that deep-pocketed competitors have the option of writing off a loan the day they make it while these small institutions must be involved in the costly business of working with the borrower up front and over the long term in order to make the loan work. The president of one small institution justified his decision to shoot for a 'satisfactory' rather than 'outstanding' rating based on his assessment that the competitive environment is so skewed in favor of larger players that those with more resources should be shouldering an increased share of the burden of CRA compliance.

Finally, some lenders protested the fact that regulators continually raise the bar for compliance. As one put it, "we are already as innovative as we can possibly be – we can't do loans on Mars." In focus groups, regulators confirmed the existence of continual upward pressure, but noted that the lenders themselves are the source of some of this pressure. This competitive compliance likely derives from differing specializations and comparative advantages across lenders that allow firms making breakthroughs to temporarily exploit them for CRA benefit, but these advantages do not persist because such activities simultaneously show others the way.

SUMMARY

The interviews conducted for this project confirm that CRA has a significant impact not only on the ways in which banks structure internal operations but also on how they relate to the communities that they serve. In many cases banks have found that compliance-oriented activities are directly profitable (if not always at the same rate as other business lines), productive of good will, or both. Many banks have found that CRA-eligible activities can be good business, particularly if they are proactive in developing clear compliance plans that take advantage of the strength of existing business units. At the same time, respondents did express concerns with regard to various aspects of the current regulations and generally do feel constrained from engaging in some activities that they calculate would more directly improve the lot of lower-income people and areas. While some interviews consisted largely of predictable gripes about regulatory burden, most respondents were thoughtful and committed to making their CRA activities work better to achieve observable improvements, particularly in the distressed communities in which they operate.