

**Joint Center for Housing Studies  
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## **Rethinking Duties to Serve in Housing Finance**

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## Introduction

If the housing crisis has had a silver lining, it is the opportunity to rethink our housing finance policy. The US housing finance system and its regulation evolved to address particular crises and problems—the Great Depression, the post-War housing crunch, the 1960s budget crises, redlining, the savings and loan crisis—rather than as a planned, comprehensive system.<sup>1</sup> As the mortgage finance market is restructured in the wake of the recent financial crisis, it is essential to ensure that it better serves the housing needs of all Americans. Thus, an important question going forward concerns the role of duties to serve (DTS)—obligations on lending institutions to reach out to traditionally underserved communities and borrowers. Should there be DTS, and if so, who should have the responsibility to serve whom, with what, and how?

As an initial matter, it is important to distinguish fair lending from DTS. Fair lending concerns the obligation not to discriminate on unlawful grounds in the actual granting of credit and its terms. The “duties to serve” concept is broader, recognizing that merely prohibiting discriminatory lending is insufficient to address the disparity of financial opportunity. DTS involve taking affirmative steps to reach out to communities traditionally underserved by the housing finance market to ensure not just that credit is granted on non-discriminatory terms, but that there is also equal access to credit granting institutions. DTS imply that a financial institution ensures its services are available to *all* eligible consumers.

Currently the US housing finance system features DTS in two major ways: depository institutions are subject to the Community Reinvestment Act (CRA) of 1977, and Fannie Mae and Freddie Mac—two government-sponsored enterprises (GSEs)—are subject to housing goals (HGs). In addition, on a smaller scale, each of the Federal Home Loan Banks (FHLBs) is required to target a share of profits to an Affordable Housing Program (AHP). The financial system has changed since these regulations were first conceived, with the rise of interstate branch banking, secondary markets, non-depository lenders, and new technologies. Yet despite these changes, some of the fundamental issues regarding access to credit for people of color or of low-to-moderate income (LTMI) or living in LTMI communities or communities of color are still

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<sup>1</sup> Levitin and Wachter (2013).

operative, though concerns shifted from redlining to predatory lending.<sup>2</sup> Furthermore, today's low regulatory and investor tolerance for risk may usher in a new phase of limited access to credit. DTS need to be revised and updated so that they align with the evolving nature of the financial market.

This paper argues that DTS must be conceived of as a question of public benefit and purpose, not strictly as a question of social justice, redress, or mandated subsidy. Financial services are not just another type of business: the US financial system functions because of the legal and financial infrastructure provided by the federal government, and government is constitutive of the market.<sup>3</sup> To the extent that private firms are suffered to operate in the system, it is conditioned on provision of equal access, much like a public utility or common carrier.<sup>4</sup>

Put differently, like transport and telecom providers, financial services providers have a social responsibility as well as a shareholder responsibility. Their right to do business is a limited one. First, unlike general corporate charters, neither bank charters nor the GSEs' charters are freely granted. Bank and GSE charters are also limited, special-purpose charters that restrict the business these entities can undertake to a specific type of economic activity thought to be in the public interest. Doing business under these special-purpose charters with the backing of federal deposit insurance comes with a set of social responsibilities, namely ensuring that financial services are available and accessible to all communities within the constraints of financial institution safety-and-soundness.

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<sup>2</sup> Quercia, Freeman, and Ratcliffe (2011).

<sup>3</sup> As the 1912 Democratic Party platform put it, "Banks exist for the accommodation of the public..." American Presidency Project, Democratic Party Platform of 1912 (<http://www.presidency.ucsb.edu/ws/index.php?pid=29590#axzz2isKCn5Lr> )

<sup>4</sup> A "common carrier" is defined as "a business or agency that is available to the public for transportation of persons, goods or messages." ([www.miriam-webster.com](http://www.miriam-webster.com) accessed 9/16/2013). Common carriers, such as airlines and shippers, offer these services to the general public in a non-discriminatory manner under a licensing and regulatory framework that serves the public interest. Specifically, they may not unreasonably refuse service to anyone willing to pay the fare. Another example is the universal service aspect of the Telecommunications Act of 1996, the goal of which is to ensure broad, nondiscriminatory access to advanced telecom services "to all consumers, including those in low-income, rural, insular and highest-cost areas at rates that are reasonably comparable to those charged in urban areas." To spread the costs, all telecom providers pay an assessment on their revenues which goes to the Universal Service Fund which also specifically funds the provision of services to schools, libraries and rural health care providers ([www.transition.fcc.gov/wcb/tapd/universal\\_service/](http://www.transition.fcc.gov/wcb/tapd/universal_service/) accessed 9/13/13).

DTS are part and parcel of the purpose for granting special-purpose charters for financial intermediation, and for the government support of the market, which comes in a variety of forms—economic, regulatory, and infrastructure—that benefit stakeholders directly and indirectly. For example, federal deposit insurance enables the scope and scale of depositories' business. Likewise, mortgage banks, though not directly backed by the government, can operate only because of the secondary mortgage market, much of which is government-backed. Even the purely private segments of the secondary market rely on the framework provided by government-supported segments of the market. Similarly, private mortgage insurance (PMI) companies do the lion's share of their business on GSE-backed loans because PMI is specifically required by the GSEs' charters. In the recent crisis, the expansion of the Federal Housing Administration (FHA) program played a countercyclical role in stabilizing the housing market, indirectly reducing potential losses for a range of stakeholders.<sup>5</sup> As these examples show, the government provides a supportive framework to the benefit of a range of market participants, who interdependently benefit from, and should contribute to, a vibrant and accessible market.

Further, we argue that DTS go beyond simply doing business with LTMI and minority communities as has been traditionally mandated. DTS must include offering the *same types of products* to all communities, adjusted for the needs of communities (e.g. seasonal income in rural agricultural communities). DTS should not sanction a type of separate but equal approach to housing finance; rather, DTS must involve ensuring access to substantively similar credit as is available to well-served communities.

We are *not* suggesting that lenders could or should offer identical loans to all borrowers. DTS must exist within the bounds of safe-and-sound lending practices. There cannot, however, exist a two-tracked, separate and unequal housing (and consumer) credit system in the US, with wealthier (and whiter) communities offered traditional, non-predatory products from depositories and prime lenders, such as long-term, fully-amortized, fixed-rate mortgages, while LTMI and minority communities go unserved or served only by non-banks offering higher cost

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<sup>5</sup> Quercia and Park (2012).

and non-traditional products that expose borrowers to greater risks than traditional products. Because of the constitutive role of government in the financial marketplace, and its direct and indirect support of the entire housing finance system, all entities in the system must have DTS that are consistent with safety-and-soundness. This DTS might reduce (but not eliminate) profitability in some cases, but is the cost of doing business in a government-constituted market. Simply put, consumers' access to a government-constituted market must be offered in a non-discriminatory and accessible manner to all.

This paper proceeds as follows: First, it discusses the importance of homeownership and housing finance for economic opportunity. It then reviews the regulatory framework and history underlying the present set of DTS, addressing the policy concerns underlying these DTS and how they have changed. The paper identifies several problems in the existing DTS framework that will continue to limit the impact of DTS unless remedied. A discussion of the public purposes of financial services follows. The paper concludes with recommendations for operationalizing DTS conceived of as public accommodations within the bounds of prudential regulation, laying out a quartet of reforms that will make DTS more effective. In particular, it proposes the creation of an independent DTS commission that would serve as an advocate for DTS and a check on financial institutions' compliance *outside* the prudential bank regulators.

## **I. THE IMPORTANCE OF HOMEOWNERSHIP FOR ECONOMIC OPPORTUNITY**

Homeownership has long been a keystone for the economic vitality of America's broad middle class, conferring financial and social benefits to families and communities.<sup>6</sup> Homes provide more than just shelter; they are also a long-term savings vehicle and nurture stable communities. Homeownership also generates various macroeconomic benefits through new construction, real estate transactions, and financial services employment. The individual and social benefits from homeownership, however, come largely from the way it is financed: since the 1930s, the housing finance system has been designed to provide affordability, stability, and societal benefits through consumer-friendly mortgages.

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<sup>6</sup> We emphasize that while there are particular benefits from homeownership, there is a role for stable rental housing as well.

That has not always been the case. Prior to the 1930s, housing finance was a private business; mortgages were usually short-term balloon loans so that the rates could be readjusted regularly. Large down payments were required, and the homeownership rate was below 50 percent.<sup>7</sup> Recurrent boom-bust cycles made homeownership a risky investment. These cycles culminated in the Great Depression, and when lending collapsed, 1,000 families were foreclosed upon per day.<sup>8</sup>

<http://www.presidency.ucsb.edu/ws/index.php?pid=29590#axzz2isKCn5Lr>

In response, President Herbert Hoover in 1932 initiated a new housing finance process with the establishment of the Federal Home Loan Bank (FHLB) System.<sup>9</sup> The New Deal launched the Home Owner's Loan Corporation in 1933 to purchase and restructure distressed mortgages with consumer-friendly terms. Federal deposit insurance was also introduced in 1933 to encourage people to put their money into banking institutions so depositories could resume lending. The Federal Housing Administration (FHA) was established in 1934 to provide a full government guaranty so lenders would extend fixed-rate, fully amortizing, long-term loans adhering to a set of standards. The Federal National Mortgage Association (FNMA or Fannie Mae) was created in 1938 as a government-owned corporation to provide low-cost liquidity for FHA-insured loans so as to enable further FHA-insured lending in the primary market. The Veterans Administration began to guarantee mortgages in 1944 as part of the GI Bill. Even with the privatization of Fannie Mae in 1968 and the creation of the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) in 1971 (originally owned by the Federal Home Loan Banks), the federal government continued to play a critical role in housing finance, both explicitly, through the Government National Mortgage Association's (GNMA or Ginnie Mae) guarantee of mortgage-backed securities built on FHA-insured/VA-guaranteed loans and FDIC deposit insurance, and through the implicit guarantee of the GSEs.

Whether through guaranteeing lending institutions, mortgages, or secondary market entities, the government has taken the ultimate credit risk on most mortgages made in the US

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<sup>7</sup> Levitin and Wachter (2013).

<sup>8</sup> Immergluck (2009).

<sup>9</sup> Levitin and Wachter (2013).

since the 1930s. The major exception occurred during the mid-2000s when private-label securitization briefly and disastrously became a dominant source of mortgage capital, and the government stepped in to bailout institutions for which it did not have an explicit guaranty. Post-crisis, government-supported financing of mortgages through FHA and the GSEs (by then in conservatorship and fully taxpayer supported) sustained the lifeblood of capital to the housing market. The importance of the housing finance system to the US economy is such that the housing finance system will always be implicitly or explicitly guaranteed against catastrophic losses.

Today, housing equity is by far the largest source of net wealth for US households.<sup>10</sup> The median wealth of a home-owning household in the US is \$174,500, compared to \$5,100 for the median renter.<sup>11</sup> In survey after survey, Americans—whether renters or owners, whether stable or recently foreclosed upon—overwhelmingly aspire to own homes. Macroeconomically, economic recovery depends heavily on the housing market.<sup>12</sup>

The same government policy that over the decades facilitated these housing-related opportunities also set up barriers to participation for minority families, many of these explicit. Federal policies once disfavored racially mixed neighborhoods, promoting the institutionalizing of redlining. For much of their initial years, FHA and VA programs advantaged white borrowers; indeed, from 1934-1959, when FHA guaranteed more than half the home purchase mortgages in the US, only 2 percent of the loans went to African-Americans.<sup>13</sup>

Though anti-discrimination and fair lending laws eventually outlawed racially-discriminatory housing and lending practices (which is not to say that they do not persist),<sup>14</sup> their long-term effects still influence lending disparities. Today, while 74 percent of white

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<sup>10</sup> Taylor and others (2011).

<sup>11</sup> Bricker and others (2012).

<sup>12</sup> Bernanke (2012).

<sup>13</sup> Immergluck (2009, Ch. 2).

<sup>14</sup> In 1948, the Supreme Court decision banned judicial enforcement of racially restrictive covenants in real estate. *Shelley v. Kraemer*, 334 U.S. 1 (1948). In 1950 FHA ended its practice of favoring racial covenants; 1962 Executive Order by Kennedy banned discrimination in federal housing programs; Title VIII of the Civil Rights Act of 1968—the Fair Housing Act—prohibited discrimination in housing markets. 1976 Supreme Court found this prohibition included denying loan applications in specific neighborhoods. Equal Credit Opportunity Act of 1974 and amended in 1976 prohibited lending discrimination including disparate treatment.

households own their own homes, less than half of black and Hispanic households do.<sup>15</sup> Prevented from full participation in homeownership over the second half of the twentieth century, minorities have not been able to accumulate the same wealth as whites.

The collapse of the housing bubble has exacerbated racial wealth gaps. Today the median white household holds \$20 dollars of wealth for every \$1 held by the median Latino or black family.<sup>16</sup> In a study following the same households over the quarter century from 1984 to 2009, the wealth gap between white and black households in the study tripled (in 2009 dollars), from a starting point of \$85,000 to \$236,500.<sup>17</sup> While the median wealth of the African American household grew from just under \$6,000 to \$28,500, the median white household saw wealth increase from \$90,851 to \$265,000.<sup>18</sup>

The primary driver of this gap is homeownership, accounting for 27 percent of the difference.<sup>19</sup> A higher share of whites attain homeownership, and they do so at an earlier age, which is in part attributable to greater access to resources for downpayments from inheritances or family assistance. Thus wealth advantages compound intergenerationally.<sup>20</sup>

Moreover, at least partly as a result of inequities in the terms of mortgage financing, minority borrowers and high minority neighborhoods experienced greater wealth stripping, less appreciation, and higher foreclosure-related wealth loss than white households and neighborhoods in the mortgage boom and bust. Hispanic and African American households hold a greater share of their net worth in home equity.<sup>21</sup> They were also more likely to receive high cost and risky loans even when controlling for credit risk and, while white borrowers have experienced the most foreclosures, minority borrowers have been more than twice as likely to lose their homes to foreclosure.<sup>22</sup> As a result, from 2005 to 2009, the median wealth for white households fell 16 percent, for African American households 53 percent, and for Hispanic households, 66 percent. By 2009, with black and Hispanic household median wealth at its

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<sup>15</sup> U.S. Census Bureau. (Data as of 4<sup>th</sup> quarter 2012).

<sup>16</sup> Taylor and others (2011).

<sup>17</sup> Shapiro, Meschede, and Osoro (2013).

<sup>18</sup> Shapiro, Meschede, and Osoro (2013).

<sup>19</sup> Shapiro, Meschede, and Osoro (2013).

<sup>20</sup> Shapiro, Meschede, and Osoro (2013).

<sup>21</sup> Taylor and others (2011)

<sup>22</sup> Bocian and others (2011).

lowest level in 25 years by some measures, the wealth gap between white households and black and Hispanic households stood at its highest level in 25 years.<sup>23</sup>

Thus, access to non-predatory structured finance is central to addressing self-compounding inequalities in financial opportunities that have far-reaching externalities, particularly for communities of color. Access to systems of economic opportunity, such as homeownership, can actually contribute to inequality if equal access to those systems is hindered at any point.

## **II. FAIR LENDING AND DUTIES TO SERVE: THE EXISTING REGULATORY FRAMEWORK**

DTS are the result of a variety of laws. While DTS are distinct from fair lending, their role needs to be understood, however, in the context of supplementing and expanding fair lending laws.

### **A. Fair Housing Act of 1968**

The Fair Housing Act (Title VIII of the Civil Rights Act of 1968) was a central piece of civil rights legislation from the 1960s. It originally prohibited discrimination in the sale, purchase, rental, or financing of residential real estate on the basis of race, color, religion, or national origin.<sup>24</sup> The Act has subsequently been expanded to prohibit discrimination on the basis of gender, familial status, and disabilities. The Act does not create an affirmative DTS. Instead, as applied to housing finance, it mandates nondiscriminatory extensions of credit. The Act is enforced by the Department of Housing and Urban Development (HUD) secretary, the attorney general, and by private rights of action.

### **B. Equal Credit Opportunity Act of 1974**

The Equal Credit Opportunity Act (ECOA) of 1974 originally prohibited discrimination against applicants for any sort of credit on the basis of gender or marital status. It was

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<sup>23</sup> Taylor and others (2011).

<sup>24</sup> 42 U.S.C. § 3601 et seq. The Civil Rights Act of 1866 also prohibited discrimination in housing, but required a showing of intentional discrimination.

subsequently amended to prohibit discrimination based on race, color, religion, national origin, age, or because the applicant receives public income assistance.<sup>25</sup> ECOA is enforced by the Consumer Financial Protection Bureau (CFPB) for large banks and non-banks and by the OCC, Federal Reserve Board, FDIC, and National Credit Union Administration (NCUA) for small banks and credit unions. The CFPB interprets ECOA as prohibiting both disparate treatment and disparate impact based on neutral policies.<sup>26</sup> There is also a private right of action. Like the Fair Housing Act, ECOA does not mandate that access to credit be provided in any particular community, and protected classes under ECOA do not include LMI communities (except to the extent individuals receive public assistance).

### **C. The Home Mortgage Disclosure Act of 1975**

The Home Mortgage Disclosure Act (HMDA)<sup>27</sup> of 1975 was an important step in identifying patterns of redlining. Originally, the law required lenders to report lending volumes by census tract but was amended in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) to require loan-level reporting of mortgage applications and originations. HMDA does not direct particular practices, but it is a key tool in policing discriminatory mortgage lending.

### **D. The Community Reinvestment Act of 1977**

In 1977, Congress enacted the Community Reinvestment Act (CRA),<sup>28</sup> which created a continuing and affirmative obligation for depository institutions (other than credit unions) with federal deposit insurance to “help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.”<sup>29</sup> CRA only applies to a depository’s activities, not the activities of its non-depository affiliates or holding company (except at the depository’s election to include affiliate activity).

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<sup>25</sup> 15 U.S.C. § 1691.

<sup>26</sup> CFPB (2012).

<sup>27</sup> For more information on the history of HMDA, see FFIEC (2012).

<sup>28</sup> For a comprehensive history of the CRA, see Art (1986-87), MacDonald (1995), The Joint Center for Housing Studies (2002), Barr (2005), and Bernanke (2007).

<sup>29</sup> 12 U.S.C. § 2901.

The CRA was motivated, at least in part, by frustration that fair lending laws alone were not eliminating redlining. The intent behind the CRA was a fundamental change in lenders' attitudes and responsibilities toward serving traditionally underserved communities:

The [CRA] settled the core philosophical dispute over whether depository institutions enjoying the benefits of federal charters and federal deposit insurance owe any duty to consider the impact on neighborhoods when determining its lending policies. The CRA was a legislative mandate for a change in policy and a rebuke to financial institutions and the federal supervisory agencies that had previously sanctioned and even encouraged redlining.<sup>30</sup>

While this obligation applies to financial services, investments, and mortgages, we focus mainly on the mortgage aspect here.<sup>31</sup> In addition to the safety and soundness provision, the hallmark principals of this law include: flexibility and adaptability by giving regulators the authority to set and revise performance criteria; a public role in “regulating from below” through public disclosure and input; a balance of quantitative and qualitative measures that considers efforts and activities in tandem with lending volumes, and a context-based approach for evaluating an institution’s performance, in which each institution is examined against the backdrop of a particular market.<sup>32</sup>

The financial world has changed significantly since CRA was enacted. In 1977, depository institutions—particularly savings and loans—funded and held most mortgages. By the early 1990s, however, through the increased use of mortgage securitization, the GSEs were funding more than half of all new loans, and depositories’ share of originations was declining, thereby lessening the share of the mortgage origination market covered by CRA.<sup>33,34</sup>

## E. The Housing Goals

As the secondary market replaced deposits as the primary source of funding for mortgages, it came to play a critical role in determining who gets access to credit and under

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<sup>30</sup> Art (1986-87).

<sup>31</sup> Detail on the mechanics of CRA are available at [www.ffiec.gov/cra/default.htm](http://www.ffiec.gov/cra/default.htm).

<sup>32</sup> Quercia, Ratcliffe, and Stegman (2009).

<sup>33</sup> Immergluck (2009, p. 45).

<sup>34</sup> For a good history of adjustments to CRA over the following three decades, see Ludwig, Kamihachi, and Toh. (2009).

what terms. The CRA does not apply to the GSEs, which are privately-owned firms operating under special-purpose federal charters. These charters specify the public purposes of the GSEs, which include: “provid[ing] ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)...” and “promot[ing] access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) ...”<sup>35</sup>

In the 1970s, HUD set goals that 30 percent of GSE funding go to central cities and 30 percent go to households earning below area median income (AMI). This goal was non-binding, and HUD did not monitor performance.<sup>36</sup>

In 1992, as the influence of GSEs in the housing market increased and concerns mounted that they were contributing to redlining, their public purposes were operationalized with the establishment of Housing Goals (HGs), part of the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA).<sup>37</sup> These are purely quantitative targets measured as the annual percentage of loans funded by the GSEs that fall in one of several target categories, defined by borrower income or census tract median income or minority population share. The performance of GSEs on these measures is benchmarked against the overall conventional conforming market (“benchmark market”).<sup>38,39</sup>

Several adjustments were made to the GSEs’ DTS regime through the Housing and Economic Recovery Act of 2008 (HERA). Those which have been implemented, beginning in 2010, include: separate goals for refinance and purchase mortgages; a lowering of income thresholds, generally to 80 percent of area median income (and thus better aligned with CRA); other adjustments to the underserved areas goals; and exclusion of loans determined by the regulator to be inconsistent with safety and soundness. Loans in private label securities

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<sup>35</sup> Fannie Mae and Freddie Mac Charter Acts. Accessed through [www.fhfa.gov/GetFile.aspx?FileID=29](http://www.fhfa.gov/GetFile.aspx?FileID=29).

<sup>36</sup> Immergluck (2009).

<sup>37</sup> A history of events leading to the establishment of the goals can be found in Fishbein (2003).

<sup>38</sup> Weicher (2010).

<sup>39</sup> The benchmark market excludes loans above the GSE’s loan limit or otherwise ineligible for purchase by the enterprises, government insured loans, second liens, high cost loans and loans from “segments of the market determined to be unacceptable or contrary to good lending practices, [or] inconsistent with safety and soundness” – Housing and Economic Recovery Act of 2008.

purchased by the GSEs are also no longer counted.<sup>40</sup>

Several other important changes have not yet been implemented. First, HERA adds a “Duty-to-Serve” underserved markets (manufactured housing, affordable housing preservation, rural housing and other segments that may later be deemed to qualify) through a more CRA-like approach that incorporates context and level of effort measures. Second, it calls for the GSEs to allocate 0.042 percent of the value of new loan purchases to a dedicated fund to support housing for the lowest income families and certain related economic development activities in underserved communities. With these changes, the secondary market DTS would become more multifaceted, using a combination of broad goals, targeted qualitative measures, and subsidies.<sup>41</sup>

## F. Comparing CRA and the HGs

The HGs were a step toward aligning secondary market affirmative obligations with those of CRA-covered lenders in the primary market.<sup>42</sup> Similar to CRA, the HGs allow for public comment, and results are reported annually. The GSEs provide a limited public dataset on their HG eligible loans. There is also a contextual element implied in the process for establishing the HGs, as they are to be based on housing needs, macroeconomic and demographic conditions, and other factors.

This alignment has not been perfect, however. The CRA gives credit for different income categories than the HGs. Also, the HGs are entirely quantitative, whereas CRA measures have a strong subjective element. CRA is based largely on local market activities, whereas the HGs are purely national in scope.

In terms of incentive for good performance, under CRA, there is both a public perception risk and a material business concern for failure to earn a passing grade. Regulators

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<sup>40</sup> Federal Housing Finance Agency (2010); 2010-2011 Enterprise Housing Goals; Enterprise Book-entry Procedures. Final Rule. 12 CFR Parts 1249, 1282. RIN 2590-AA26, at <http://www.fhfa.gov/webfiles/16603/finalruleaffhsggoals9210.pdf>.

<sup>41</sup> The Housing and Economic Recovery Act of 2008; Public Law 110-289-July 30, 2008. Title I Subtitle B—Improvement of Mission Supervision, at <http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm>.

<sup>42</sup> 12 U.S.C. § 4565.

are required to consider an institution's CRA performance when reviewing applications for mergers, and for such activities as opening and closing branch banks. How heavily to weigh the CRA performance is largely left to the regulator's discretion, although the public nature of the process gives advocates some leverage over the determination. However, in practice, there has been little use of sanctions. Since 1990, only 0.35 percent of exams have resulted in a failing grade, while 96 percent earned satisfactory or higher.<sup>43</sup> From 1985 to 1999, only eight applications for actions subject to the CRA had been denied out of 92,177 applications submitted.<sup>44</sup>

The GSEs met or exceeded their HGs in nearly all years,<sup>45</sup> although the penalty for failing to meet them—a requirement to create a strategic plan for improving performance—is not particularly burdensome. However, reputational concerns likely exerted strong influence in this case as well.

Perhaps most importantly, both of these affirmative obligation regimes incorporate a safety and soundness requirement. The GSE Charter specifies that activities be undertaken “at reasonable economic return” and the 1992 act establishing the goals required them to be based “the need to maintain the sound financial condition of the enterprises.”<sup>46</sup>

## **G. FIRREA Requirements for Federal Home Loan Banks**

A final and distinct DTS rests with the Federal Home Loan Bank (FHLB) system, a system of 12 federally-chartered member-owned banks that provide liquidity to the housing finance market by issuing tax-exempt bonds to finance the rediscounting of mortgages held by member banks.<sup>47</sup> The FHLB charter conveys privileges on the FHLB system (passed on to its members, which are commercial banks and S&Ls) in the form of access to low-cost liquidity and dividends.

Prior to 1989, the FHLB's mission was to provide liquidity to the S&L sector. In the

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<sup>43</sup> [http://www.ffiec.gov/craratings/Rtg\\_spec.aspx](http://www.ffiec.gov/craratings/Rtg_spec.aspx). From 1990 to December 2012, out of 69,792 ratings, there were 246 of “substantial noncompliance,” many to the same institution for different exam periods. There were 2,517 “needs to improve” ratings. Since the beginning of 2008, from 8,822 exams, 0.2% were rated “substantial noncompliance” while 97.5% earned “satisfactory” or higher.

<sup>44</sup> Barr (2005).

<sup>45</sup> Financial Crisis Inquiry Commission (2010); Weicher (2010).

<sup>46</sup> Housing and Community Development Act of 1992/Title XIII/Subtitle A/Part 2/Subpart B.

<sup>47</sup> See Levitin and Wachter (2013) regarding the history of the FHLBs.

aftermath of the S&L crisis, FIRREA created a specific DTS for the FHLB system in two forms. First, all FHLBs must offer Community Investment Programs (CIPs)<sup>48</sup> to provide lower-cost advances for loans that provide housing and certain commercial activities for LMI households and neighborhoods, though the size and scope of these activities are not mandated. More explicit is the requirement that 10 percent of each FHLB's profits (or at least \$100 million per year in aggregate) must go to affordable housing program (AHP's) "to subsidize the interest rate on advances to members engaged in lending for long term, low and moderate-income, owner-occupied and affordable rental housing at subsidized interest rates."<sup>49</sup>

Like Fannie Mae and Freddie Mac's goals, this duty to serve applies to the secondary market entities only (the FHLBs themselves); most members of the FHLBs are subject to the CRA. The FHLB profit diversion is a distinct form of DTS. Though easier to measure and implement, it may not reach as far and leans toward providing special programs rather than expanding access to mainstream offerings. In contrast to CRA and HGs, the AHP requirement is more redistributive. Some within the FHLB system view it as a reasonable and effective tax; others consider it core to the system's mission.<sup>50</sup> HERA has called for the establishment of HGs similar to Fannie Mae and Freddie Macs' on FHLBs' mortgage purchase programs, but these have also not been implemented.

### **III. EFFECTIVENESS OF EXISTING DUTIES TO SERVE – A REVIEW OF THE EVIDENCE**

There is little consensus about the impact of existing DTS. One school of thought holds that affirmative obligation requirements have improved access to credit, though more can be done. A second posits that affirmative obligation requirements led lenders to make riskier loans, eventually leading to the financial crisis of 2008. A third view holds that the affirmative obligations have not accomplished much for good or bad. The accumulated evidence indicates

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<sup>48</sup> Federal Home Loan Bank Act § 10 (12 U.S.C. §§ 1430) requires that "Each bank shall establish a program to providing funding for members to undertake community-oriented mortgage lending...Advances under this program shall be priced at the cost of consolidated Federal Home Loan Bank obligations of comparable maturities, taking into account reasonable administrative costs." At [www.fhfa.gov/Default.aspx?Page=113](http://www.fhfa.gov/Default.aspx?Page=113).

<sup>49</sup> Federal Home Loan Bank Act (12 U.S.C. §§ 1421). Net earnings are calculated after the deduction of the bank's obligation to REFCORP bond defeasement.

<sup>50</sup> Hoffman and Cassell (2002).

that DTS have changed institutional behavior and had a modest impact on increasing underserved communities' access to housing finance without compromising safety-and-soundness.

### **A. Change in Institutional Behavior?**

The evidence is consistent in identifying changes in institutional behavior. Harvard's Joint Center for Housing Studies found that CRA "influences the plans of most lenders at the margin."<sup>51</sup> A Federal Reserve survey found that 73 percent of institutions had implemented at least one special CRA program. While more than 40 percent reported they were motivated by the opportunity to earn additional profits, the most common reasons for these programs were "responding to the credit needs of the community" and "promoting community growth and stability," suggesting that lenders' view of CRA had aligned with the spirit of the Act.<sup>52</sup>

Other documented changes made by CRA-covered lenders include setting up dedicated CRA units; working with community partners and local governments; investing in Community Development Corporations, loan consortia, and Community Development Financial Institutions; and funding borrower counseling.<sup>53</sup> Many lenders also entered into "CRA Agreements," which are "a pledge signed by a community organization(s) and a bank outlining a multi-year program of lending, investments, and/or services."<sup>54</sup> A 2007 study by the National Community Reinvestment Coalition reported 446 of these Agreements.<sup>55</sup>

Likewise, research shows that the GSEs responded to the HG challenge by offering more flexible lending programs.<sup>56</sup> Fannie Mae's Office of Low-and Moderate-Income Housing opened in 1987, some five years before the goals were established; by 1990, this office had committed \$5 billion, and in March of 1991 Fannie Mae launched "Opening Doors," a \$10 billion initiative expanding its LMI housing programs.<sup>57</sup> Fannie Mae's "trillion dollar commitment" to affordable

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<sup>51</sup> The Joint Center for Housing Studies Harvard University (2002, p. vi).

<sup>52</sup> Avery, Bostic, and Canner (2000).

<sup>53</sup> Barr (2005).

<sup>54</sup> National Community Reinvestment Coalition (2007, p. 4).

<sup>55</sup> National Community Reinvestment Coalition (2007, p. 4).

<sup>56</sup> Listokin and others (2000), Temkin, Quercia, and Galster (2000).

<sup>57</sup> Levine (1993).

housing was announced in 1994 and achieved by 2000. Similarly, Freddie Mac made a \$3 billion commitment in 1991 and 1992 for affordable homeownership and rental.<sup>58</sup>

In pursuit of these commitments, the GSEs developed new programs in partnership with other agencies and mortgage insurers such as the “3/2” program launched in 1991.<sup>59</sup> The GSEs also incrementally introduced flexibilities in reviewing credit history and debt-to-income ratios, funded employer-assisted housing, engaged in special efforts in rural areas and for elderly borrowers, made investments in low-income rental housing and state housing finance agency bonds, and made targeted purchases of “goals-rich” loans.

## **B. Change in Lending Practices?**

Did these organizational changes translate into lending activities? Case study evidence confirms it did. For example, Self-Help, a non-profit financial institution in North Carolina, found in the early 1980s that many banks had special CRA programs but did not have a secondary market outlet for these loans, which constrained the amount of lending they could do. Self-Help started buying these portfolios, and demonstrated that they performed well, despite having characteristics that disqualified them from purchase by the GSEs. In 1998, Fannie Mae entered into an agreement where Self-Help, with \$50 million in capital backing from the Ford Foundation, would serve as a conduit and guarantor of such loans originated to satisfy CRA and HGs and subsequently sold to Fannie Mae. Self-Help’s national affordable mortgage secondary market program, the “Community Advantage Program” (CAP), funded 46,500 mortgages originated by 36 lenders.<sup>60</sup> These loans did not comply with standard, conforming underwriting requirements, yet they proved profitable. This is just one of many cases of the lending motivated by DTS programs.

A few studies have examined the relationship between CRA agreements and lending activity. Schwartz (1998) found that banks with CRA agreements had higher shares of

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<sup>58</sup> Brendsel (1991).

<sup>59</sup> The 3/2 Option program permits the homeowner to make a down payment of 3% of the property value, with another 2% being contributed by a family member, grant, loan from a government or nonprofit agency. Fannie Mae boasts no less than ten “Community Lending” products for LTMI borrowers.

<sup>60</sup> Quercia, Freeman, and Ratcliffe (2011).

mortgages approved to targeted borrowers and lower denial disparity rates than other banks, though these differences could not be conclusively tied to the agreements.<sup>61</sup> In case studies, Shlay (1999) found that CRA-eligible lending increased in all the markets examined, irrespective of agreement activity, and among all the lenders, though the lenders with CRA agreements increased their CRA lending activity more than others.<sup>62</sup> Bostic and Robinson (2003) found a statistically significant and sustained increase in CRA qualified volumes by lenders entering an agreement, although this finding is not benchmarked against change in the institutions' overall lending activity or other lenders' CRA activity.<sup>63</sup>

Interestingly, banks receiving downgrades were not found to subsequently improve their performance.<sup>64</sup> More recently, Agarwal et al. (2012) compared the rate at which applications were converted to mortgages by CRA-covered institutions undergoing CRA examinations to those not undergoing examinations. They observed a relative increase in conversions among the banks undergoing CRA examinations only among the 49 large banks out of the more than 5,000 banks studied.<sup>65</sup> The study's findings have been questioned, however, because the periods studied do not correspond with the period considered in CRA examinations.<sup>66</sup>

In terms of the GSEs, the HGs corresponded with a substantial increase in funding to LTMI homeowners and multifamily properties. For example, in 1993, 32 percent of the GSEs' activities met the low-and-moderate income goal,<sup>67</sup> but by 2001 this share regularly represented at least half of their activity. Considering the growth in GSE volume over this time, this represents a sizable increase in LTMI financing in the market as a whole. Moreover, the GSEs steadily closed the gap by which they lagged the benchmark market by 2002. From 1995 through 2008, the level of such lending activities by the benchmark market remained

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<sup>61</sup> Schwartz (1998).

<sup>62</sup> Shlay (1999, pp. 35, 247).

<sup>63</sup> Bostic and Robinson (2003).

<sup>64</sup> Dahl, Evanoff, and Spivey (2010).

<sup>65</sup> Agarwal and others (2012).

<sup>66</sup> Reid and others (2013).

<sup>67</sup> HUD Office of Policy Development and Research (1998).

essentially flat.<sup>68</sup>

There is a paucity of research on the impact of FHLB advances and the AHP and CIP programs in particular on the provision of housing finance to underserved segments.<sup>69</sup> Higher FHLB advances are associated with higher levels of mortgage lending, generally<sup>70</sup> and FHLB members originate a higher proportion of loans to targeted areas and minority borrowers than non-members,<sup>71</sup> but there has been no link established between FHLB advances, let alone AHP program usage, and increased lending to underserved markets. Simply in terms of activity, the FHLB system reports that “more than 776,000 housing units have been built using AHP funds” totaling more than \$4.6 billion since 1990.<sup>72</sup>

### C. Impact on Profitability?

What about costs to the institutions? Gunther (2000) proposed that profitability concerns conflict with CRA objectives.<sup>73</sup> As noted, however, both CRA and the HGs stress that DTS exist within the boundaries of safety-and-soundness. CRA-covered institutions surveyed reported that 78 percent of CRA lending was at least break-even. At the same time, respondents reported that their special CRA lending programs had comparable or better delinquency and charge-off rates than all mortgage lending.<sup>74</sup> Addressing the notion that non-credit costs can be a factor, Willis (2009) lays out a number of categories of costs arising from CRA, from administrative and production costs to perceived pressures to reduce pricing to uneconomic levels.<sup>75</sup> To this latter point, however, Federal Reserve economists compared interest rates charged by institution type and borrower CRA eligibility and found no evidence of a bank subsidy to attract CRA loans.<sup>76</sup>

The evidence regarding the impact on credit losses is fairly consistent and does not

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<sup>68</sup> Weicher (2010).

<sup>69</sup> McCool(2005).

<sup>70</sup> Tuccillo, Flick, and Ranville (2005).

<sup>71</sup> Courchane and Steeg (2005).

<sup>72</sup> [http://www.fhlbanks.com/programs\\_affordhousing.htm](http://www.fhlbanks.com/programs_affordhousing.htm).

<sup>73</sup> Gunther (2000).

<sup>74</sup> Avery, Bostic and Canner (2000).

<sup>75</sup> Willis (2009).

<sup>76</sup> Canner and others (2002).

support the contention that these laws have materially harmed institutions. Evidence from Self-Help's Community Advantage Program (CAP) confirms that CRA lending can be undertaken profitably, even in tumultuous times. CAP loans have gone to borrowers with a median income of \$30,792. Half the borrowers had credit scores below 680, and most made down payments of under 5 percent. Despite the recent economic and housing market challenges, the portfolio has continued to perform relatively well and within the risk tolerance supported by the program's pricing.<sup>77</sup> Other empirical studies have confirmed no causal evidence of an effect of CRA lending on delinquency.<sup>78</sup>

Agarwal et al. (2012) is the only study to find evidence of any risk differentials for CRA loans, and the ones identified are weak and small. Specifically, the study finds no material difference in the risk factors for loans made by institutions undergoing exams versus those not being examined, and finds no increase in defaults associated with CRA exams, except for in 2004-2006 originations, where defaults among examined banks were slightly higher than for banks not undergoing exams.<sup>79</sup> Since most of the elevated defaults were due to loans made *after* the CRA exam or in tracts not eligible for CRA credit, this suggests that factors other than CRA drove performance.<sup>80</sup> In fact, the authors attribute this effect to the then vibrant private-label securities market.<sup>81</sup>

A review of goal-qualifying loans made by the GSEs from 2005 to 2008 found that loans that could be "clearly attributed to the increase in goals" constituted only 8 percent of their 90-or more-day delinquencies.<sup>82</sup> Weicher (2010) provides compelling evidence that factors other than HGs led the GSEs to pursue the risky subprime and Alt-A lending that ultimately accounted for a disproportionately higher share of their delinquencies.<sup>83</sup>

The FHLB economic model is quite different. Only 10 percent of a FHLB's net income is directed to funding the AHP programs, so the allocation varies with the FHLB's ability to pay it.

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<sup>77</sup> Quercia, Freeman, and Ratcliffe (2011).

<sup>78</sup> Jiang, Nelson, and Vytlačil (2012).

<sup>79</sup> Agarwal and others (2012).

<sup>80</sup> Agarwal and others (2012).

<sup>81</sup> Agarwal and others (2012).

<sup>82</sup> Seiler (2010).

<sup>83</sup> Weicher (2010).

#### D. Risk to the Financial System?

Federal Reserve Board Governors, the Comptroller of the Currency, and the Financial Crisis Inquiry Commission have all concluded that CRA was not responsible for the risky lending that led to the foreclosure crisis.<sup>84</sup> Indeed, the evidence suggests that CRA was a deterrent to risky lending.<sup>85</sup> Returning to the CAP study, a comparison of CAP borrowers with similar borrowers who received subprime and private-label mortgages shows that the private-label borrowers defaulted at three to five times the rate of comparable CAP-borrowers. CAP loans, motivated by both CRA and the HGs, were prime-priced, fully underwritten, long-term fixed-rate mortgages. In contrast, loans made through the private-label sector, which were generally not subject to CRA or GSE HGs, carried more of the high-risk features that have been associated with increased likelihood of default.<sup>86</sup> Other studies have shown that loans made by CRA lenders within their assessment areas to LTMI borrowers were less likely to have risky product features than loans made by independent mortgage companies.<sup>87</sup> Federal Reserve economists found that CRA loans made in 2006 performed better than all loans combined and have had defaults a quarter of the level of 2006 higher-priced loans.<sup>88</sup> In an empirical study of the impact of both CRA and HGs on lending patterns, Avery and Brevoort (2011) summate: “Our lender tests indicate that areas disproportionately served by lenders covered by the CRA experienced lower delinquency rates and less risky lending.”<sup>89</sup>

Research has absolved the HGs of causing the financial crisis as well. Hernández-Murillo and others (2012) do not find any increase in subprime lending or differential pricing that would be expected if lenders were seeking riskier loans to meet the HGs. Thomas and Van Order (2010)<sup>90</sup> conclude that the evidence proves that “Fannie and Freddie did not cause the subprime boom and bust.”<sup>91</sup> Their evidence suggests that the goals explain only a small element of risk taking. Notably, less than 10 percent of the credit books of GSEs were for loans

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<sup>84</sup> Kroszner (2009). OCC (2008); The Financial Crisis Inquiry Commission (2011).

<sup>85</sup> Reid and Laderman (2011); Traiger and Hinckley (2008).

<sup>86</sup> Ding and others (2011).

<sup>87</sup> Laderman and Reid (2009).

<sup>88</sup> Bhutta and Canner (2013).

<sup>89</sup> Avery and Brevoort (2011).

<sup>90</sup> Thomas and Van Order (2011).

<sup>91</sup> Thomas and Van Order (2011, p. 25).

with high loan-to-values—a proxy for lending to lower wealth households—as of June 2008, just prior to conservatorship and less than 1 percent were for borrowers with higher LTV and a low credit score.<sup>92</sup> Instead, disproportionate credit losses arose from their “Alt-A” loans, which, with generally lower LTVs and higher loan amounts, did not, on net, help satisfy the chief, LTMI lending goals.<sup>93</sup>

The influence of both the CRA and the GSEs waned during 2004-2006, as the share of all mortgages made by CRA lenders declined<sup>94</sup> and Fannie and Freddie’s share of mortgage securitizations fell below that of the private-label sector. In fact, only 6 percent of the high-cost high-risk mortgages made during 2004-2006 were eligible for CRA credit, accounting for only 1.3 percent of all originations.<sup>95</sup> As one scholar concludes, “Put simply, when so much subprime lending was performed by financial institutions acting beyond the scope of the CRA, it is hard to argue that the CRA was responsible for the type of risky lending that led to the financial crisis.”<sup>96</sup>

### **E. Greater Access to Credit?**

The ultimate question is whether these provisions produced systemic improvements in access to credit. On the one hand, there was a clear increase in lending to LTMI and minority borrowers and communities over the last three decades. On the other hand, since the mid-1990s, CRA’s influence has declined. And, despite the increase in HGs for the GSEs from 1995 to 2007, the share of overall benchmark market lending that went to target borrowers and neighborhoods remained largely static or even declined.

The empirical evidence generally suggests these rules have had, on the whole, modest but positive effects on overall credit flows. Earlier studies find increased volumes of lending, though broad-based growth in lending to LTMI borrowers and neighborhoods makes it hard to

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<sup>92</sup> LTV > 90% and Credit Score < 620.

<sup>93</sup> According to Seiler (2010, p. 11), “Alt-A and IO made it harder to achieve the goals but easier to achieve the purchase subgoals.”

<sup>94</sup> Essene and Apgar (2009).

<sup>95</sup> Park (2010).

<sup>96</sup> Brescia (2013)

discern how much to attribute to CRA.<sup>97</sup> A detailed analysis of 30 million loans made from 1993 to 2000 found that CRA-covered lenders originated a greater share and rejected a smaller share of CRA-eligible home purchase loans “than they would have if CRA were not in place.”<sup>98</sup> Barr’s (2005) review of the collective evidence finds “a statistically significant and economically important role for CRA.”<sup>99</sup>

CRA-motivated lending also appears to have had positive effects on target neighborhoods. Avery and others (2003) found mixed results in terms of the neighborhood outcomes associated with CRA.<sup>100</sup> Reviewing the literature on neighborhood outcomes, An and Bostic (2007) noted that increased GSE HG lending was offset by a reduction in FHA lending.<sup>101</sup> This is still a positive outcome, as FHA loans are generally considered more expensive than conventional conforming loans, and it indicates increased options and competition for borrowers in those neighborhoods.

Indeed, Spader and Quercia (2012) found that CAP lending at the neighborhood level in 2000-2002 offset only a small number of FHA loans, and that most of the CAP loans represented loans that would not otherwise have been made. But in 2004-2006, CAP loans were much more likely to supplant subprime lending, which carried higher default risk, suggesting that such loans can have beneficial neighborhood impacts in a variety of market environments.<sup>102</sup>

Using discontinuity analysis of neighborhood lending patterns, Bhutta (2011) found a statistically significant if modest increase in bank lending attributable to CRA—65 loans per Census tract over a nine-year period.<sup>103</sup> Using the same approach, Bhutta (2010) found a similarly modest effect associated with the geographically-based goal of 23 originations per tract over a seven-year period, concluding that “these results do not provide much support of the notion that the GSE Act had a major impact on homeownership and household debt by

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<sup>97</sup> Avery and others (1996); Belsky, Schill, and Yezer (2001);; Evanoff and Siegal(1996); Litan and others (2001); Gunther (2000); Barr (2005).

<sup>98</sup> The Joint Center for Housing Studies Harvard University (2002, p. 76).

<sup>99</sup> Barr (2005, p.164).

<sup>100</sup> Avery, Calem, and Canner (2003).

<sup>101</sup> An and Bostic (2007).

<sup>102</sup> Spader and Quercia (2012).

<sup>103</sup> Bhutta (2011).

expanding credit supply to marginal groups from the mid-1990s to the mid 2000s.”<sup>104</sup>

#### **F. Summary of the Evidence**

Were CRA and the HGs effective, ineffective, or disastrous? The evidence confirms that these DTS provisions changed lenders’ basic approach to serving LTMI and minority borrowers. It also confirms that institutions have not compromised safety and soundness in efforts to satisfy these provisions. Finally, while there is strong empirical evidence that credit flows to these segments have improved, they have not been substantial enough to address the market failures that DTS seek to correct.

Critically, however, DTS may have affected the credit availability in LTMI and minority communities in a qualitative manner. If DTS did not exist, there would likely be housing finance available, but less of it, and it would be qualitatively different. Even with DTS, a two-tracked credit system emerged, but it would likely have been worse without DTS.

#### **IV. BARRIERS TO EFFECTIVE DTS**

Several factors appear to have limited the effectiveness of DTS, and going forward, DTS need to be crafted to address these factors. The effectiveness of DTS has been undermined by three factors: changes in the institutional composition of the mortgage market, regulatory failures, and the advent of risk-based pricing and “reverse redlining.”

#### **A. Change in the Mortgage Market**

Since CRA and the HGs were instituted, the financial landscape has undergone a series of tectonic shifts in the sources of credit, underwriting, and terms of credit. These changes have significant impact on the flows of mortgage credit to minority and LTMI households and communities. The CRA and HGs have not kept pace with these changes. For example, CRA, despite some modernization attempts, is still largely predicated on the structure of the financial services market in 1977, when direct mortgage lending was done overwhelmingly by local

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<sup>104</sup> Bhutta (2010).

depositories.<sup>105</sup> CRA assessment areas are generally the counties in which a depository institution has offices or deposit-taking ATMs. By 2006, however, only about 25 percent of mortgages were made by depository institutions in markets where they had a physical presence.<sup>106</sup> Meanwhile, non-bank lenders had come to originate a large share of mortgages.

The optional inclusion of non-bank affiliates in CRA exams allowed depository institutions to provide limited service to underserved markets, while serving that same segment with a non-bank arm that specialized in higher-cost products.<sup>107</sup> From 1994 to 2007, banks grew the LTMI share of their lending faster among subsidiaries/affiliates than through their depositories.<sup>108</sup> Depositories also began making more of their loans outside of their assessment areas. In 1990, banks of all sizes originated about 70 percent of their mortgages within their assessment areas, but by 2006, the large banks originated more mortgages outside their assessment areas than within them.<sup>109</sup>

A similar story occurred with the HGs. The GSEs lost market share rapidly to the private-label securitization market from 2004 to 2006.<sup>110</sup> This meant that the HGs, like the CRA, simply applied to a smaller part of the market. In fact, the majority of toxic loans that triggered the recent financial crisis were financed by the market sectors that were subject to neither the CRA nor the HGs: non-depository lenders and private-label securitization.

## B. Regulatory Failure

The effectiveness of DTS is necessarily dependent on their enforcement. The DTS are only enforced publicly; no private right of action exists. History suggests that regulators have been lenient in their application of the duties. CRA was designed to discipline regulators who

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<sup>105</sup> In 2000, citing increased regulatory flexibility, better information technology, and increased flow of mortgages to minority and LTMI communities particularly from institutions not covered by CRA, Gunther claimed that CRA was no longer relevant. Gunther (2000).

<sup>106</sup> Essene and Apgar (2009).

<sup>107</sup> The CRA itself only covers depositories. The optional inclusion of affiliates is part of the regulatory implementation.

<sup>108</sup> Avery, Courchane, and Zorn (2009).

<sup>109</sup> Avery, Courchane, and Zorn (2009).

<sup>110</sup> Levitin and Wachter (2012).

were disregarding the new fair lending regulations,<sup>111</sup> yet over the course of CRA's history, there have been few sanctions for failure to engage in sufficient community reinvestment.<sup>112</sup> It is hard, however, to attribute this to industry success in community reinvestment. Rather, it seems to reflect regulatory enforcement attitudes.

Even so, regulators have staked out different positions in enforcing the CRA. In the first decade after passage, while the FHLB board labored to implement CRA, the Federal Reserve was blatant in "resistance to CRA,"<sup>113</sup> never declining a merger application and unconditionally approving many that were strongly protested.<sup>114</sup> In 1990, the Office of Thrift Supervision (OTS) (successor to the FHLB board) gave out more than twice as many unsatisfactory ratings as the other regulators, but as regulatory competition for chartering increased, CRA laxity became a method for federal bank regulators to distinguish themselves and thereby attract chartering business (which provides the bulk of some regulators' operating budgets).<sup>115</sup> Thus, by 2007, OTS was awarding about twice as many "outstanding" evaluations as the other federal regulators. Moreover, in a 2005 joint rulemaking, the OTS took a separate path from other regulators, and exempted 88 percent of its supervised institutions from significant CRA obligations, and, perhaps more importantly, set a precedent for regulator defection.<sup>116</sup>

The GSEs, in contrast, have met their goals almost consistently, but there are no material repercussions for failing. In the most recent HGs proposal, the regulator set the goals to levels well below those set previously, and below current performance of the GSEs.<sup>117</sup>

DTS measures were motivated in large part by public engagement. The CRA provided explicit ways for the public to regulate the regulators. The HGs process also allows for public comment, which the regulator can choose to disregard. Over time, however, the public voice has been muffled. For example, since 1990, there has been tremendous volume in bank merger activity, but the Federal Reserve has only held 13 public meetings on community reinvestment

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<sup>111</sup> Immergluck (2009).

<sup>112</sup> Barr (2005).

<sup>113</sup> Immergluck (2009, p. 1122).

<sup>114</sup> Art (1986-87).

<sup>115</sup> On chartering competition, see generally Levitin (2009), Levitin (2013).

<sup>116</sup> See Marsico (2006).

<sup>117</sup> See Federal Housing Finance Agency (2012).

in relation to mergers. Regulators have pointedly refused to consider CRA agreements in the merger approval process, yet merger approval is one of the primary CRA enforcement levers.<sup>118</sup>

### **C. Reverse Redlining and Risk-based Pricing**

Another factor that undermined the effectiveness of the DTS was the rise of risk-based pricing in mortgage underwriting. New, data-driven technologies for assessing and sorting borrower risk enabled lenders to charge based on a borrower's characteristics and thus eschewed the rate-based credit rationing of earlier underwriting methods. The prospect of high returns also enabled lenders to lend in communities they previously saw as too risky. In 2005, the Federal Reserve Board Chairman Alan Greenspan applauded these innovations:

...lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. ...These improvements have led to rapid growth in subprime mortgage lending.... Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes.<sup>119</sup>

Risk-based pricing, however, did not simply result in the extension of credit where it had not been granted before. Instead, credit was granted on substantively different terms than the standard, prime-priced, long-term, fixed-rate, fully amortized mortgage. As a result, the subprime and alternative lending that emerged with risk-based pricing was not evenly distributed. Although most subprime borrowers were white, and most subprime loans were made in higher income neighborhoods, a disproportionate share of this lending was concentrated in LTMI and minority communities,<sup>120</sup> and among LTMI and minority buyers even after controlling for risk factors.<sup>121</sup>

These markets were the very places where DTS efforts were supposed to encourage well-regulated depository institutions to lend. Despite the progress made in the 1990s, these markets still suffered from lack of equal access to credit. Essene and Apgar (2009) report that borrowers in high minority, lower-income neighborhoods were less likely to receive a loan from

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<sup>118</sup> Taylor and Silver (2009)

<sup>119</sup> Greenspan (2005).

<sup>120</sup> See Ding and others (2008).

<sup>121</sup> Jackson (2007).

a CRA-regulated lender lending in their assessment area than borrowers in higher-income and whiter neighborhoods.<sup>122</sup> Areas that exhibited “high latent demand” in 1996 (by virtue of high mortgage denial rates), experienced the most growth in loans originated for sale to private-label securitization conduits in 2002-2005, and subsequently experienced the elevated defaults associated with such loans. These areas were characterized by lower socioeconomic conditions and a higher share of minority residents.<sup>123</sup> Thus, once redlined communities became targets of “reverse redlining.” In this sense, the concentration of high-cost, high-default lending in LTMI and minority markets was a result of inadequate access to standard depository credit.

HMDA, CRA, and the HGs were inadequate to address the change in credit terms. HMDA did not contain information about pricing until 2004, and even then did not contain adequate borrower level risk data, such as information about product structures. CRA did not consider loans made outside of assessment areas or loans made by depositories’ affiliates except by a depository’s request. The GSEs were allowed to count qualified high-cost loans, as well as non-prime loans packaged into private-label mortgage-backed securities that they purchased, toward their HGs.

A major lesson from the housing bubble should be that loan characteristics are as important as borrower characteristics. To the extent that the policy goal of the CRA and HGs is to ensure equal access to mortgage credit, it must also be equal access to similar products, structured to be sustainable and affordable.

Since the financial crisis, some of these shortcomings have been addressed by the Housing and Economic Recovery Act (HERA) of 2008. But these adjustments are still inadequate and nothing has been done to bring DTS in line with the realities of the current mortgage finance market. Overall, there has been so much working against the effective implementation of DTS—lack of market coverage, weak regulatory engagement, and the development of risk-based pricing—that we cannot really know how effective they could be if properly designed and implemented.

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<sup>122</sup> Essene and Apgar (2009).

<sup>123</sup> Mian and Sufi (2009).

## **V. RETHINKING DUTIES TO SERVE**

The aftermath of the housing bubble presents an opportunity to rebuild DTS. The subsequent regulatory focus has been on regulations emphasizing safety-and-soundness in mortgage lending. A spate of new and pending regulations aimed at ensuring safety-and-soundness portend an institutionalization of post-crisis credit constriction. These new policies include title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its regulatory implementation by the CFPB, particularly the ability-to-repay requirement, new mortgage servicing regulations, new regulatory capital standards to comply with the Basel III capital accord, and ongoing changes in FHA's single-family mortgage insurance. These changes could greatly and permanently limit the availability of credit, especially from prime, well-regulated sources, and particularly to borrowers with less wealth and income. If safety-and-soundness regulations are not adequately balanced with efforts to ensure access to credit broadly and equitably, they could exacerbate disparities in access to the mortgage finance system and in so doing, undermine the market in many communities.

Now as much as ever, DTS need to be understood as a fundamental part of the financial system. The federal government is constitutive of the financial market from the most basic levels, such as enforcement of contracts, up to direct assumption of credit risk on mortgages, deposits, and secondary market entities. The financial system only operates because of the legal and financial infrastructure provided by the government. This infrastructure is costly to provide. Moreover, private market participants benefit from government support of the market. This is perhaps most obvious in the case of depositories with FDIC insurance; absent FDIC insurance, depositories' cost of funds would presumably be higher and their deposit funding base smaller.

The benefits of federal support for financial markets extend past depositories, however. Absent the federal government's support, it is difficult to imagine a secondary mortgage market of any size, thereby forcing more balance sheet lending by financial institutions, which would in turn limit the volume of business they could do. Similarly, non-banks benefit indirectly from federal deposit insurance as they rely on insured depositories for their warehouse lines of credit. Absent federal deposit insurance and the liquidity from the secondary mortgage market,

warehouse line availability might be more limited and/or more expensive.

Because of the public cost and private benefits from constituting financial markets, it is quite reasonable to require that financial services firms operate in the public interest, as well as in their own private financial interests. Fulfilling certain public mandates is a precondition of market participation and enjoyment of the federal government's support for the financial marketplace. As the federal government has a deep policy interest and arguably duty to ensure the availability of economic opportunities to all Americans, DTS should be seen as a basic duty of all financial institutions.

Accordingly, we suggest a quartet of reforms to make future DTS more effective and appropriate to the modern mortgage marketplace. Implementing these reforms calls for more complexity than it is possible to present in this paper, but future success will rest on the basis of these fundamental principles.

*(1) DTS Should Apply Universally to the Entire Primary Market.*

DTS should cover the entire marketplace, depositories and non-depositories alike, so we do not repeat the situation where non-regulated entities have a competitive advantage and can crowd out regulated purveyors. Non-depository lenders are virtually all dependent upon depositories for warehouse lines of credit and other funding; accordingly, as they benefit indirectly from federal support of depositories, they should be held to similar standards. DTS should depend on activities, not on the identity of the financial institution. Applying DTS to all mortgage lending institutions would help reduce regulatory arbitrage incentives.

*(2) DTS Should Apply Equally for All Secondary Market Entities*

DTS must apply not only at the primary market level, but also at the secondary market level, and the primary and secondary market DTS must be aligned. Application of DTS to the secondary market should not be restricted to the GSEs or whatever federally-backed entity or entities eventually fill their roll; it should also apply to depositories that are active in funding the primary mortgage market. The very largest banks have outgrown the role that CRA originally envisioned for them. These institutions have national service areas and undertake

significant lending through affiliates and subsidiaries that do not fall under CRA. They also serve secondary market functions through warehouse and wholesale lending, and securitization. As such they should be subject to additional and exceptional DTS, akin to those applied to the mortgage GSEs.

*(3) DTS Must Be Good Business But Must Also Be Supported by Evaluative Tools and Metrics and Incentives*

While we believe that DTS should be understood as a cost of doing business in exchange for privileges previously described, we acknowledge that specific DTS provisions must make business sense. The evidence indicates that DTS activities can be undertaken profitably, sometimes even more so than non-targeted business lines as in the subprime lending spree.

There are proven ways to extend mortgages to target segments in ways that mitigate risk—through products, underwriting, servicing, and partnerships. However, the experience to date with DTS shows us that just because a DTS activity is profitable does not necessarily mean that lenders will pursue it. Post-crisis, regulatory policy, investors and lenders have become risk-averse as new rules and practices are put in place, making it harder for all but the strongest borrowers to get credit.<sup>124</sup> It is therefore essential that DTS mechanisms act as a thumb on the scale to lead institutions to invest in and sustain meaningful DTS activities over the long term.

DTS experience to date shows us that profitability alone is not enough to change resource allocation. The incentives for compliance must encourage long-term investment in targeted activities, linked to measurable outcomes, without encouraging excessive risk-taking. This includes appropriate sanctions and rewards, as well as tools and benefits for compliance that have a tangible economic benefit or a risk mitigating effect.

Material incentives could include a menu of sanctions and benefits, such as various levels of fines, adjustments to the cost of FHLB advances or dividends, guaranty fees, or deposit insurance. These activities could be staged so that regulators have alternatives to “nuclear options” like cease and desist orders and denial of bank mergers. Importantly, the soundness

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<sup>124</sup> Parrott and Zandi (2013).

imperative should include consequences for serving underserved segments with inferior alternatives. DTS must mean serving all communities with appropriate products.

The metrics employed should be both quantitative and qualitative, neither relying on good faith efforts alone, nor solely on hard quotas. Rather, they should be framed around identified financing gaps and policy goals, and represent actionable objectives that relate to an institution's function within the system.

In terms of tools, requirements should be accompanied by supporting mechanisms that can facilitate expanding access safely. One example is a research and development fund such as the proposed "Market Access Fund" to be built into a reformed secondary market to support efforts to safely serve more borrowers.<sup>125</sup> In a similar vein, the Affordable Housing Trust Fund and the Capital Magnet Fund, envisioned in HERA but not yet funded, would be important complementary tools. Such tools, of course, should be deployed alongside, not instead of, DTS obligations. On a smaller scale, the AHP program taken as part of a CRA effort, is a model to build upon; doubtless many depositories have earned CRA credit in connection with projects that benefited from the AHP program. Similarly, regulatory waivers from some consumer protection laws (namely disclosure requirements of dubious effectiveness) could be granted to approved test programs, much as the CFPB's Project Catalyst is considering enabling innovations in consumer disclosures.

#### *(4) DTS Must Have a Credible Enforcement Mechanism*

DTS are unlikely to be effective absent true commitment from federal regulators to their application. To ensure that DTS are in fact observed, regulators must be held accountable, which requires greater transparency in the regulatory review process. Public participation is a hallmark of the creation of these rules, as well as their continued improvement and effectiveness.<sup>126</sup> Yet while CRA has the public role conceptually right, in practice, the public role has become muted. Transparency of data, public input into the planning process, and public review of performance of both institutions and regulators should be reinvigorated and central

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<sup>125</sup> Mortgage Finance Working Group (2011).

<sup>126</sup> See, e.g., MacDonald (1995).

to all DTS provisions. Moreover, the public should be given greater leverage so that regulators cannot simply ignore DTS. One possibility is to create an independent DTS commission, ombudsman, or inspector-general (perhaps based in the CFPB, which has an explicit access to credit mission<sup>127</sup>) charged with reviewing regulatory enforcement of DTS and/or being required to formally comment on regulatory decisions (such as merger applications under the current CRA). The idea is to create an institutional actor with a single duty of advocating for DTS for all regulators (thereby reducing regulatory arbitrage incentives) and provide this institutional actor sufficient resources to do so.

## **VI. CONCLUSION**

The original motivations for DTS were about disparate access to credit, as measured by gaps in lending and denial rates between borrowers and communities that are white or higher income and minority or LTMI borrowers and communities, respectively. But by the mid-2000s, these disparities manifested in differences in terms of credit, with minority and LTMI borrowers and neighborhood residents much more likely to receive loans with disadvantageous terms.

Today we are facing a potential “back to the future” where tight credit is disparately constraining access to credit for minority and LTMI households and communities. At the same time, we are facing a massive demographic shift in household formation and housing demand. Future housing demand will be driven by a greater share of LTMI, minority, and younger households.<sup>128</sup> These demographics mean that market stability converges with the access-related issues of equity. To the extent that LTMI and minority borrowers have difficulty accessing the housing finance markets, the effects will be felt both in those communities and more broadly because of the suppressed demand for home purchases. Persistent lending disparities that prevent these potential homebuyers from obtaining mortgages could have broad and far-reaching effects by depressing the real estate economy and curbing household

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<sup>127</sup> 12 U.S.C. § 5511(a) (“The Bureau shall seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services....”).

<sup>128</sup> Masnick, McCue, and Belsky (2010).

wealth formation.

Certainly, caution is warranted in the wake of the devastating crisis that grew out of the lending excesses of the mid-2000s, when unregulated lenders disproportionately targeted segments historically underserved by traditional lenders with products that were less safe. These lenders were less likely to be subject to CRA,<sup>129</sup> and the private-label securitization channel that financed the majority of loans during the bubble years of 2004-2006 were not subject to any HGs. It would be a regrettable mistake to conflate reckless (and frequently fraudulent) lending based on inadequate underwriting and risky repayment terms with prudent lending that enables lower wealth and lower income borrowers to safely become homeowners.

The competing tensions of safety-and-soundness on the one hand and access on the other each carry their own systemic risks. The negative externalities of leaving a large part of the market underserved include economic weakness; while mis-serving market segments with unproven products contributed to a global economic crisis. Neither approach serves to foster equity and economic opportunity. Effectively resolving these tensions presents another strong rationale for mechanisms that explicitly motivate lenders to balance access to credit with safety and soundness to all potential homebuyers.

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<sup>129</sup> Gunther (2000).

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