

Commentary: Filling a Gap in the Community Reinvestment Act Examiner Toolkit

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Critical to the success of the Community Reinvestment Act¹ (CRA) of 1977 is how bank regulators evaluate a bank's performance in meeting the credit needs of low- and moderate-income (LMI) borrowers. Failure to measure the right outcomes results in a less-effective, if not ineffective, CRA, as banks focus on simply checking off boxes that may make little difference in the communities they serve. A particular problem is if the examiners cannot fully take into account variations in local market conditions and credit opportunities. As noted in Willis (2009), the examination process is critical if CRA is to continue to play a meaningful role in strengthening LMI households and communities. This commentary considers one aspect of the challenge of keeping CRA effective: the criteria for determining how well large banks (banks with assets of \$1 billion or more) are serving the home purchase mortgage needs of LMI households. More specifically, I examine how well a bank is doing in helping to meet the credit needs of the LMI community compared with its performance in serving higher income groups.

The burden of determining a bank's CRA performance falls on bank examiners, who currently need better guidance for making evaluations across the vast array of housing market conditions in the United States, ranging from cities plagued with disinvestment and abandonment to those with high housing costs.² The lack of adequate guidance results in a lack of clarity that does not serve any of the stakeholders well. Advocates want banks to be held to a consistent and high standard. Bank examiners value standardized tests to increase consistency and to help arm them against second-guessing by advocates. Bankers are looking for standardization and predictability to enable them to develop a forward-looking business plan for their CRA activities.³ Therefore, the language and results of the evaluation process (which appear in the performance evaluation published with a bank's ratings) show a heavy reliance on a narrow set of standardized statistics. Information on local market and business conditions supplied by the bank as part of its performance context seems incapable of swaying the examiner to reward the bank with a rating any higher than "adequate."⁴

¹ Pub. L. 95-128, 91 Stat. 1147, Title VIII.

² The standard criterion for *affordable* is housing costs of no more than 30 percent of income.

³ A lag in completion of prior exams exacerbates the challenge for banks in planning their CRA activities, by delaying any feedback from the results of those exams.

⁴ The terms "excellent," "good," "adequate," "poor," and "very poor" correspond to CRA ratings of "outstanding," "high satisfactory," "satisfactory," "needs to improve," and "substantial noncompliance."

Reliance on only a few standard statistical tests can be a particular problem in high-housing-cost areas; what is a bank to do if market conditions do not make buying a home feasible for an LMI household?

To judge a bank's CRA performance with regard to home mortgage lending to LMI households, examiners look at three benchmarks: (1) the LMI share of the population, (2) the LMI share of homeowners, and (3) the performance of the bank, as measured by its distribution of home mortgages across households by income compared with that for all the lenders in that locality. None of these three benchmarks, however, provides a reliable basis for assessing the extent to which a bank helps to meet the home purchase mortgage credit needs of LMI households in high-housing-cost markets.⁵

The shortcomings of these three benchmarks are made clear by the example of New York City (NYC) where, since 2000, median home prices have more than doubled while incomes have continued to stagnate (NYU Furman Center, 2016). Exhibit 1 presents the benchmarks traditionally used as part of a CRA exam. Benchmark 1, the LMI share of households in NYC (51.6 percent), is meaningless as an indicator for credit demand unless the distribution of sales prices of housing allows for equal proportions of households at all income levels to sustain homeownership—clearly not the case for NYC. Benchmark 2, the percentage of LMI households that are homeowners (30.9 percent), is equally problematic as a target because existing homeowners reflect an amalgam of sales made over many years, including sales made well before house prices boomed. Benchmark 3, the percentage of home purchase mortgages made to LMI households by all lenders in NYC, remains. Is 8.7 percent good or bad? Are banks in NYC meeting local credit needs? There is no way to know if an 8.7-percent share of home purchase mortgages meets the credit needs of LMI households, and the first two benchmarks do little to help.

I argue that a better, localized benchmark is needed for judging whether a bank carries out the intent of CRA and helps to meet the credit needs of its community, and I propose one approach to doing so.⁶ To be useful, a benchmark needs to account for differences across cities in home prices and in the factors that go into a lender's ascertainment of how much it can lend. Based on the assumption that most LMI homebuyers take out a mortgage, this commentary demonstrates how such a benchmark can be developed for NYC using 2014 home sales and Home Mortgage

Exhibit 1

Comparison of Benchmarks for New York City, 2014

Benchmark	Percent
LMI share of households	51.6
LMI share of homeowners	30.9
LMI share of home purchase mortgages	8.7

LMI = low- and moderate-income.

⁵ Although refinancing mortgages is also part of the home mortgage market, the income distribution of customers for home purchase mortgages can differ greatly from that for refinancing mortgages. The home purchase market is sensitive to the price distribution of the homes for sale, whereas the refinancing market depends on the distribution of existing homeowners and, in particular, those who already have a mortgage.

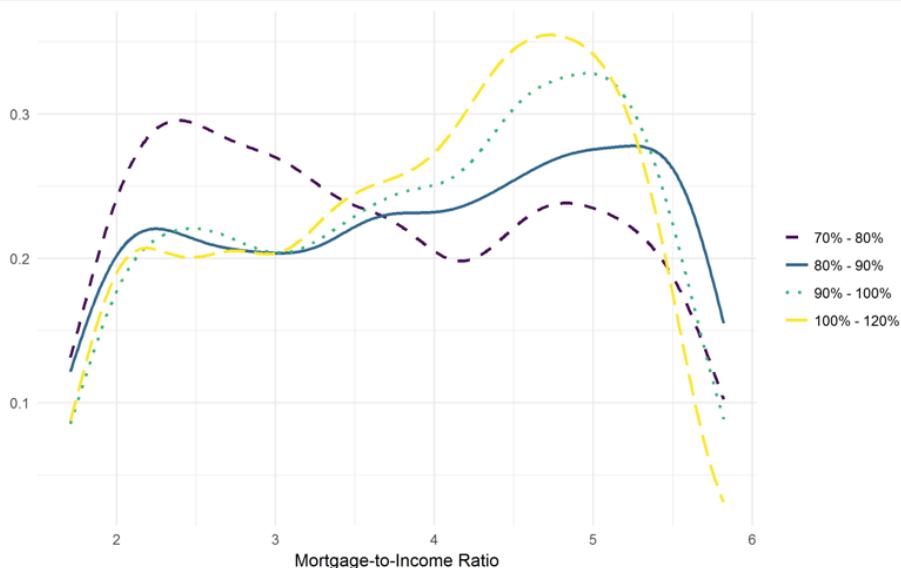
⁶ Although this commentary is able to provide only an overview of the methodology, the specific details are available on request from the author.

Disclosure Act⁷ (HMDA) data.⁸ The home sales data provide us with the price distribution of homes sold—in other words, the potential “stock” of homes LMI families could buy.⁹ HMDA provides data on income levels and mortgage amounts by borrower and so enables us to determine the distribution of mortgage-to-income ratios (MIRs) for borrowers within different income ranges. By making assumptions regarding LMI borrower incomes and downpayments, we can use an MIR distribution to estimate a distribution of purchasing power for LMI homebuyers and then match it to the distribution of sales prices to determine a share of sales that LMI homebuyers are likely able to purchase. The distribution can then be used as a benchmark against which to judge lender performance.

The first step is to calculate how much LMI families can realistically borrow. To guard against using an MIR distribution that embodies a failure by banks and other lenders to meet the home purchase mortgage credit needs for the LMI community, we compare the MIR distribution for LMI borrowers with incomes from 70 to 80 percent of the Area Median Family Income (AMFI) with the MIR distributions for borrowers with higher incomes: 80 to 90, 90 to 100, and 100 to 120 percent of AMFI (exhibit 2).¹⁰ Although the shapes of the MIR distributions vary across these income groups,

Exhibit 2

Distribution of Mortgage-to-Income Ratios by Income Range of the Borrowers, New York City, 2014



Sources: Home Mortgage Disclosure Act (2014 data); NYU Furman Center

⁷ Pub. L. 94–200, 89 Stat. 1124.

⁸ LMI households that purchase two- to four-family homes can often use a portion of the rental income in their mortgage application, thus potentially raising the income that is reported in HMDA above the maximum income for an LMI household, in which case the borrower would be placed in a higher income category.

⁹ For more information on the sales data, see NYU Furman Center (2016).

¹⁰ The 2014 AMFI for NYC is compiled using American Community Survey 2006–2010 estimates for the New York, NY Metropolitan Statistical Area.

the bulk of the MIRs lies between 2 and slightly more than 5 in all cases.^{11,12} It is clear, however, that households earning between 70 and 80 percent of AMFI have, on average, lower MIRs than those who earn more. This difference may reflect tighter lending standards for LMI borrowers than for higher-income borrowers but can also be explained by numerous other factors. Such factors include the potentially higher cost of credit (with LMI borrowers possibly having to pay higher interest rates, given that their credit histories tend to be weaker than those of higher-income households), borrower concerns about having sufficient residual income after making mortgage payments (for example, needing to make sure they have enough to cover other debts and living expenses, including house repairs and rehab), and the fact that LMI homebuyers may be limited in the amount of house they can purchase because they likely have less savings to devote to a downpayment, closing costs, and lender-required reserves (often two to three times projected monthly housing costs).

The power of this analysis is that it is now possible to map each of the four MIR distributions against the distribution of home sales prices to derive estimates of the share of homes for sale that LMI households could be expected to buy. To simplify the calculation for translating the MIR distributions into LMI borrowing power, I assume that LMI borrowers are evenly split between those with incomes at 80 percent of AMFI and those at 70 percent. That assumption somewhat inflates the borrowing power of LMI borrowers who, based on the HMDA data, were more heavily weighted toward those with incomes less than 70 percent of AMFI than toward those with incomes between 70 and 80 percent of AMFI.

Exhibit 3 shows the results when applying the four different MIR distributions based on that split of LMI borrower incomes, assuming downpayments of either 3 or 20 percent of the purchase price. Although I do not have direct information on the size of downpayments, the low end of this range

Exhibit 3

Estimated Share of 2014 Home Sales That Could Have Been Bought by LMI Households Based on HMDA-Derived MIR Distributions

AMFI Range for the MIR Distribution Used (%)	Estimated LMI Market Shares (%)	
	Assuming Borrowers Able To Put Down 3 Percent of the Sales Price	Assuming Borrowers Able To Put Down 20 Percent of the Sales Price
70–80	6.7	10.2
80–90	7.6	11.6
90–100	7.5	11.5
100–120	7.3	11.2

AMFI = Area Median Family Income. HMDA = Home Mortgage Disclosure Act. LMI = low- and moderate-income. MIR = mortgage-to-income ratio.

¹¹ Note that the graphs reflect the “cleaning” of the data of ratios that seemed unreasonably high by truncating the HMDA-generated MIR distribution at the 90th percentile and truncating the bottom 10 percent to guard against biasing the results downward.

¹² Interestingly, using the maximum “ability-to-repay,” or QM, ratio of 0.43 and the 2014 average mortgage interest rate of 4.5 percent (and no mortgage insurance), Realtor.com yields what might be considered a maximum possible MIR of 5.3, based on a 20-percent downpayment and machine-generated projections for NYC property taxes and insurance costs for a mortgage of \$288,000.

is likely to predominate, especially for the first-time homebuyers, given the generally low level of savings of LMI households (Federal Reserve, 2015; see page 23).¹³ Assuming a 3-percent downpayment, the MIR distribution for LMI borrowers yields an estimated share of sales of 6.7 percent. Using the MIR distributions of higher-income borrowers yields estimates as high as 7.6 percent, with the highest produced by the MIR distribution for borrowers with incomes between 80 and 90 percent of AMFI. Interestingly, the MIR distributions for the next two higher-income groups actually yield smaller LMI market shares, suggesting that 7.6 percent may reasonably be considered an upper estimate for a benchmark of the potential LMI share of home sales in NYC in 2014, if borrowers put down only 3 percent of the sales price. If LMI borrowers are able to put down 20 percent, the estimated shares of loans are higher, ranging from 10.2 to 11.6 percent.

The numbers in exhibit 3 provide an estimated market share of LMI households and a more realistic benchmark to serve as a target for CRA evaluation. If a bank is working to effectively expand access to credit, and a 3-percent downpayment seems standard, then 6.7 percent of home purchase loans to LMI households would be a good benchmark for judging performance. This calculation also suggests that the industrywide LMI share of 8.7 percent in NYC (exhibit 1) might reflect a strong performance. Such a conclusion would be valid even if it turns out that as many as 25 percent of LMI homebuyers have sufficient savings to put down 20 percent. Even using the highest estimates in exhibit 3—7.6 and 11.6 percent—and weighing them accordingly, the benchmark estimate would be 8.6 percent. In other words, based on this metric, examiners could more effectively conclude that, overall, lenders in NYC are abiding by the spirit of CRA, so any bank that meets or exceeds that standard should also get credit for stepping up to help meet LMI credit needs for home purchase mortgages.

This proposed metric is far from perfect and is based on a lot of assumptions that can surely be further documented and refined. For example, more information is needed on the size of downpayments made by LMI borrowers, but examiners could probably ascertain that information by working with the banks in a local market. In addition, relying on HMDA data of the actual experience of mortgage borrowers where housing costs are high may bear further scrutiny to make sure that this analysis does not simply replicate whatever shortcomings may exist in the way lenders make credit available. Clearly, if lenders are not helping to meet the credit needs of LMI borrowers, then the HMDA data cannot shed light on the true borrowing potential for LMI households. Nevertheless, the existing benchmarks do not provide much guidance in high-housing-cost locations for examiners who are tasked with determining whether a bank meets its CRA obligations. For CRA to work as effectively as it should, regulators need to establish metrics that can effectively capture whether banks meet market demand across the diversity of housing market contexts in the United States.

Acknowledgments

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¹³ As a result of low saving rates, it is not surprising that surveys of prime, working-age household heads show only minimal net worth among those with incomes in the bottom four deciles (Thompson and Suarez, 2015; see page 39).

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