Redlining or Red Herring?

Are low-income neighborhoods the victim of redlining? Absent government constraints, would the financial marketplace delineate entire city blocks as unworthy of credit, despite the potential presence of creditworthy borrowers? Would some communities find themselves cut off from access to lending services, based not on their creditworthiness but on their predominant race or ethnicity?

Two decades ago, concerns about discriminatory housing and lending policies gave rise to a vast regulatory and compliance infrastructure aimed at improving the workings of our credit markets. At the center is the Community Reinvestment Act (CRA), which advocates contend remains the primary force preventing the financial marketplace from cutting off credit to low-income neighborhoods.

But others believe redlining may have become a red herring, drawing attention away from the effectiveness of market forces in breaking down the types of financial barriers prevalent when the CRA was enacted. If this is true, the CRA may not be needed in today's financial environment to ensure all segments of our economy enjoy access to credit.

Legislating Universal Access

A veritable alphabet soup of acronyms describes government attempts to regulate the flow of credit—CDB, CDFI, CRA, ECOA, FHA, HMDA and SBA, to name a few. At bottom, these interventions reflect the view that lending patterns produced by unfettered financial markets are unfair, in the sense that creditworthy low-income borrowers and neighborhoods tend to be cut off from receiving loans. Intervention advocates sometimes contend these programs not only enhance the availability of credit to previously neglected borrowers and areas but also help boost profits for financial institutions.

Perhaps the government's most well-known attempt to enhance the availability of credit is the CRA, passed as Title VIII of the Housing and Community Development Act of 1977. The CRA requires that federal banking regulators encourage commercial banks and thrifts to help meet the credit needs of the communities in which they are chartered, consistent with safe and sound operations. The legislation's primary purpose is to prevent creditworthy residents of low-income neighborhoods from being denied access to lending services.

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Economic Pessimism Doubting the Market

It is easy to understand why the CRA was enacted in 1977. Until the late 1940s, government agencies themselves often relied on racial and ethnic composition to classify neighborhoods according to perceived lending risk. Real estate appraisers took explicit account of racial composition until the late 1970s. In this environment, it would not be surprising if some financial institutions redlined, curtailing funding and development in low-income neighborhoods with a high proportion of minority residents. Three characteristics common to the financial services marketplace when the CRA was passed help explain why redlining may have occurred: limited competition, information barriers and coordination problems.

Limited Competition. One of the virtues of a fully competitive financial system is that it normally would resolve a lack of credit availability resulting solely from racial or ethnic discrimination. Nondiscriminatory lenders would step in to serve the communities that had been discriminated against. Discriminatory practices would then have little effect other than to strengthen rival lenders.

However, the regulatory structure in place when the CRA was enacted did not foster competition. From the 1930s through the 1970s, financial institutions faced numerous, stringent restrictions on the types of products and services they could provide, the geographic scope over which they could operate and the range of interest rates they could offer depositors or charge borrowers. Moreover, strict chartering requirements raised the cost of establishing new financial entities.

In this restrictive environment, a bank or small group of financial institutions may have been the only major source of credit for local residents. When community groups in the early 1970s documented that bank mortgages tended to be concentrated in predominantly white neighborhoods, it was concluded that banks had restricted the supply of loans to minority communities.

Information Barriers. Also contributing to the lack of competition among

financial institutions was limited information technology, which hampered the ability of out-of-market institutions to enter less competitive markets. Information costs may also have had a direct effect on the potential for redlining. Given that lenders have historically faced uncertainty in assessing the creditworthiness of individuals, they may have seen residence in a low-income neighborhood as an indication of unobservable factors that would detract from a borrower's overall repayment capacity.[1] Such a strategy may have been profitable if information on certain borrower characteristics, such as job stability, was difficult or costly to obtain but correlated with place of residence. But the practice would disadvantage low-income communities, since it would restrict credit to all individuals in a neighborhood, even those who were creditworthy.

Similarly, questions about the value of the property pledged as collateral reduce the expected value of a loan to the lender. Because lending volume and real estate appraisal activity were limited in low-income neighborhoods, uncertainty about property values may have been particularly high. This lack of information may have worked against any growth in lending to low-income communities. Individual lenders would have been less interested in expending the resources required to generate more information on property values if they thought doing so would resolve uncertainty in the real estate market generally and thereby benefit competitors.

Coordination Problems. Coordination problems may also have contributed to redlining. The value of any property is typically influenced by the value of other properties in the same neighborhood. If an owner remodels and repaints an older home and adds new landscaping, the entire street generally benefits. Conversely, when a single property is allowed to deteriorate, the entire street can suffer.

As a result of such spillover effects, existing and potential homeowners may hesitate to make improvements in a neighborhood if they believe other residents will not follow suit or, worse yet, will allow their properties to deteriorate. Similarly, lenders may hesitate to finance improvements to a particular property if they feel the overall neighborhood is likely to remain in poor condition.

However, if agreement can be reached concerning the degree of improvement that should take place, more improvement could occur. Property owners and their lenders would know that the external benefits associated with improvement projects would be matched by similar external benefits generated by improvements to other properties in the neighborhood.

It is possible that fears about potential spillover effects held back improvement of low-income neighborhoods during the 1970s and earlier. Individual homeowners and lenders may have hesitated to invest in isolation, even though their investments would have been successful had they been made in concert.

Economic Optimism

Credit Access Through Competition

CRA advocates argue that these types of problems not only existed in 1977 when the CRA was enacted but remain today, implying the financial services marketplace lacks appropriate self-correcting mechanisms. While the flow of credit to low-income neighborhoods has increased greatly since the 1970s, some believe the CRA is responsible and, absent the law, previously neglected neighborhoods would see their supply of credit cut off.

But an alternative scenario is also plausible. Government lending mandates could be largely unnecessary today if the dynamics of the financial services marketplace have improved the conditions that may have limited access to lending services in the past.

Limited Competition Revisited. The erosion of interest-rate and geographic restrictions, in addition to other forms of deregulation, has worked with technology to transform the once static financial industry into a fast-paced, competitive environment involving all sorts of players. Forgoing profitable lending opportunities in today's financial marketplace would mean, in most cases, giving a boost to competitors. If a lender cuts off access to credit for a predominantly low-income or minority neighbor-

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hood, the profit motive would lead another one to move in and fill the void. These considerations suggest that widespread redlining as the result of direct discrimination is far less probable in today's financial environment.

The subprime mortgage market, which makes funds available to borrowers with impaired credit or little or no credit history, offers a good example of competition at work. In the past, subprime borrowers were often seen as a captive segment of the mortgage market, with few opportunities to obtain credit. But in the early 1990s, increased competition in the mortgage market overall led to a surge in subprime lending by specialty lenders. Today, large mainstream lenders are also increasing their presence in the subprime mortgage market, and subprime borrowers are benefiting from increased access to funds. They are not limited to a single institution or compelled to settle for the first one that will provide credit. While individual cases of fraud and abuse tend to be well publicized, they represent a small portion of subprime lending. The vast majority of subprime borrowers—many of whom have relatively low income—have benefited from the emergence of this market.

Information Barriers Revisited. Information barriers have been substantially reduced since the 1970s. Rapid advances in computer, telecommunication and financial technology have brought us from the 1970s, when lending decisions were primarily based on personal contact and loan officer discretion, to the information age, in which many such decisions are increasingly automated and often made across great distances.

Financial institutions now have access to large databases, rich with information on both individual borrowers and their neighborhoods. Real estate transaction information, including prices, is widely and instantly available in a variety of forms. With all this information in hand, lenders are increasingly moving to automated systems for underwriting and risk-based pricing. The growing ability of lenders to package and sell mortgage loans made to individuals with below-prime credit ratings is evidence of how much information flows have improved.

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While some barriers to information remain, it is difficult to square the hypothesized existence of high information costs with today's typical fear that other parties—including lending institutions—know too much about our lives, rather than too little.

Coordination Problems Revisited. While spillover effects and the associated coordination problems are important considerations in low-income neighborhoods, they also affect investment decisions in relatively affluent communities. Moreover, by focusing mainly on the behavior of individual lenders, the CRA may not give lenders sufficient incentive to coordinate their activity.

Several factors suggest that private initiatives can solve coordination problems through the creation of formal coordinating mechanisms. The work of real estate developers, for example, largely involves a coordinating role. With respect to property owners, neighborhood associations facilitate group decisions about potential spillover effects. Another possibility is that individual institutions might be able to fully meet loan demand in particular areas, thereby obviating the need for coordination across different lending institutions.

In addition, coordination problems have arguably been reduced substantially, even in situations where no formal arrangements exist. Homeowners and lenders generally become more willing to invest in individual properties when their expectations for the neighborhood are revised upward. While formal coordinating mechanisms can raise expectations, confidence in a neighborhood might rise for other reasons as well.

Consider the potential benefits of deregulation and technology in promoting competition and universal service. In the past, existing and potential homeowners in a deteriorated area may not have sought financing for improvement projects because the neighborhood was partially sealed off from credit. Even if they, as individuals, were to receive a loan, not many others in the neighborhood would, implying the improvement would be isolated and therefore have reduced value. But this type of negative expectation should be ameliorated in the current environ-

ment, to the extent that deregulation and technological advances have improved access to credit.

Economic Reality: Is Optimism Justified?

These counterpoints raise the issue of whether the CRA is still needed to encourage financial institutions to pursue profitable lending activities in low-income neighborhoods. Without repealing the legislation, it may be difficult to demonstrate conclusively the current effects of the CRA. It is possible, though, to determine whether recent trends in lending are at least consistent with the view that deregulation, technological advances and heightened competition have promoted universal access to credit.

Some Evidence. If lending to low-income neighborhoods really would be cut off in the absence of the CRA, one would expect to find that the most active lenders to these neighborhoods would be institutions subject to the law's lending requirements. Put another way, if financial institutions outside the purview of the CRA widely compete for lending opportunities in these neighborhoods, why is the CRA necessary?

Growth in lending to low-income neighborhoods by institutions outside the CRA's jurisdiction would suggest that deregulation and technological advances have increased competition, lowered information costs and increased access to financial services. In this case, a good part of the lending to low-income neighborhoods by financial institutions subject to the CRA also might reflect the benefits of deregulation and technological advances, rather than CRA lending mandates.

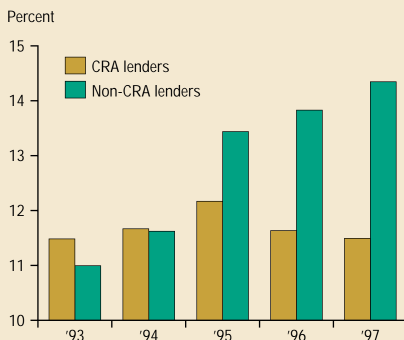
A New Twist on HMDA Data. The mortgage market offers fertile ground for empirically assessing which force is providing the greater impetus to lending in low-income neighborhoods: the CRA's mandates or competition. Concerns over disparities in residential mortgage lending were the primary force behind the creation of the CRA, and home-purchase lending is an important component of CRA evaluations. In addition, lenders subject to the Home Mortgage Disclosure Act (HMDA) are required to report detailed information on the home-purchase loans they originate, including the location of the property backing each loan and the income of the borrower.[2]

Lending to Low-Income Neighborhoods. By dividing HMDA data between financial institutions covered directly or indirectly by the CRA and those not covered at all, it is possible to determine which group of lenders has been more active in low-income neighborhoods.[3] The analysis used here defines low-income neighborhoods as census tracts having a median household income less than 80 percent of the median for the corresponding metropolitan statistical area.[4]

To get a clear picture of the two groups' relative strength in serving low-income neighborhoods, it is useful to examine the portfolio shares they devote to such lending. Chart 1 shows the proportion of the total number of one- to four-family home-purchase loans made by CRA-covered institutions that was extended to households in low-income neighborhoods. The corresponding portfolio share for institutions not covered by the CRA is also shown. The analysis begins in 1993, when data for indepen-

If financial institutions outside the purview of the CRA widely compete for lending opportunities in these neighborhoods, why is the CRA necessary?

Chart 1
Portfolio Share of Home-Purchase Loans to Low-Income Neighborhoods



NOTE: Low-income neighborhoods are defined as census tracts having a median household income less than 80 percent of the median for the corresponding metropolitan statistical area. CRA lenders include commercial banks, savings associations and their affiliates. Non-CRA lenders include independent mortgage and finance companies and credit unions.

SOURCE: Federal Financial Institutions Examination Council.

dent mortgage companies—an important component of lending activity not covered by the CRA—were first reported under HMDA. The analysis ends in 1997, the latest year for which HMDA data are available.

As a group, lenders not covered by the CRA have devoted a growing proportion of their home-purchase lending to low-income communities, with the community lending share of their loan portfolios rising from 11 percent in 1993 to 14.3 percent in 1997.[5] This expanding portfolio share implies that for financial institutions outside the CRA's reach, lending to low-income communities grew faster than other lending activity. Moreover, these institutions are not a small part of the total lending picture. Lenders not covered by the CRA accounted for just under 40 percent of all one- to four-family home-purchase loans extended to low-income neighborhoods in 1997. These findings indicate CRA lending mandates are not necessary to invoke a significant focus on lending to low-income neighborhoods.

As a group, lenders not covered by the CRA have devoted a growing proportion of their home-purchase lending to low-income communities.

In contrast, CRA-covered lenders, as a group, devoted about the same proportion of their home-purchase loans to low-income neighborhoods in 1997 as they did in 1993. In both years, their community lending share was about 11.5 percent. Even though these institutions were subject to the CRA, their lending to low-income communities grew no faster than other lending.

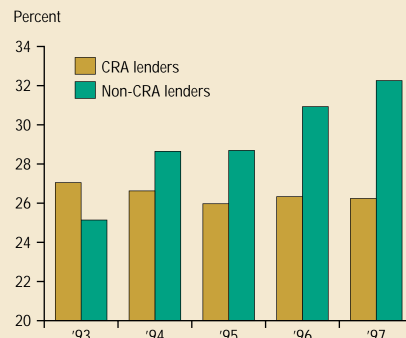
This is not the type of pattern that could be expected if the CRA were the impetus for recent increases in lending to low-income neighborhoods. It is, however, consistent with deregulation and technological advances leading to lower information costs and increased competition in the mortgage market. Independent mortgage companies tend to have more leeway to specialize in relatively risky lending than their more conservative and more heavily regulated counterparts in the banking industry. It is not surprising, then, that independent companies appear to have taken the lead in focusing on lending activity in the riskier segments of the mortgage market.

Lending to Low-Income Borrowers. While the CRA places a heavy emphasis on lending to low-income communities, it also considers lending to low-income borrowers, irrespective of their neighborhood. To analyze this type of lending, low-income borrowers are defined as having income less than 80 percent of the median for the metropolitan statistical area in which the property is located.

Chart 2 shows the proportion of the total number of one- to four-family home-purchase loans made by CRA-covered institutions that was extended to low-income borrowers, along with the corresponding proportion for lenders not subject to the CRA. Consistent with the findings for low-income neighborhoods, lenders outside the CRA have devoted a growing proportion of their home-purchase lending to low-income borrowers. Their portfolio share of such loans rose from 25 percent in 1993 to 32 percent in 1997.[6] In contrast, as a group, CRA-covered lenders extended 27 percent of their home-purchase loans to low-income borrowers in 1993 and 26 percent in 1997.

These trends are consistent with the view that in recent years, progress predicated on technology, financial innovation and competition—not the CRA—has broadened the U.S. financial services marketplace. The fundamental role of competition in this process suggests that not only have an increasing number of

Chart 2
Portfolio Share of Home-Purchase Loans to Low-Income Borrowers



NOTE: Low-income borrowers are defined as having income less than 80 percent of the median for the metropolitan statistical area in which the property is located. CRA lenders include commercial banks, savings associations and their affiliates. Non-CRA lenders include independent mortgage and finance companies and credit unions.

SOURCE: Federal Financial Institutions Examination Council.

consumers gained access to credit, but in the vast majority of cases they have done so at competitive prices and terms.

Conclusion

Today's financial marketplace far exceeds yesterday's in its ability to serve a broad array of customers. Previously, rigidities in housing and credit markets helped make the case for remedies such as the CRA. While this legislation may have been instrumental in initially improving the flow of credit to neglected areas, fears that low-income neighborhoods would still suffer from a lack of credit if not for the CRA may be unjustified. Consideration of the conditions that previously may have limited access to lending services suggests that deregulation and technological advances have enhanced linkages between low-income neighborhoods and the credit markets.

In this regard, the mortgage lending data presented above are consistent with the view that today, low-income neighborhoods' access to credit may not depend on the CRA. In terms of portfolio allocations, financial institutions not covered by the CRA have become more active lenders in low-income neighborhoods than their CRA-covered counterparts. Since economywide market forces have led relatively unregulated financial institutions to increase their lending activity in low-income communities, it is likely those same market forces are also responsible for a large part of the community lending that has occurred at CRA-covered institutions.[7]

These conclusions are subject to some caveats. The analysis covers only home-purchase loans, and the findings may not carry over uniformly to other types of lending. In addition, the conceptual analysis focuses on the positive role of market forces in promoting universal access to credit services, while other factors—including a wide variety of government programs not mentioned here—may also have increased lending to low-income neighborhoods.

Nonetheless, the developments and data reviewed here suggest it is unlikely the CRA is responsible for the recent increases in home-purchase lending to low-income neighborhoods. Instead, deregulation and technology have lowered information costs, heightened competition and increased access to financial services. These findings raise questions about the degree to which the CRA is needed to ensure all segments of our economy have fair access to credit.

—Jeffery W. Gunther
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Notes

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1. Lenders also could have interpreted the race or ethnicity of individual borrowers as sending such a signal. However, because this type of discrimination is not based on neighborhoods but on specific nonfinancial characteristics of individual applicants, the enforcement of existing fair lending laws—not the CRA—is the appropriate policy response.
2. Rural and certain small-scale lenders are not required to report HMDA data.
3. Commercial banks and savings associations are directly covered by the CRA. Because mortgage and finance companies affiliated with these types of lenders may also be influenced by the CRA, they, too, are included in the group of CRA-covered lenders. Independent mortgage and finance companies and credit unions are not covered by the CRA.
4. The analysis treats all low-income tracts equally and does not attempt to distinguish between tracts that are within or outside a particular institution's primary market area. The market area for many mortgage companies is very broad, so such a distinction often becomes irrelevant.
5. To provide a complete picture of lending activity in any given period, the analysis uses all the HMDA data available for each year. Because the boundaries of metropolitan statistical areas are periodically redrawn, the geographic area covered by the analysis is not constant.
6. Moreover, lenders not covered by the CRA accounted for nearly 40 percent of all one- to four-family home-purchase loans extended to low-income borrowers in 1997.
7. This view is supported by research indicating most of the recent growth in lending by CRA-covered institutions to low-income neighborhoods has occurred in areas where the institutions do not operate banking offices and so have no CRA obligations. See "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act," *Federal Reserve Bulletin*, February 1999.

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