BANKS AND THE COMMUNITY REINVESTMENT ACT

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To be covered:

- Hypothesis
- The Community Reinvestment Act
  - Definition
  - Intended purpose
  - How it works
  - Issues
- Research/Data
- Results

Hypothesis

- Is there a relationship between CRA ratings and percentage of loan losses?
  - What kind of relationship?

- Do banks with high CRA ratings show high loan losses?

Community Reinvestment Act

- What is it?
  - Community Reinvestment Act of 1977
    - Discourage lending institutions from discrimination
    - Assist community members in low- to moderate-income neighborhoods, small businesses or small farms
  - Credit Unions not affected/regulated
  - “Institutions have an obligation to serve their communities” (Spong, 2000).

CRA, contd.

- 1980's
  - "Redlining" caused implementation of the CRA
  - People affected by redlining were tired of depositing their money into institutions which would not loan them money.
- "Many people felt that the visible economic decline of urban areas was aggravated by financial institutions" (Thomas, 1993).

Intended Purposes

- Eliminate “redlining”
- Extend credit to community members in low- to moderate-income category
  - “Increased lender sensitivity to such lending needs can help preserve, rehabilitate, and revitalize such neighborhoods” (Thomas, 1993).

Banks' Requirements

- CRA requires banks to:
  - Make community members aware of policies
    - Availability of the Community Reinvestment Act Statement
  - Keep file of comments from the public
    - "CRA Public File"
  - Receive evaluations periodically

Requirements, contd.

- Make public their CRA evaluations
- Report data for:
  - Small business loans
  - Farm loans
  - Specific community development loans

Evaluations

- Based on:
  - Size of institution
  - Expertise
  - Financial strength
  - Type of community
  - Local economic conditions
  - Nature of institution’s competition and business strategy

Evaluations, contd.

- Four Levels
  - Outstanding, Satisfactory, Needs to Improve, Substantial Noncompliance
- Small banks
  - Evaluated every 4-5years
- Large banks
  - Evaluated in lending, investments, and services

Enforcement

- Regulatory agencies cannot legally enforce compliance
  - Give instruction on meeting community needs

- Lenders receive pressure to comply in order to please regulators

Issues

- Bankers:
  - believe they are being told where and to whom they will lend money
    - “credit allocation”
  - Evaluations dependent on regulators
  - Riskier loans
  - Unfair compared to Credit Unions

Issues, contd.

- Community members:
  - Not enough regulation and enforcement
  - Ratings not public enough

Issues, contd.

- Regulators:
  - A more proven evaluation system with more purpose
  - Agree with the need of more public records
  - Wanted confidentiality for individual regulators

1989 Amendment

- Financial Institutions Reform, Recovery, and Enforcement Act of 1989
  - Made new rating system
  - Required ratings to be publicly available

Research

- Federal Reserve
  - CRA Rating Data

- Federal Deposit Insurance Corporation
  - Bank Financial Statements

Research, contd.

- Assumptions and variables
  - Date range: 1992—2000
  - Net charge offs due to CRA losses
  - Three asset sizes
    - 1: $100M-$1B
    - 2: $1B-$10B
    - 3: $10B-$100B

Research, contd.

- Compared:
  - Outstanding rated banks to Substantial Noncompliance *and* Needs to Improve banks combined.
    - Combined these two to increase noncompliant data size
- Eliminated asset size 3
  - No data for noncompliant banks

Outstanding

	year	Asset Size 1		Asset Size 2		Asset Size 3
Total charge-offs	1992	0.73%	1993	0.30%	1994	0.22%
	1992	0.23%	1993	0.62%	1994	0.42%
	1992	1.40%	1993	0.42%	1996	1.23%
	1992	0.52%	1993	0.21%	1996	0.32%
	1992	0.26%	1994	0.20%	1996	0.11%
	1993	0.11%	1994	0.58%	1996	0.65%
	1993	0.41%	1994	0.25%	1998	0.48%
	1993	0.77%	1994	0.26%		
	1993	0.45%	1994	0.25%		
	1994	0.59%	1997	0.33%		
	1994	0.10%	1997	0.62%		
	1994	0.27%	1997	0.72%		
	1994	0.14%	1997	0.29%		
	1994	0.41%	1997	0.24%		
	1994	0.27%	1997	0.21%		
			1997	0.14%		
			1999	0.26%		
			1999	0.21%		
			1999	0.44%		
			1999	0.22%		
Averages:		0.44%		0.34%		0.49%
Total Averages, all asset sizes:		**0.38%**				

Substantial Noncompliance

	Year	Asset Size 1		Asset Size 2	Asset Size 3
Total charge-offs	1993	0.21%	2000	0.01%	N/A
	1998	1.42%			
	1993	0.09%			
Averages:		0.57%		0.01%	
Total averages, all asset sizes:		**0.29%**			

Needs to Improve

	Year	Asset Size 1		Asset Size 2	Asset Size 3
Total charge-offs	1997	0.32%	1995	0.28%	N/A
	1992	0.13%	1994	0.51%	
	1998	0.65%	1993	0.75%	
	1995	1.97%	1992	0.27%	
	1996	0.86%	1992	1.89%	
	1992	0.81%	1992	0.90%	
	1994	0.77%			
	1998	0.00%			
	1997	0.20%			
	1993	0.04%			
	1992	0.10%			
	1999	0.04%			
Averages:		0.49%		0.77%	
Total Averages, all asset sizes:		**0.58%**			

Loan loss percentages for each CRA category and asset size:

	1	2	3	All
Substantial Noncompliance	0.57%	0.01%	N/A	0.29%
Needs to Improve	0.46%	0.68%	N/A	0.58%
Substantial Noncompliance + Needs to Improve	0.51%	0.66%		**0.56%**
Outstanding	0.44%	0.34%	0.49%	**0.38%**

Results

- Raw data
  - Loan loss percentages of non-compliant banks higher than compliant banks
    - Combining Substantial Noncompliant banks with Needs to Improve banks

Means Difference Test

- Statistical T-test:
  - To see if there is a statistical difference between the two means
  - What level of confidence the difference is

- Difference between group means/variability of groups

T-Test

$$t = \frac{(\overline{y_1} - \overline{y_2}) - 0}{s\sqrt{\frac{1}{n_1} + \frac{1}{n_2}}}$$

where:

$$s^2 = \frac{\sum_{t=1}^{n_1}(\overline{y_i} - \overline{y_1})^2 + \sum_{t=1}^{n_2}(\overline{y_i} - \overline{y_2})^2}{n_1 + n_2 - 2}$$

(Mendenhall & Reinmuth, 1982)

T-Test Results

- T-value of 1.6325
  - Critical t-values for different means are:
    - 1.282 at the 0.90 confidence level
    - 1.645 at the 0.95 confidence level
  - This data shows there is a distinct difference in the means of loan losses between the two CRA rating categories.

T-Test Analysis

- Therefore, from 1992-2000, compliance with the CRA appears to have *reduced* bank loan losses.
  - At the statistical confidence level of 0.90 but not at 0.95.
  - The statistical analysis show a strong difference in the means of the two groups

Research Results

- There is a relationship between different CRA ratings and their loan loss averages
  - Not the relationship I had hypothesized

- My research does not support the theory that compliance weakens bank performance.
  - It may indicate that compliance strengthens bank performance.

Explanations

- Why are loan losses low for compliant banks?
  - The majority of CRA loans are not bad loans
    - CRA regulations are consistent with safe lending practices
  - CRA regulations encourage diversification of investments
  - Something besides the CRA is causing loan losses

Conclusion

- There is a relationship
  - There is a distinct, statistical difference between the two means
- The CRA does not harm financial institution's performance ratios
- Further research should be done for current years when data becomes available

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