Edward Pinto

Yes, the CRA Is Toxic

So why is Congress thinking about expanding it?

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Did the Community Reinvestment Act—the 1977 federal law pressing banks to lend to low- and moderate-income borrowers—fuel toxic lending and thus play a significant role in causing the financial meltdown? "CRA was not the cause of the crisis," Comptroller of the Currency John Dugan maintained this past August. Though he had little quantitative detail about the performance of CRA-related loans, Dugan claimed that they had performed better than loans made by lenders not subject to the CRA. Further, he contended, borrowers of CRA loans had defaulted at much lower rates than borrowers of subprime mortgages. Other defenders of the act assert that almost all CRA loans originated at "prime" interest rates, rather than the higher rates that lenders offered risky "subprime" borrowers. And they add that the mortgages made under CRA were almost entirely fixed-rate, not the notorious adjustable-rate mortgages with quick rate resets and high payment shock that led so many borrowers to default.

The question of how well CRA loans have performed is of vital importance because of the trillions of dollars in such lending. During the first 15 years of the act's existence, total announced commitments under the CRA totaled $9 billion. But starting in 1992, volume exploded. Over the next 16 years, from 1992 to 2008, announced CRA commitments totaled $6 trillion. And incredible though it may seem, the same federal regulators who forced the CRA on banks have neglected to track the performance of trillions of dollars of loans made to satisfy it. But there is a strong prima facie case that they constitute toxic lending—that is, lending that leads to unsustainable loans, resulting in an unacceptable level of foreclosures.

To begin with, the CRA defenders' claim that CRA lending mostly wasn't subprime is highly misleading. It would be more accurate to say that 90 percent of CRA lending wasn't classified as subprime. CRA lenders, along with Fannie Mae and Freddie Mac—the two government-sponsored entities that bought loans from lenders, enabling them to make more loans—commonly classified CRA loans as "subprime" only if they contained such features as high fees, high rates, or low initial payments with adjustable interest rates. But approximately 50 percent of CRA loans for single-family residences were nevertheless made to borrowers who made down payments of 5 percent or less or had low credit scores—characteristics that indicated high credit risk. Whether or not anyone *called* these loans "subprime," in other words, the chances are good that many of them have defaulted or remain at high risk of doing so.

Though the feds, again, haven't collected figures for CRA loans' performance as a whole, we do have statistics from a few lenders that are troubling indeed. In Cleveland, Third Federal Savings and Loan has a 35 percent delinquency rate on its CRA-mandated "Home Today" loans, versus a 2 percent delinquency rate on its non–Home Today portfolio. Chicago's Shorebank—the nation's first community development bank, with largely CRA-related loans on its books—has a 19 percent delinquency and nonaccrual rate for its portfolio of first-mortgage loans for single-family residences. And Bank of America said in 2008 that while its CRA loans constituted 7 percent of its owned residential-mortgage portfolio, they represented 29 percent of that portfolio's net losses.

Whatever the precise magnitude of the CRA's role, there is no question that as the government pursued affordable-housing goals—with the CRA providing approximately half of Fannie's and Freddie's affordable-housing purchases—trillions of dollars in high-risk lending flooded the real-estate market, with disastrous consequences. Over the last 20 years, the percentage of conventional home-purchase mortgages made with the borrower putting

5 percent or less down more than tripled, from 8 percent in 1990 to 29 percent in 2007. Adding to the default risk: of these loans with 5 percent or less down, the average down payment declined from 5 percent to 3 percent of the loan's value.

As for Fannie and Freddie, most of the loans with 5 percent or less down that they had acquired by 2005 had down payments of 3 percent or even no down payment at all. From 1992 to 2007, the two entities acquired over $3.1 trillion in low-down-payment or credit-impaired loans and private securities backed by credit-impaired loans—and these are performing horribly: the delinquency rate on Fannie's and Freddie's remaining $1.1 trillion in such high-risk loans is 15.5 percent as of this past June 30, about 6.5 times the rate on the entities' traditionally underwritten loans. All this risky lending, of course, drove the nation's homeownership rate up and inflated a housing-price bubble.

Taxpayers deserve to know why not one regulator had the common sense to track the performance of CRA loans. They also deserve to know why the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and other regulators appear to have no idea how trillions of dollars in CRA loans are performing now. But above all, they deserve to know that the damage done by the CRA won't happen again. Incredibly, the House Financial Services Committee is considering legislation that would *broaden* the scope of the CRA. Before it takes any action on HR 1479—which would expand the CRA's mandates from banks to bank subsidiaries, mortgage bankers, credit unions, insurance companies, and other nonbank financial institutions—the committee should demand that regulators request detailed CRA performance data from Fannie Mae and Freddie Mac, as well as from the four banks that have announced 94 percent of the nation's $6 trillion in CRA commitments: Wells Fargo, JPMorgan Chase, Citibank, and Bank of America. These six institutions should be able to provide performance information for an estimated 70 percent of outstanding CRA loans.

The pain and hardship that CRA has likely spawned are immeasurable. What is measurable, though, is exactly how the trillions in past CRA loans are performing and what we can learn from this debacle.

Edward Pinto, a consultant to the mortgage-finance industry, was the chief credit officer at Fannie Mae in the 1980s.