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Moving into New Territory: Internet Banks Make Defining COMMUNITY Difficult

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Communities & Banking

The mission of *Communities & Banking* is to enhance community and economic development by exploring effective ways for lenders to work with public, private, and nonprofit sectors toward proactive compliance with the Community Reinvestment Act.

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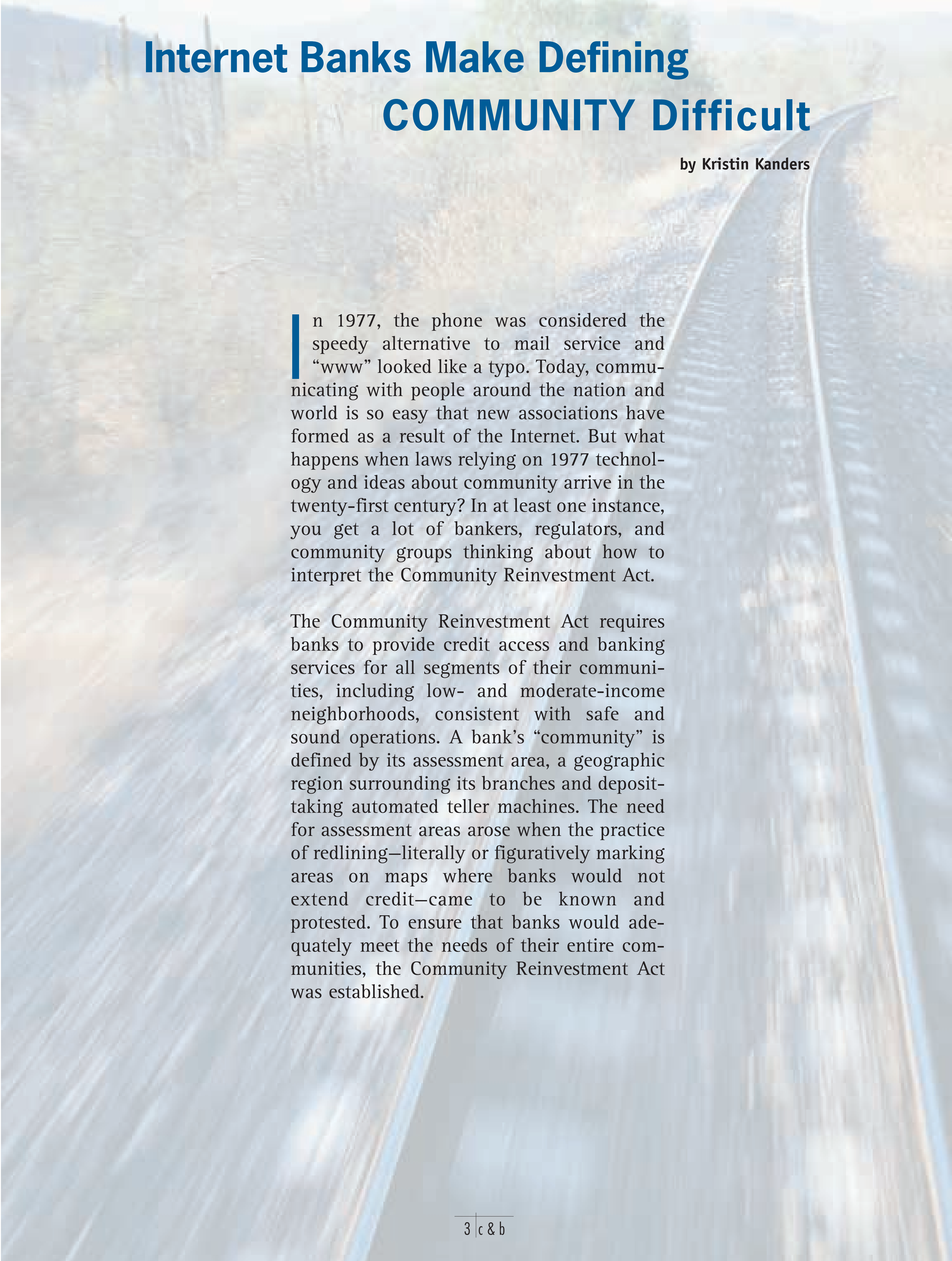


moving into new territory

Internet Banks Make Defining COMMUNITY Difficult

by Kristin Kanders

In 1977, the phone was considered the speedy alternative to mail service and "www" looked like a typo. Today, communicating with people around the nation and world is so easy that new associations have formed as a result of the Internet. But what happens when laws relying on 1977 technology and ideas about community arrive in the twenty-first century? In at least one instance, you get a lot of bankers, regulators, and community groups thinking about how to interpret the Community Reinvestment Act.

The Community Reinvestment Act requires banks to provide credit access and banking services for all segments of their communities, including low- and moderate-income neighborhoods, consistent with safe and sound operations. A bank's "community" is defined by its assessment area, a geographic region surrounding its branches and deposit-taking automated teller machines. The need for assessment areas arose when the practice of redlining—literally or figuratively marking areas on maps where banks would not extend credit—came to be known and protested. To ensure that banks would adequately meet the needs of their entire communities, the Community Reinvestment Act was established.

Internet-based banks, those that do not supplement their services with a traditional branch or ATM infrastructure, present a challenge to the CRA because their "community" is not based on geography. Because the deposits they gather can be from across the nation, should their reinvestment be across the nation? Or is nationwide reinvestment asking too much from these start-ups, most of which have small staffs relative to asset size? To date, most Internet banks have reinvested in the community around their headquarters. The sensitive issue, though, is that an Internet bank's headquarters may not be located in an area that represents its customer base. Also, Internet bank headquarters may be unevenly distributed throughout the United States—for example, a large percentage are located in the Southeast.

The regulatory agencies have not produced guidelines for Internet-based banks to use in defining their assessment areas because they have no authority to do so.

Exit Hype

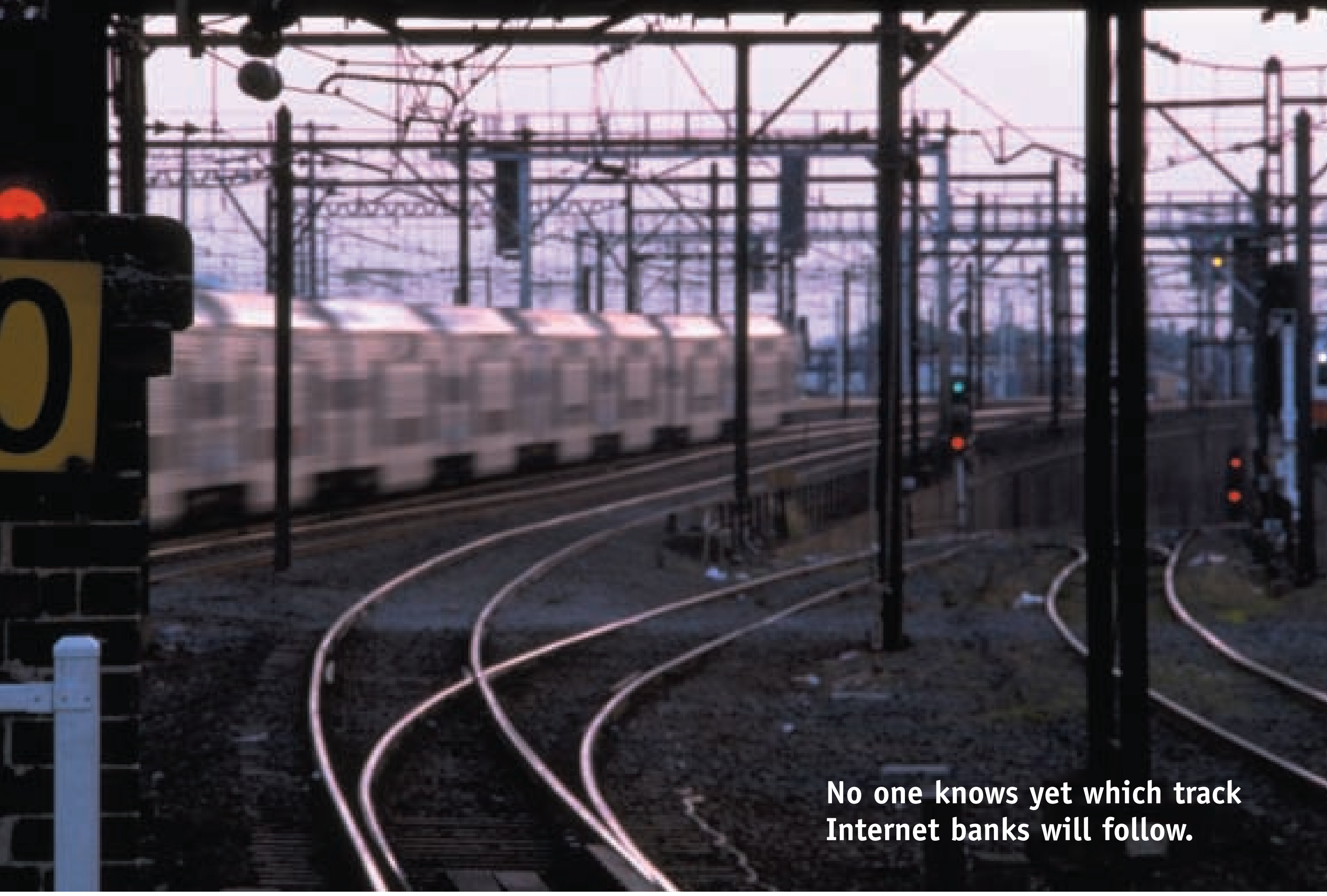
Five years ago, the race was on to put traditional operations on the Internet, with the idea that the Internet would make operations more efficient and cost effective. Theory, however, has hit reality. The costly ingredients Internet banks wanted to avoid, such as branch offices, real estate, and staffing, matter to consumers. Internet benefits such as home banking and high-interest earning accounts are attractive, but not enough to create customer loyalty.[1] In addition, because many Internet-based institutions don't originate loans, but buy them on the wholesale market through third-party brokers, they struggle with thin profit margins. The Federal Deposit Insurance Corporation estimates that of the nearly 10,000 FDIC-insured financial institutions in the United States, about one-half have a web site and about one-fifth offer transactional Internet banking services.

Of the Internet-based banks operating in 2001—various estimates range in the few dozen—many have retrofitted their operations to include either branches, kiosks, or automated teller machines. Cynthia Bonnette, Assistant Director of the FDIC's Bank Technology Group, says, "The large majority that started a few years ago have expanded their delivery channels." Brick-and-click operations, such as Salem Five Cents Savings Bank and its Internet subsidiary directbanking.com, are having an easier transition than Internet-only operations, partly because they can rely on current customers to sign up for their Internet services rather than spend large amounts of money marketing to a new clientele.

Some Internet-based banks, though, have proved that they can sustain profitability, and that's why various groups of people are interested in the debate over where Internet banks are responsible for reinvestment. These groups care, not only because Internet banks question how to define communities in an era of increasing reliance on communications technology, but because the standards being set today may influence the scheduled revision of the CRA in 2002.[2] The Federal Financial Institutions Examination Council, an interagency group representing the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Office of the Comptroller of the Currency, and National Credit Union Administration, is responsible for revising the CRA next year. Lynn Bedard, Community Affairs Liason for the OTS Southeast Region, thinks that "How you define an assessment area will probably be the number one issue in the 2002 CRA review."

Until 2002, and possibly after as well, Internet banks' CRA activities will be evaluated on a case-by-case basis. The regulatory agencies have not produced guidelines for Internet-based banks to use in defining their assessment areas because they have no authority to do so. Tom Venables, President and Chief Executive Officer of Internet-based Lighthouse Bank, of Waltham, MA, explains his view. "It's difficult to figure out how to comply with the CRA because it's very geographically based. To fit our model into that world was tough. Also, the regulators can't provide much guidance because they are restricted by what the law says, so until that changes, it's kind of a circular problem." But since Internet banks have not been waiting around for further instructions, here are some examples of how Internet banks and their regulators are interpreting CRA responsibilities.

Says Lighthouse Bank's Tom Venables of the approach his institution took, "What we did to meet our responsibilities with the CRA was to create a business plan shaped by CRA. As a 'de novo'



No one knows yet which track Internet banks will follow.

institution, which is a 'small' institution in the regulation, our requirement was to do the majority of our lending in our assessment area, so it's a fairly well-defined requirement.[3] We chose Waltham [as a headquarters location] for business purposes and then the question became, 'How big do we draw the circle?' We decided to focus our marketing efforts in Eastern Massachusetts and with this approach we came up with a logical assessment area. We couldn't handle all of Eastern Massachusetts as our assessment area so we chose a 60-community area starting in Boston and moving west. So far, we have done about 70 percent of our lending in that assessment area."

This approach of structuring the bank's business model to satisfy CRA is not how all Internet banks shape their businesses, nor do they all target marketing to a geographic area. Although Lighthouse Bank, which opened for business in June 2000, has not been profitable for its bank holding company, Brookline Bancorp, and is expected to be sold to a third party or merged with Brookline's traditional operations by the third quarter of this year, the method the bank followed to comply with the CRA is still instructive. Lighthouse Bank's lack of profitability, it should be noted, is not a result of its CRA approach, but of the high start-up costs associated with Internet banking.

Nationwide Community Reinvestment

NetBank, which premiered in 1996 and calls itself "The World's Largest Independent Internet Bank," is an example of a profitable Internet-based bank that's been in business for ages, at least Internet ages. Headquartered in Alpharetta, GA, an Atlanta suburb, its lending patterns have changed as the institution has matured. In 1997, NetBank's CRA plan was for community reinvestment around its headquarters. As a start-up operation, NetBank was encouraged to define its headquarters area as its assessment area. By 1999, though, NetBank was receiving deposits from all 50 of the United States and 20 foreign countries.

In January 2000, NetBank submitted a plan to the Office of Thrift Supervision, regulator of federally and state-chartered thrift institutions, detailing how it could implement a national CRA program. Says their CEO D.R. Grimes, "When we started, we were making about 50 percent of our loans in Atlanta and received about 25 to 30 percent of our deposits from there. As we got bigger our percentages shrank and it became clear that we were going to be national. With less than 15 percent of our market now in Georgia, it would be difficult to comply with CRA—it would be fiscally irresponsible." The "fiscal irresponsibility" Grimes is referring to is that compliance with the CRA might suggest doing a majority of loans in an assessment area, yet safety and soundness regulators wouldn't want such a high concentration of loans—especially a high concentration in low- and moderate-income loans—to be made in an area that isn't representative of its customer base.

What NetBank received OTS approval for in March 2001 is to reinvest in three communities that are its biggest business generators: California, Georgia, and Florida. NetBank's strategic plan, which outlines its CRA goals and

We need to update our concept of community to reflect today's marketplace. . . . This is by no means a simple problem to solve. . . . there are aspects of the regulations, as we all know, that do not work particularly well in today's market of Internet banks, nationwide lending, alternative delivery, and deposit-gathering mechanisms.

Ellen Seidman, OTS Director
October 2000 speech

approach, states that should its current market demographics change, so will its CRA plan. NetBank's strategy of CRA lending in three areas is a "great resolution," says Grimes because, while demonstrating how to be creative with CRA, it roughly matches loans with deposits and so is in keeping with the spirit of community reinvestment. Lynn Bedard, who worked on behalf of the OTS to help NetBank develop its strategic plan, says of the plan, "It probably isn't perfect, but it's a start."

To some, that might be an understatement. But even so, a strategic plan is often considered to be a better solution than having Internet banks automatically choose their headquarters as their assessment areas. Home base designations concern community advocates who feel that Internet banks unfairly limit their areas for reinvestment. For example, ebank, formerly under the name Commerce Bank, has its headquarters area as its assessment area. The reinvestment area description in Commerce Bank's public evaluation, the document each federal regulator produces after examining a bank for CRA compliance, states: "Commerce Bank's assessment area includes some of Metropolitan Atlanta's most affluent areas. None of the census tracts in the Fulton County portion of the assessment area are designated as either low- or moderate-income." Likewise, Telebank, which was acquired by E*TRADE Bank in January 2000, had an assessment area in Arlington, VA, which contained, "no low-income census tracts. . . ." Community advocates are also wary that the affluent suburbs of Silicon Valley, Atlanta, and Washington, DC, where many of the banks are located, may disproportionately receive reinvestment benefits at the expense of lower-income neighborhoods in the United States.

CRA Evaluation Standards

To foster creativity with the CRA, OTS Director Ellen Seidman has encouraged Internet banks to prepare "strategic plans." Regulators and Internet bankers agree that strategic plans are a useful tool for complying with the CRA until the regulation is amended. Lynn Bedard of the OTS believes that "All Internet banks should consider the strategic plan option for their CRA compliance because it is very difficult for a retail lender, using the Internet as its primary outlet, to comply with the regulation. Filing a strategic plan," she adds, "enables an institution to identify and get maximum credit for its strengths." The strategic plan is an option that has so far been used primarily by wholesale and credit card institutions to guide CRA reinvestment. The plans allow banks to set their own standards for how their CRA compliance should be judged, rather than rely on the standard lending, service, and investment test mix, which values lending about twice as heavily as services and investments. The strategic plan became part of CRA regulation in 1995. Its greater flexibility works better for institutions with nontraditional communities. To become valid, the plans must be submitted for public comment and may undergo regulator-suggested revisions.

Some Internet banks do not have strategic plans, nor do they have CRA compliance evaluated by the standard CRA tests for either "small" or "large" financial institutions. This is because they operate as wholesale, as opposed to retail, banks, which means that they do not originate loans directly but buy them on the wholesale market. Regulators of wholesale and limited-purpose banks use the Community Development Test to assess community development services, investments, and lending in total, rather than separately. If a wholesale bank does not directly make loans, the theory goes, it's more difficult for it to earmark lending to an area when it doesn't make loans in the first place.

Telebank operated as a wholesale bank until it was bought by E*TRADE Bank. In fact, because Internet banks often operate in this manner, Bank of Internet USA has turned its retail status into a marketing tool. It emphasizes on its website, "Many so-called 'online lenders' are actually mortgage brokers or simple lead generation web sites. Bank of Internet USA, however, is a direct portfolio lender." As D.R. Grimes, a direct-lending Internet banker, has speculated, wholesale Internet banks may be afraid of doing direct lending nationwide because they don't know how to handle the CRA implications.

Strategic plans and Community Development Tests have value in making CRA compliance flexible for different kinds of banking insti-

Internet Value

Bankrate.com, in a 2001 survey of consumer financial products, determined that Internet banks surpass their brick and mortar competition on the checking account front. Eighteen of the top 20 checking accounts were associated with Internet banks.

tutions, but community groups fear that lending, the crux of CRA's impact and the most heavily weighted factor a regulator uses to assess a CRA rating for a typical retail institution, may become diluted—especially if Internet banking becomes more powerful. The Woodstock Institute, a Chicago-based nonprofit that promotes community reinvestment, considers strategic plans to be imperfect because they allow banks to set the thresholds for attaining a certain CRA rating as low or high as they want. The Woodstock Institute suggests looking at market share to determine assessment areas for Internet banks. Its position is that for each MSA, Internet institutions with 0.05 percent of the market share of a particular product should have a CRA obligation for at least that product in that area. For institutions that don't have 0.05 percent of the market share in any areas, then the institutions should look nationally at the ratio between lending to low- and middle-income groups and middle- and upper-income groups. "Ideally," says the Institute's Katy Jacob, "the ratio should be one or higher."

Some Internet bankers believe that a solution to fulfilling CRA will develop from looking nationally—although in a different manner than the Woodstock Institute proposes. Bob Connors, Community Affairs Officer of First Internet Bank of Indiana (First IB), says, "Because we operate with the entire country as our marketplace, we think that any loan we can make to that targeted [LMI] market should qualify toward our CRA commitment." First IB, which is classified as a "small institution," currently has an assessment area consisting of two counties around its Indianapolis headquarters. He adds, "With the Internet-business model, we don't have geographic control over our customer base—we have the entire country—so we need to come up with some creative solutions to measuring CRA compliance."

D.R. Grimes of NetBank also thinks that meeting the national LMI percentage with the number of loans an Internet bank makes is "appropriate; it's a reasonable approach." Another Internet banker, Gary Lewis Evans, President and CEO of Bank of Internet USA, a $120 million asset bank that opened on the Fourth of July 2000 and is looking to be profitable by its one-year anniversary, thinks that his bank can meet the needs of its community by reinvesting according to the current regulation. He'll be more confident, of course, after the CRA review his bank is scheduled for in June. Says Evans of his San Diego-based bank, "We don't think we will need to develop a strategic plan," but he is hoping that the CRA will be revised to "address the realities of our market."

The nationwide approaches suggested by First IB and NetBank, however, are only theoretical. While alternative approaches to fulfilling the CRA are being debated, some Internet banks are managing to fit their triangle of an operation into the CRA regulation square by modeling CRA activities on a method of compliance discussed in the FFIEC's interagency CRA question and answer section. The specific question addresses the need for immediacy or direct benefit of community reinvestment on an institution's assessment area. The answer is that immediacy and direct benefit do not have to be shown as long as the "purpose, mandate, or function of the organization or activity includes serving geographies or individuals located within the institution's assessment area."[4] This statement has encouraged Internet banks, such as G & L Bank, to pursue compliance with the CRA in ways that coordinate with their business philosophies.

Niche Internet Communities

G & L Bank, a $90-million-asset bank that caters to the gay and lesbian community, serves its assessment area by caring for the needs of its nationwide community, of

Tracking CRA Policy

Legislation to address how a financial institution (including Internet-only banks) should fulfill CRA requirements was reintroduced to the House of Representatives on March 6, 2001, by Representatives Thomas Barrett and Luis Gutierrez.

The Community Reinvestment Modernization Act, which has since been referred to two subcommittees of the House Committee on Financial Services, has 33 cosponsors and calls for expanding a financial institution's assessment area to each community in which the financial institution makes more than 0.5 percent of its loan volume and each state in which it has a branch outside the metropolitan area.

The legislation was drafted by the National Community Reinvestment Coalition, a community advocacy group. As in the current regulation, the assessment area would also include metro areas in which the financial institution has one or more branches.

This legislation faces strong opposition, as it did during the Clinton Administration, because it calls for expanding CRA obligation areas and extending CRA obligations to lending affiliates of financial institutions that are currently exempt under the Gramm-Leach-Bliley Act, such as insurance companies and mortgage banks. It is also opposed because it calls for increased reporting of Home Mortgage Disclosure Act data.

which the assessment area population is a part. (Its assessment area consists of Pensacola, Florida, plus two neighboring counties.) G & L Bank specializes its direct community reinvestment in Pensacola by supporting gay and lesbian community groups, programs that provide medicine for people with HIV, AIDS, or other diseases, and programs that provide sustenance and financial assistance to those in need. Primarily, though, it views its community impact in broad terms as a national provider of affordable loans and mortgages to gay and lesbian individuals, couples, and companies.

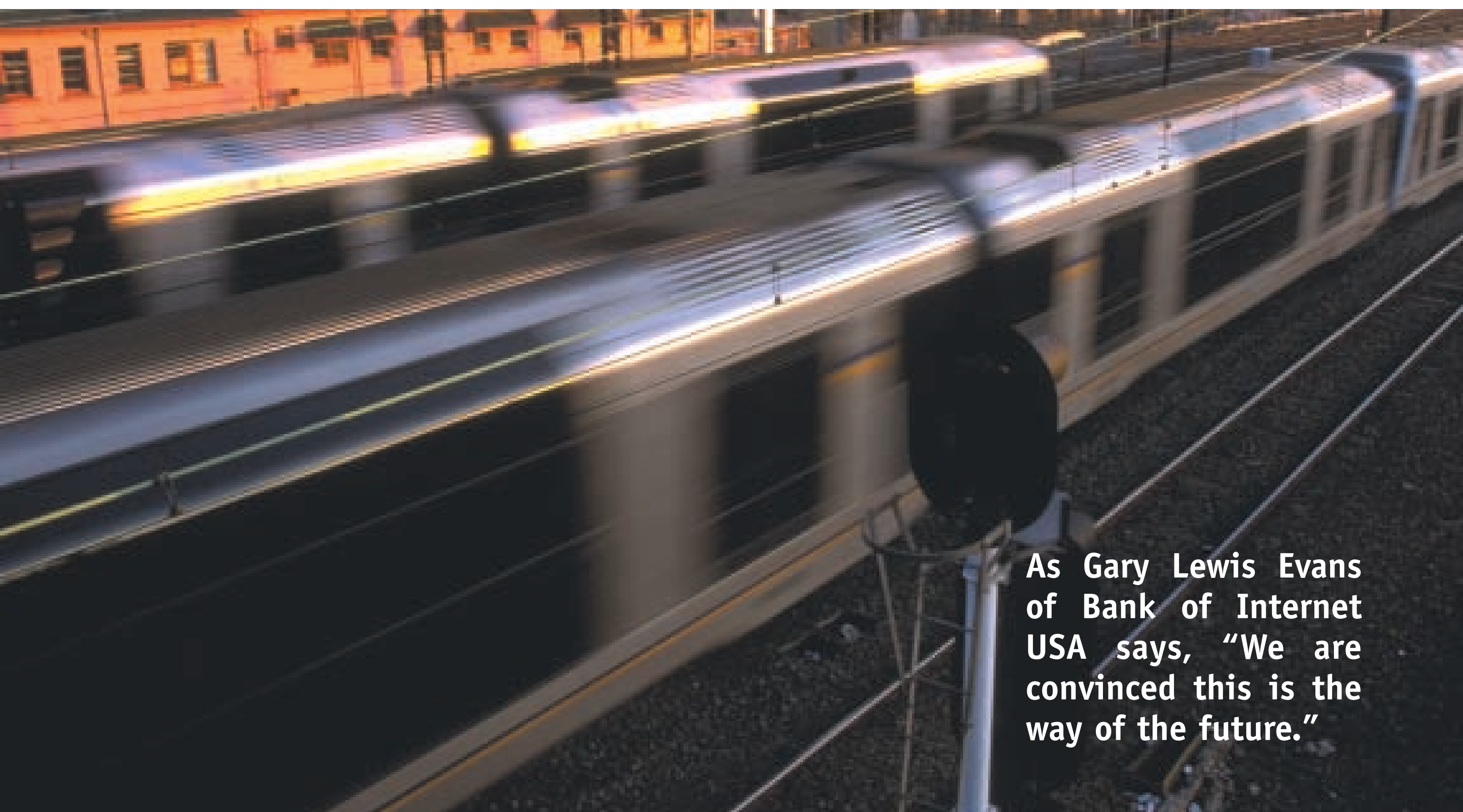
The G & L Bank model seems new to the financial services industry because its community is based neither on geography nor on income. Internet banks, by virtue of their reliance on computer-literate and generally computer-owning customers, and because some of them are linked to brokerage houses, attract higher-income customers than traditional banks. But G & L Bank is a prime example of how Internet banks are illuminating new communities that need access to credit. CRA Officer Bill Knight says that G & L Bank serves a community that is not being served by traditional means. "The gay couples we serve tell us that traditional banks typically do not allow gay couples to use their joint income to qualify for mortgages or loans. This is a major issue with our customers and is why home mortgages for same-sex couples has been our strongest product offering. Small-business owners too tell us that discrimination happens." In this way, Internet banks, often thought of as threatening to traditional community reinvestment, may turn out to encourage credit access for nontraditional communities that sometimes feel disenfranchised from the banking world—just not by income.

Other communities that may be better targeted by the Internet than by a traditional bank include ethnic groups. Bancointernet bills itself, in three languages, as the "Personal Finance Community for Latinos." It offers products such as mortgages for nonresidents, international money transfers, and financial information that is geared toward Hispanic and Brazilian communities living or newly arrived in the United States. Bancointernet, however, is a misnomer, as it does not provide transactional banking services. VirtualBank is a bank for technology professionals, and it is offered through technology firms. Its special services include things that the technology-savvy appreciate, such as a single database that holds a person's entire financial portfolio, from mortgages to checking accounts. These financial providers are finding lifestyle, ethnic, and professional niches and are redefining what it means to have a banking relationship.

Reaching out to the local community through technology is also popular with Internet banks, for obvious reasons. Lighthouse Bank's Tom Venables believes that it is important "to expand the technology revolution to those behind the curve, to expand computer literacy." To do this they forged an alliance with the Charles River Computer Center, a nonprofit organization that offers free training and computer time to the Waltham community. NetBank also plans to focus on technology. As stated in their strategic plan, one of their service goals is to "Form a partnership with an organization [that] serves the low- and moderate-income community, to provide computers and Internet access with a goal of bridging the digital divide and providing these communities with more low-cost banking products and services." This type of community outreach, which diverges from traditional CRA activity, makes sense to Internet bankers because it provides them with a way that they can complement (and avoid competition from) what traditional banks currently do for community outreach.

In Our Future

These examples show how Internet-based banks are finding ways of reinvesting that relate to the communities they serve. They present one method of community reinvestment that Internet banks are following, and one method that regulators are



As Gary Lewis Evans of Bank of Internet USA says, "We are convinced this is the way of the future."

assessing. Because there is no uniform policy on how Internet banks should fulfill CRA, many other reinvestment examples can be found.

The FFIEC policymakers have a short history to rely on for some big decisions. Only a handful of Internet banks have been examined for CRA compliance to date, and most of them have been regulated as "small banks," which limits their reinvestment obligations to their headquarters assessment area. NetBank's strategic plan, the first one approved (in March 2001) for an Internet bank, has stirred debate about its strength and weaknesses. The policymakers, who will take into account the positions of community advocacy groups and regulation-averse bankers, have a tough job ahead of them.

But the Internet banking industry too has encountered strife in its young life. Some Internet banks have witnessed a decline in venture capital; others haven't been able to turn profits, have changed their business plans to include branches, or have been bought by a traditional banks, brokerages, or Internet conglomerates. Some are trying to remain Internet-only. While it's difficult, there are business reasons for remaining in the field. Of the numerous dot-com businesses out there, Internet bankers believe that few are as well suited for the Internet as financial services. As Gary Evans of Bank of Internet USA says, "We are convinced this is the way of the future." At the end of the day, his bank is doing "basic, pure banking" without the high overhead. Yes, Internet banks may have eradicated the need for the middleman, along with our quaint ideas of how to define a community.

Comments on this article? E-mail kristin.kanders@bos.frb.org

Endnotes

1. OTS Director Ellen Seidman remarked in a September 2000 speech that ". . . we have observed that, in most cases, Internet-only institutions are forced to pay very high rates in order to acquire customers. As soon as they lower their rates, the deposits flow out. Thus, the second conclusion we have drawn is that most Internet-only institutions attract primarily non-core deposits. This 'hot money' comes from depositors who are simply seeking high interest rates and have no loyalty toward one particular institution."

2. Regulators expect to release a document requesting public commentary on CRA this June. In addition to the topic of Internet bank compliance, it may also request comments on bank mergers, exam processes, and the investment test.

3. "Small" institutions are characterized as those with assets of less than $250 million or less than $1 billion in assets if it is a part of a bank holding company. To satisfy CRA, small institutions are supposed to do a majority of their lending within their assessment areas. Large institutions, on the other hand, are those with assets of $250 million or more or assets of more than $1 billion if in a holding company. Large institutions are evaluated for CRA according to three tests: lending, service, and investment. The lending test typically weighs twice as heavily as the other two tests.

4. An excerpt from the answer reads, "Therefore, an institution's activity is considered a community development loan or service or a qualified investment if it supports an organization or activity that covers an area that is larger than, but includes, the institution's assessment area(s). The institution's assessment area need not receive an immediate or direct benefit from the institution's specific participation in the broader organization or activity, provided the purpose, mandate, or function of the organization or activity includes serving geographies or individuals located within the institution's assessment area. Furthermore, the regulations permit a wholesale or limited-purpose institution to consider community development loans, community development services, and qualified investments wherever they are located, as long as the institution has otherwise adequately addressed the credit needs within its assessment area(s)." For the entire question and answer, see section .12(i) & 563e.12(h)-5 of the interagency CRA Q&A.

Art's Economic Power in New England

by Kathleen Gill

We must never forget that art is not a form of propaganda, it is a form of truth.
-John F. Kennedy

Art is making something out of nothing and then selling it.
-Frank Zappa

When *TIME* magazine's "100 People Who Made the Millennium" were named, twenty-five were artists. Our admiration for artistic people and places is such that one of the measures of a community's desirability is the amount of art and cultural activities available to its citizens. Art is also big business.

In New England, nonprofit cultural organizations and attractions generate $3.9 billion dollars in annual revenue and support 110,000 jobs, according to the New England Foundation for the Arts. Further, this estimate covers only a small portion of the arts "industry." An inclusive definition of arts and culture can include movies, music, graphic design, publishing, and other businesses. Together these enterprises make up the "Creative Economy," according to a June 2000 report by the New England Council.

Seeing the Path of the Wind, by Stacy Levy is a wind installation currently on display at Mass MoCA. Eight strategically placed fans replicate wind patterns detected from the museum's rooftop and "breeze" onto the flags.

Using a broader definition of art, including enterprises and individuals that directly and indirectly produce cultural products, the Creative Economy supports more than 245,000 jobs in the region, and 3.5 percent of New England's job base. In dollar terms, New England attracts $6.6 billion in revenues from cultural tourism alone. However, this is just part of the value produced by the Creative Economy. Businesses and workers are attracted to the New England region and to particular communities because of the quality of life. Fortunately, the New England Council projects that Creative Economy jobs will grow 18 percent over the next ten years.

While art has many positive economic and social effects, it also has many expenses that the economy at large is asked to subsidize. For example, museums on average generate only a fraction of their operating revenue from admission sales. According to a 1995 survey of 174 member institutions of the Association of Art Museum Directors, the average cost per museum visitor was $30, while admission fees per visitor averaged $1.45. To cover the revenue gap, in 1995 the public sector contributed $281 million to museums and the private sector contributed $372 million. By this fiscal measure, museums are an economic drain, not an economic engine. Art and culture's impact has traditionally been measured with this model, and it is viewed not as a moneymaking enterprise, but as an expense.

But the economic model of art is changing. A more contemporary and practical way of viewing the arts economy is through an example provided by the Federal Reserve Bank of Cleveland. The Bank examined the economic impact of Playhouse Square, a cultural enclave in downtown Cleveland. To describe the relationship of the public sector investment to the enterprise, the Bank used the metaphor of a ski resort. It noted that the ski lifts in a resort are a "loss leader," designed to attract visitors to the resort. The ski resort makes its profits from the surrounding vacation condominiums, time-shares, restaurants, and other retail activity that subsidize the ski lifts as a business expense. In an art investment, the public sector acts as a ski resort, creating an enterprise that attracts visitors, who in turn generate sales tax dollars and increase property values. This metaphor is accurate in that museums attract visitors who then patronize a variety of businesses in the community.

Several examples of how art and culture play a role in revitalization efforts can be found in New England. Pittsfield, Massachusetts, is incorporating cultural activities into a larger downtown revitalization strategy. North Adams, Massachusetts, is benefiting from the opening of a large museum complex and Providence, Rhode Island, is using art as a centerpiece for downtown renewal.

Pittsfield, Massachusetts

The Berkshires of Massachusetts have long been a cultural magnet for the East Coast. Tanglewood, the summer home of the Boston Symphony Orchestra, has been a summer attraction for over 70 years. Berkshire County attracts an estimated 2 million visitors per year, most in the summer months. While the southern section of Berkshire County has prospered, the central and northern regions have not been so fortunate. Pittsfield, located in central Berkshire County, is attempting to reverse this trend with a downtown revitalization plan that emphasizes cultural and entertainment activities.

Pittsfield has historically been an industrial center in western Massachusetts. However, in the late 1980s, General Electric closed two of its three divisions in Pittsfield. At the same time, General Dynamics closed its plant following defense spending cutbacks. As a result of the two closings, 8,000 workers were displaced. Many left the area and Pittsfield's population has been in decline since the plant closings. In addition, retail stores moved from downtown to malls on the edge of town. As a result of these events, the downtown stores had a 30 percent vacancy rate as of three years ago.

To combat the blight that was taking over downtown Pittsfield, a group of business owners, known as Downtown, Inc., decided that a plan was needed. Downtown, Inc. approached the remaining large businesses and asked for a three-year monetary commitment to develop a revitalization strategy. Armed with $50,000 per year for three years, Downtown, Inc. hired the Berkshire Housing Development Corporation for a revitalization strategy.

Berkshire Housing's approach was pragmatic. They proposed public/private partnerships and a combination of rehabilitation of historic buildings for commercial space and cultural activities to bring people downtown. In the past, large-scale development projects were proposed, but no developers could be found to take the risk a major development required. Berkshire Housing developed an incremental strategy consisting of three parts with a total plan cost of $25 million. The first part of the plan was to develop office space, which was in short supply in Pittsfield. The second part was to restore some historic buildings and tear down non-historic abandoned buildings. The third part of the plan was to develop a cultural action strategy for Pittsfield. The cultural action strategy was developed by Hunter Interests Inc. and contained a set of strategic steps aimed at utilizing existing assets more effectively, then developing new facilities.

The strategic plan for Pittsfield consisted, first, of using the Berkshire Museum, an art and natural history museum located in downtown Pittsfield, as a centerpiece. The recommendation was to focus funding, human resources, and regional marketing support on the Berkshire Museum. Since this recommendation was made, the Berkshire Museum has hired a new director, revamped its exhibits, and doubled annual visitors from 30,000 to 60,000.

The Berkshire Museum attracts twice as many visitors as before Pittsfield's revitalization plan.

Second, the strategic plan suggested that Pittsfield restore and reopen the Colonial Theatre, a historic theatre located in downtown. After having been closed for several decades, it is now being used as an art supply store. Currently, a nonprofit group has an option to purchase and rehabilitate the Colonial Theatre to its original use. Part of the restoration proposal is to include a Theatre Museum within the structure to focus fund-raising activities and raise awareness of the project. Hillary Clinton helped to generate publicity for the theatre when she visited it last year as part of her tour of America's hidden treasures.

Third, the plan called for developing the North Street Arts Collaborative, a private venture launched by individuals in Pittsfield. It offers studio space and art classes for Pittsfield area residents. Other recommendations in various stages of development include a new cinema complex, a stadium, and an arts center.

Art is a viable economic engine in Pittsfield because of the city's geographic location between two major cultural centers. To the south, Tanglewood, Jacobs Pillow, and a summer Shakespeare Company all attract seasonal art patrons from Boston and Albany. To the north, The Massachusetts Museum of Contemporary Arts (Mass MoCA) opened two years ago. It has attracted visitors who make day trips through Pittsfield to the North Adams museum. Also, Pittsfield had been holding "Art Walks," an annual festival in which artists set up displays in the vacant storefronts of the downtown area. The Art Walks start-

A decaying building in the Central Block area of Pittsfield (above) may soon look like Berkshire Housing Development Corporation's plan (below).

Now showing—an art supply store. Pittsfield hopes to reopen the Colonial Theatre to its original use.

ed in 1996 and raise awareness of art and culture in this traditionally working-class town.

One of the concerns of the cultural revival is that it may suffer disproportionately in the case of an economic downturn. While it seems logical that during weak economic periods people will spend less on leisure activities and vacations, Pittsfield does not believe it will be severely affected. "During the last recession we saw very little decline in the number of visitors. When times are lean, people take shorter vacations and many choose trips to the Berkshires," says Peter Lafayette of Berkshire Housing. The Berkshires' economy may also be more stable because of the number of wealthy individuals choosing to summer near Tanglewood, as evidenced by the number of expensive new homes being built in the area.

The results of Pittsfield's revitalization have been excellent, so far. The storefronts in downtown, which once had a 30 percent vacancy rate, now have a 15 percent vacancy rate and falling. Investment dollars are flowing into downtown development of offices and stores. Recently, one of three major banks located in town completed a new $1 million building on the site of an abandoned department store. Other building owners have seen their property values double in the past five years. While the art and cultural aspect of the revitalization cannot take all of the credit, it has certainly played an important part in bringing people downtown.

North Adams, Massachusetts

In some ways the development of Mass MoCA (Massachusetts Museum of Contemporary Arts) in North Adams is similar to Pittsfield's revitalization. The two communities share similar economic histories—both suffered when major manufacturing plants closed. In the case of North Adams, Sprague Electric left in the 1980s. Sprague had employed 4,000 people in a town of 18,000. Almost every family in North Adams was affected by the plant closure. Sprague vacated 27 brick industrial buildings located on 13 acres in downtown, about one-third of the downtown area. After trying unsuccessfully to sell the buildings, Sprague eventually donated them to North Adams.

In the late 1980s Tom Krens, who was Director of the Williams College Museum of Art, conceived of the concept for Mass MoCA. He was motivated by the observation that modern art was becoming larger in scale and at the same time, exhibit space in New York was becoming more expensive. When Krens pitched his idea to the Mayor of North Adams, he originally had another North Adams building in mind, but the Mayor suggested the Sprague buildings.

After hiring Joseph Thompson as director of the project, Krens left to become the director of the Solomon L. Guggenheim Museum in New York. The project was thought to require about $35 million dollars in public funds from the state of Massachusetts. Governor Dukakis enthusiastically supported the plan as a way of revitalizing North Adams. He approved the plan and Mass MoCA began to conduct its feasibility study.

Soon after, Governor Weld, who did not support the plan for financial reasons, was elected. After lobbying from several members of the legislature, including then-Senator Jane Swift, Weld agreed to consider the museum if North Adams could demonstrate its support by raising $1 million. The North Adams community managed to raise the money quickly through a grassroots campaign, which caught the Governor's attention. After several more rounds of negotiation, Weld agreed to a three-to-seven match of funds, for the bricks and mortar portion of the project.

Because public monies did not fund Mass MoCA in full, it began to look elsewhere for revenue and reshaped its concept for greater economic viability. Instead of being designed as a pure art museum, Mass MoCA has developed a performance arts component and rents one-third of its 250,000 square feet to private businesses. The performance arts section of the museum contains a 10,000 square-foot black box theatre with seating capacity of 650, another smaller theatre, and a summer open-air cinema. Nearly 20,000 people annually attend one of its performing arts events. Including office space in a museum complex is unusual, but it has provided many benefits. For example, several new businesses have been attracted to North Adams by the space. Presently Mass MoCA's tenants employ almost 350 people. Companies such as Kleiser-Walczak Construction Company, a computer animation company, and eZiba.com, an online gift retailer, have settled in North Adams, attracted by Mass MoCA's unique image.

Mass MoCA has renovated 250,000 square feet of a potential 750,000 square feet at a cost of about $65 per square foot. This is a remarkable achievement because museum renovation is generally between 10 and 30 times as expensive. One reason for the low cost of renovation has been the design technique practiced by Bruner/Cott & Associates, the firm hired to redesign the space. These architects work with the existing structure and design renovations to suit the building. The technique is aptly called architecture from found buildings. The result in this case is a

Kiki Smith's *Constellation* is a creation that's not meant to be hung on the typical gallery wall; it finds ample space at Mass MoCA.

set of large airy spaces to house each of the large artworks. Mass MoCA is the largest contemporary art museum in the United States, with exhibits including a large-scale bronze sculpture and Uberorgan, designed by Tim Hawkinson, who describes it as a giant self-playing reed organ.

The economic benefits of Mass MoCA are just beginning to be realized. During its first two years of operation, the museum attracted 100,000 visitors per year and another 20,000 visitors annually attended the performing arts events. In response to the influx of visitors, new restaurants have begun to open in North Adams. The Holiday Inn in North Adams has seen a 75 to 80 percent increase in occupancy. A new inn, The Porches at Mass MoCA, is scheduled to open in July. Finally, property values in North Adams have begun to rise, after several years of stagnation and devaluation. In all, Mass MoCA has done what it set out to do, breathe life back into North Adams. The museum has been open for just two years, so it will take several more to measure its long-term impacts.


Tim Hawkinson's giant organ was designed with Mass MoCA in mind.

Providence, Rhode Island

Providence presents an interesting counterpoint to the two industrial towns in Massachusetts that were looking to reshape their economies. In Providence, revitalization through the arts is one part of the city's much larger revitalization effort. While North Adams and Pittsfield suffered dramatic downturns when powerful employers left, Providence suffered from a long-term malaise exacerbated by the early 1990s recession. Currently, the situation is quite different. Providence is experiencing a renaissance. Like the other examples, Providence has built on its cultural and artistic strengths and resources. The city has enjoyed a long history of art involvement thanks to the Rhode Island School of Design and Brown University, both of which are located in Providence.

Providence has actively encouraged its art community through a variety of initiatives that may have been inspired by one organization, AS220, formed fifteen years ago. AS220 is an art community located in downtown Providence. The name is derived from Alternative Space and the street number of the original address. The 22,000 square foot space forms the centerpiece of Providence's Arts and Entertainment District.

Almost ten years ago, a small group of artists representing AS220 approached Mayor Cianci with the idea of renovating a building and creating a live/work space for artists. Although AS220 had a budget of just around $100,000, the Mayor listened and supported its effort. Through volunteer fund-raising, Community Development Block Grants, grants from the Federal Home Loan Bank, and loans from three local banks, AS220 financed a $1.1 million renovation that now houses low-income artists and provides unjuried performance and gallery space to Rhode Island artists. To support the arts, the city instituted a special tax relief program that provides sales tax relief to artists selling their work in the Providence Arts District. The city also offers a lower property tax rate to landlords who redevelop space for artists.

Providence also honors contributors to the arts with annual awards. Business Volunteers for the Arts, Rhode Island, presents a series of awards for various accomplishments. Examples include the Encore Award for corporate leadership in support of cultural initiatives, the Individual Achievement Award for outstanding volunteerism, and the Arts Advocate Award for fundraising contributions. A city of only 160,000 people, Providence is considered disproportionately rich in artistic talent. "Art contributes to our sense of place. Providence wants to keep its artists," explains Catherine Horsey of the Providence Preservation Society.

Perhaps it is the sense of place associated with art that makes artistic expression desirable both to residents and visitors. While some areas of modern cities may look interchangeable, the cultural institutions and works of art make a place unique, providing identity. Since artists are known for seeing the potential beauty around us, it is not surprising that artists are attracted to areas that need renovation. Perhaps it takes an artist's vision to show us the potential of neglected areas. As an ever-growing number of New England communities can attest, support for the arts is an investment in a community's future and can be the first step in revitalization.

Comments on this article? E-mail kathleen.m.gill@bos.frb.org

Suggestions for Further Reading

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John Bos, "Culture As Its Own Reward," *Pittsburg Post-Gazette*, August 13, 2000.

John Kifner, "Museum Brings Town Back to Life," *The New York Times*, May 30, 2000.

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Michael Pare, "Volunteer of the Year Finds Arts a Powerful Vehicle," *Providence Business News*, January 15, 2001 v15, i39, p4.

National Endowment for the Arts "American Canvas: The Evolving Cultural Landscape," http://arts.endow.gov/pub/AmCan/Contents.html

The New England Council, "The Creative Economy Initiative, The Role of the Arts and Culture in New England's Economic Competitiveness," June 2000.

About the Author

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Soft Second Program Celebrates 10 Years

by Jim Campen and Tom Callahan

On January 29, 1991, Florence Hagins, an African-American single mother with a moderate income who had been denied a mortgage once before, became the first person to purchase a home with the assistance of Boston's new Soft Second Mortgage Program. Almost exactly ten years later, in early February 2001, she stood before 350 people as co-chair, along with Boston Mayor Thomas M. Menino and Fleet Bank President of Consumer Banking Robert J. Higgins, of a black-tie event to celebrate the Program's tenth anniversary.

Between those two dates, Hagins—still the proud owner of the same two-family house in Boston's Dorchester neighborhood—has been followed by more than 2,100 other lower-income, first-time homebuyers. She has become Director of Housing Education for the Massachusetts Affordable Housing Alliance (MAHA), the community-based organization primarily responsible for the Soft Second Program's creation and growth.

Boston's Soft Second Program gets its name from the fact that participating homebuyers receive two mortgages rather than one: a first mortgage for 75 percent of the purchase price and a second mortgage for 20 percent (the program requires a 5 percent down payment). The interest rate on both mortgages is 50 basis points below the bank's two-point rate.[1] The second mortgage is "soft" (for the first ten years) in two ways—payments are interest-only and payments may be further reduced for qualifying homebuyers by public subsidies. The Massachusetts Housing Partnership Fund and Boston's Department of Neighborhood Development also fund loan loss reserves for each bank equal to 10 percent of the total value of the second mortgages the bank has originated. The existence of the reserve fund makes it possible for borrowers to avoid the cost of private mortgage insurance, while the banks are still protected from credit losses. Affordability is further increased by no payment of points (even though, as noted above, borrowers receive their loans at 50 basis points below the two-point interest rate) and the provision of down payment and closing cost assistance.

Initially dismissed by some bankers as a "one-shot deal" when it emerged from almost two years of confrontation and finger-pointing, the program is regarded in Boston today as both unusually comprehensive and remarkably successful.

Measuring Success

First, an examination of the income levels of all SSP borrowers during the ten-year history of the program, shows that 32 percent of all SSP homebuyers had incomes of $25,000 or less, 60 percent had incomes of $30,000 or less, and 94 percent had incomes of no more than $40,000. Second, over half of all Boston SSP loans during the ten-year period, 1,098 loans, have gone to low-income homebuyers—those with incomes at or below 50 percent of the median family income of the Boston metropolitan area, as determined annually by HUD; the low-income ceiling has risen from $25,100 in 1991 to $32,750 in 2000.

Although affordability was their primary goal, MAHA's Homebuyers Union members have always recognized that there are no real benefits to homebuyers—and their neighborhoods—unless they are able to remain homeowners. The priority that the group has attached to sustaining homeownership is evidenced by its early decision (reaffirmed on several occasions) that homebuyers must make a significant down payment. MAHA's low-income members believe strongly that potential buyers must demonstrate some ability to save money in order to adequately prepare themselves for the expense of owning and maintaining a home, especially an older home in an urban neighborhood. Consequently, the SSP requires that at least 3 percent of the total 5 percent down payment come from the buyer's own funds.

Delinquency rates for SSP loans have generally been somewhat lower than the rates for all Massachusetts mortgages. For example, at the end of December 2000, the SSP delinquency rate was 2.5 percent in Boston (and 2.9 percent statewide), compared to a delinquency rate of 4.0 percent for all mortgages in the state. The only other targeted mortgage program in Massachusetts with available delinquency data is that of the Massachusetts Housing Finance Agency (MHFA), which sets its income limit at 120 percent of the metropolitan area median (rather than the limit of 80 percent adopted by the SSP). Recent MHFA (statewide) delinquency rates—for example, 5.4 percent at the end of December 2000—have been well above those of the Soft Second Program. Furthermore, foreclosures on SSP loans have been rare. By the end of 2000, only five of the 2,112 loans originated by the Boston SSP had ended in foreclosure—a rate of 1 in 422, or 0.24 percent.

Although affordability was their primary goal, MAHA's Homebuyers Union members have always recognized that there are no real benefits to homebuyers—and their neighborhoods—unless they are able to remain homeowners.

Members of the MAHA Homebuyers Union have currently negotiated Community Reinvestment Act agreements with 14 banks for over $500 million in below-market Soft Second loans in Boston (including two banks that had not yet made their first loan by year-end 2000). MAHA has also worked to create a local secondary market for SSP first mortgage loans. This effort bore fruit in 1997, when the first securities backed by SSP first mortgages were sold. Packaged by Fannie Mae, the securities offered a rate of return 50 basis points below the market level. Savings Bank Life Insurance committed itself to buying $20 million of these securities over the next ten years, and had already fulfilled 40 percent of that commitment by the end of 2000. The Life Initiative, an investment entity established by Massachusetts life insurance companies, became the second buyer of SSP mortgage-backed securities with a $6 million investment.

Lessons Learned

For the last ten years, the Boston Soft Second Program has been a laboratory, of sorts, for community groups, banks, insurance companies, and government agencies. The experience gained suggests several important lessons that are explained below. One such lesson is that success is a moving target. To keep up with that target, it's useful to identify challenges that are likely to confront the SSP in the near future.

Grassroots involvement is crucial.
From day one, the Soft Second Program has benefited from an extraordinary degree of involvement from low- and moderate-income members of MAHA. Members of MAHA's Homebuyers Union were intimately involved in negotiating the details of the program and they were the guiding force in challenging bankers and government officials to increase the affordability of these loans. Large community meetings have convinced banks that there remains a large, grassroots constituency for genuinely affordable home mortgages.

You can't stand still.
As the financial system has changed around the program, the SSP has changed and evolved as well. It has grown from three participating banks in 1991 to nine in 2001. A homebuyer can now get a loan from Fleet Bank, the seventh largest bank in the country, or from Hyde Park Cooperative, an $82 million, two-branch bank. The program started with banks needing to retain both first and second mortgages in their portfolios. Today, Fannie Mae and insurance companies provide an outlet for the first mortgages.

Get it in writing.
Written agreements for the SSP evolved from a one-page letter from the bank to a ten-page memorandum of understanding (MOU) that spells out many significant details. These MOUs have been useful for resolving questions that arise with the passage of time and changing bank personnel. The more formal documents have been particularly valuable in merger-related negotiations conducted by MAHA and other organizations.

When the agreement is signed, the work has just begun.
This sage advice was offered to

MAHA in 1990, and the last ten years have borne it out. There have been countless hours of meetings to implement, monitor, and renegotiate the agreements. MAHA has added three new programs (homebuyer counseling, homeowner education, and foreclosure prevention) to help support the SSP. It organized large community meetings focused on the program in 1994, 1996, 1997, and 1999.

Partners are essential.
Bankers have spent numerous hours in boardrooms and community rooms discussing details of implementing the SSP. The Massachusetts Housing Partnership, Boston's Department of Neighborhood Development, and other government agencies have expended enormous time and energy to make the program a success. Other neighborhood-based nonprofits have promoted the program through outreach and workshops. The Massachusetts Community & Banking Council has been instrumental in monitoring delinquencies. Public officials and private companies have provided financial support. The list could go on. The program has been inclusive, and a wide variety of public and private organizations share in the credit for the SSP's achievements.

Challenges Ahead

Between 1990 and 1999, the share of Boston home-purchase loans made by mortgage companies and other lenders not subject to CRA for their Boston lending has tripled, from 21.9 percent of all loans at the beginning of the decade to 61.9 percent at the end. During this time, however, no mortgage company has seriously explored the option of joining the Boston SSP. As barriers between different financial industries continue to crumble, consumers may soon be able to get mortgages from their insurance agents. Public comments by top officers of Boston's biggest banks have raised the possibility that some institutions might decide to get out of the highly competitive, low-margin business of making mortgage loans. Increasing, or even maintaining, lender commitments to the SSP in this changing institutional environment could be difficult.

The declining number of Boston SSP loans in the last three years reflects the impact of the sustained escalation of housing prices in the city. On the one hand, potential homebuyers find it increasingly difficult to find a house they can afford. On the other hand, some buyers have located houses they could afford with the assistance of the SSP, but they cannot buy them because their prices exceed SSP maximums. Early March 2001 increases in the price ceilings, the second set of increases within a year, will provide some relief from the latter problem but do nothing to address the underlying problem of the erosion of affordability by continually rising house prices.

The most likely scenario leading to lower housing prices—an economic downturn—is not a remedy. Potential homebuyers' ability to purchase new homes might be reduced more by falling incomes than it would be increased by declining house prices. Furthermore, the ability of SSP homeowners to continue to make their monthly payments in a timely fashion could be seriously threatened by rising unemployment and falling household incomes. The Boston SSP's low delinquency and foreclosure rates have been achieved during the longest uninterrupted economic expansion in U.S. history. A recession would bring about the first real test of the sustainability of SSP homeownership during hard times.

Between 1990 and 1999, the share of Boston home-purchase loans made by mortgage companies and other lenders not subject to CRA . . . has tripled . . . . During this time, however, no mortgage company has seriously explored the option of joining the Boston SSP.

While these challenges are serious, the achievements—and the adaptability—of the Boston Soft Second Loan Program during its first ten years provide grounds for optimism about its ability to meet these and other challenges that are bound to arise in its second decade.

Endnote

1. A bank's two-point mortgage rate will have a lower interest rate than a similar mortgage without points. Consumers can "pay" points, each of which is equal to 1 percent of the mortgage balance, to reduce their interest rates, which in turn reduces monthly payments.

About the Authors

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Editor's Note

This article is adapted from a paper presented at the Federal Reserve System's Community Affairs Research Conference held April 5-6, 2001. To read the full paper, which provides an in-depth analysis of the program's impact in a changing financial services environment, visit www.chicagofed.org/cedric/2001/Aprilconference.cfm.

Performance & Profitability of CRA-Related Lending

Research by Robert B. Avery, Raphael W. Bostic, and Glenn B. Canner
Quotations Provided by Communitiies & Banking

In November 1999, the U.S. Congress asked the Board of Governors of the Federal Reserve System to conduct a comprehensive study of loans made under the Community Reinvestment Act of 1977. The Board's study focused on the loans' delinquency and default rates—their performance—as well as their profitability. This article reports the results of the study.

Responding to the CRA, banking institutions have used various methods to expand lending to lower-income customers and those in lower-income neighborhoods, but their approaches fall into two broad types, both typically involving special marketing and outreach. In one approach, lenders have sought additional CRA-related customers who would qualify for market-priced loans using traditional standards of creditworthiness. In the other, lenders have gained customers by modifying their underwriting guidelines or loan pricing. Many banking institutions, especially the larger ones, have established or participate in special programs to foster lending.

Special lending programs vary widely but they often feature more flexible credit-underwriting guidelines than those used for other products; education and counseling for prospective borrowers; enhanced, targeted marketing of credit products; and coordination with a wide range of third parties, both private and public. In addition, some banking institutions offer pricing incentives for loans made under these programs and have established procedures to mitigate the credit risk associated with such loans.

The question we need to ask is not 'How profitable is this [CRA lending], but what is the overall value of this lending?'

—James Head, President, National Economic Development and Law Center Remarks at the Federal Reserve's 2001 Community Affairs Conference

Although the CRA's effects on lending to lower-income populations and neighborhoods are difficult to assess, such lending has increased substantially over the past decade or so. For example, home-purchase lending to lower-income households has increased 86 percent since 1993 (compared to about 50 percent for higher-income households). Lending to borrowers in lower-income neighborhoods also has risen sharply (nearly 80 percent) since 1993.

There is no appropriate sound bite to describe CRA profitability.

—Robert Avery Remarks at the Federal Reserve's 2001 Community Affairs Conference

Despite all this experience, little systematic information has been publicly available about performance and profitability, either for CRA-related lending activities as a whole or for the loans extended under CRA special lending programs.

Congressional Mandate

In November 1999, the U.S. Congress asked the Federal Reserve Board to do a comprehensive study on the performance (that is, the delinquency and default rates) and profitability of loans made in conformity with the CRA. Before responding to their request, the Board needed to address three basic questions: What is a CRA loan? How does one measure the effect of a law or regulation on the profitability and performance of lending? Is previous research adequate to fulfill the congressional request?

In considering the first question—how to define a CRA loan—the Reserve Board staff looked to the CRA statute and regulations for guidance. Banking institutions alone are subject to the law, so we focused on them exclusively and did not consider credit unions or mortgage companies. Next, we determined that a CRA-related loan was one extended to a lower-income household anywhere in a banking institution's local community or to a borrower of any income in a lower-income neighborhood within that community. We used a similar definition for small business lending. Note that these definitions exclude about half of all lower-income lending done by banking organizations.

The second question proved considerably more difficult. In principle, to assess a law or regulation's influence on loan performance and profitability, one must measure its "marginal" effect; ideally, this would mean considering only the additional loans made because of the law. Such an assessment, however, is impossible in practice because one cannot specify the subset of loans that are made solely because of the CRA. In the end, we chose to examine the performance and profitability of all loans made in conformity with the CRA; in other words, those that met our definition of a CRA-related loan. This approach, though not ideal, complied with the language of the law that mandated the study.

To answer the third question—whether the research already available was capable of satisfying the congressional request—Board staff reviewed the existing studies of the performance and profitability of CRA-related lending. We found that such research as did exist was too limited to meet our needs. Nearly all of it had focused on the performance and profitability of home lending, and most of this concerned the relatively narrow group of loans made under affordable-home-loan programs. Although they target much of the same population as the CRA, loans extended under affordable-home-loan programs often deviate from the definition of a CRA loan in a few important respects: They are often extended by institutions, such as mortgage companies, that are not subject to the CRA; they frequently include loans made by banking institutions outside their local communities; and they sometimes are made to borrowers whose incomes exceed our lower-income criterion.

Our experience has been that as rates move up and down, conventional mortgage and small-business borrowers will refinance while the iron is hot; however, those receiving CRA loans might not be able to refinance because of how the assistance programs helped to get that loan off the ground. What you end up with is CRA portfolio characteristics that are more stable than in a conventional mortgage portfolio. While the rule of thumb says that the average person stays in a mortgage for seven years, for the first-time homebuyer or low-income homebuyer, it's often one and a half to two times that.

–Richard Staples, CRA Officer, People's Savings Bank of Brockton
April 2001

Our review of previous loan performance research showed wide variation in the experience of individual banking institutions, depending on such factors as their location and the kinds of approaches they used to extend credit. The delinquency rates reported are generally higher than those for other loans, while default rates are slightly higher or about the same.

Two types of research on loan profitability have been conducted, one based on a special survey of banking institutions' experiences and the other on statistical analysis of standardized reports filed by all banking institutions. The Federal Reserve Bank of Kansas City's 1995 survey focused on home-purchase lending; its main finding was that CRA-related lending was profitable, but somewhat less so than traditional lending. Statistical analysis of Call Report data, merged with data on home-purchase lending, showed that institutions doing relatively more lower-income mortgage lending are no less profitable than other institutions.

The Board's Study

Having concluded that existing research did not provide adequate data to satisfy Congress' request, the Board decided to undertake some new research. To this end, the 500 largest retail banking institutions were surveyed about their lending experience, focusing on CRA-related loans. This focus included special lending programs, which are sometimes an important aspect of institutions' CRA-related lending activities. We selected the 500 largest retail banking institutions because they account for about 75 percent of all CRA-related lending. Respondents were assured that the data reported would not be disclosed to the public in a manner that compromised confidentiality. In preparing the survey instrument, we received input from many sources, including banking institutions, community-based and nonprofit organizations, and members of Congress and their staffs.

The survey had limited goals. It is especially important to note that its results do not represent a cost/benefit analysis of the CRA. Consistent with the Congress' mandate, the survey focused only on the performance and profitability of CRA-related lending. It did not examine investment and service activities that banking institutions may have undertaken because of the CRA. It did not address the CRA's effects on local communities and included little information about its benefits to individual institutions. The survey collected information about activities in only four loan-product categories (the most significant ones for most institutions). These included home purchase and refinance lending, home improvement lending, small business lending, and community development lending.

In Massachusetts, the Soft Second Program is an exception to the general statement on the delinquency of special lending programs. This program has undertaken a large number of originations with low delinquencies, resulting in higher profitability than might be expected of a CRA portfolio.

–Richard Staples

Special Challenges

Three of the challenges posed by this survey warrant particular comment. Because of statutory deadlines imposed by the Congress, banking institutions had little time to prepare responses. In fact, we continued to accept responses for nearly a month beyond the deadline. The timing of our survey coincided with due dates for the annual reports that institutions must file under the provisions of the Home Mortgage Disclosure Act and the CRA, as well as several other regulatory reports.

In addition, we encountered some confusion as to the definition of a CRA loan. The definition was not well understood by all survey respondents, some of whom equated CRA loans with loans made under special lending programs.

Finally, the study used return on equity as a measure of profitability. To calculate it, we sought very comprehensive data, asking respondents to include all sources of costs and revenues. Survey responses and follow-up phone calls, however, indicated that some lenders had considered cost of capital and others had not. As a result, much of our analysis focused on a relative ranking of profitability for CRA and nonCRA lending within a bank. Such internal comparisons are not affected by failure to consider the cost of capital or any other factor, as long as it is reported consistently within a bank.

I. Survey Results: CRA-Related Lending

We received responses from 143 of the 500 institutions to which we sent the survey (a 28.6 percent response rate). These responses and our follow-up telephone contacts revealed that banking institutions generally do not track profitability and performance separately for CRA-related lending, so our report emphasized qualitative results regarding profitability. Because fewer than half of the respondents answered quantitative questions on performance, one must be cautious when using these responses to draw qualitative inferences comparing the performance of CRA-related and other lending.

The results varied by loan product. Home purchase and refinance lending has the largest origination volume by far ($570 billion, of which about 10 percent is CRA-related). Responses indicated that overall as well as CRA-related home purchase and refinance lending is profitable or marginally profitable for most institutions. On a dollar-weighted basis, about 85 percent of survey respondents said that their CRA-related lending as a whole was at least marginally profitable. However, CRA-related home purchase and refinance lending was reported to be less profitable and to have similar or higher delinquency rates than other home purchase and refinance lending. Concerning this product, about 63 percent of respondents said that their CRA-related lending was less profitable than their overall lending. Differences are less dramatic when measured on a per-institution basis.

One of the strongest relationships revealed by the survey concerns the correlation between an institution's size and the profitability and performance of its CRA-related lending. Large banks were less likely than small banks to report that CRA-related lending is profitable, and much more likely to say that it is less profitable than their overall lending. A large proportion of respondents in all bank-size categories reported that CRA-related and other home purchase and refinance loans have very similar origination and servicing costs, credit losses, and pricing on a per-institution basis. However, the respondents who did report differences most often said they had lower prices or higher costs or credit losses for CRA-related home purchase and refinance loans than for others.

We have also found that pre- and post-purchase counseling have a very important role in the profitability of CRA loans.

—Richard Staples

Home Improvement and Refinance Lending

The results for home improvement lending ($12 billion in originations, of which about 18 percent is CRA-related) are similar to those for home purchase and refinance lending, although fewer differences between CRA-related and other home improvement lending were reported. The vast majority of respondents in all size categories said that origination and servicing costs, credit losses, and prices for home improvement lending were about the same for CRA-related loans as for others.

On how the 1995 CRA influences profitability:

But because of the regulation's emphasis on performance . . . in some markets there is extreme competition for 'CRA loans.' Competition is so stiff that profit margins are under significant pressure, scaring away smaller community banks. . . . And some institutions feel compelled perhaps to make loans for the sake of getting them on their books—maybe with loan terms that are too flexible, or to borrowers who are only marginally credit-worthy. These trends, if they continue, threaten to play into the hands of those who argue that CRA lending is an unprofitable business. Our goal must be CRA regulations that foster sustainable community reinvestment.

**—Ellen Seidman, OTS Director,
National Association of Affordable Housing
Lenders speech, October 5, 2000**

Small Business Lending

Nearly all respondents reported that small business lending overall ($117 billion in originations) and CRA-related small business lending are both profitable. They reported few differences in performance and profitability between CRA-related and other small business lending. The same was true of origination and servicing costs, credit losses, and pricing. These results may reflect the relatively large proportion (about 50 percent) of all small business loans that are CRA-related.

Community Development Lending

Virtually all respondents reported that community development lending ($13 billion in originations) is at least marginally profitable. Comparative questions were not asked for this category of loans because it was unlikely that we would be able to construct valid comparison groups from banking institutions' loan portfolios.

2. Survey Results: CRA Special Lending Programs

Evidence suggests that CRA special lending programs ($11 billion in originations across all loan-product categories) are relatively small and account for a small proportion of the loans extended by most banking institutions. Only 1 percent of respondents reported that they established these programs solely to obtain a "satisfactory" or "outstanding" CRA rating. A large share said they established their programs to meet the local community's credit needs and to promote its growth and stability. Programs have a wide range of characteristics but they commonly feature altered underwriting standards. About three-quarters of all programs involve third parties, such as government entities, nonprofits and lending consortia, which are often a source of subsidies and provide many services such as screening of prospective borrowers. In addition, third parties often share the credit risk of a loan with the lender. A majority of CRA special lending programs were reported to be profitable or marginally profitable. About 25 percent of them were described as unprofitable or marginally unprofitable.

Here we mention an interesting debate about interpreting results from the CRA special lending programs. One side maintains that these programs represent the marginal impact of the CRA—"the bite of the law"—and therefore are the appropriate focus for analyses of the CRA's effects. The other side maintains that these programs exist for several different reasons, only one of which is to respond to the CRA, and do not necessarily measure the bite of the law.

Concluding Comments

The report does not characterize the overall performance and profitability of banking institutions' CRA-related lending because it does not cover all the activities of a given bank. However, the performance and profitability of most institutions' CRA-related home purchase and refinance and small business lending provide a good indication of the performance and profitability of their CRA-related lending as a whole, because these two categories are the most important ones for the majority of banks. The relatively low response rate to the survey does not necessarily imply that its results are idiosyncratic. In particular, we found no evidence that the survey's results are not broadly representative of the experiences of the 500 institutions considered together. Although the response rate was 28.6 percent, the institutions that responded are estimated to account for between 45 and 50 percent of all the CRA-related lending in each loan-product category. Furthermore, statistical tests indicate that survey respondents resemble nonrespondents along several dimensions, including overall profitability and CRA performance ratings.

The survey data are primarily reflections of the experiences of larger banking institutions in a particularly healthy economic environment. Experiences may differ for small institutions or under different economic conditions. Our current research efforts are focused on a fuller assessment of the section of the survey that concerns special lending programs.

The study, which was released today, indicates that the great majority of CRA-related home and small business lending is profitable. This study is consistent with an earlier study conducted in 1997 by two Federal Reserve Board economists finding that banks offering a high number of loans to low- and moderate-income borrowers are slightly more profitable than banks that make few loans to these populations.

–National Community Reinvestment Coalition, press release, July 17, 2000

The results of the study are clear and consistent: CRA lending is significantly less profitable than ordinary lending, and the most unprofitable CRA loans are those that are made through special lending deals with CRA specialists and other third parties. I am astounded by the data that shows every third dollar lent through these special deals is lent at a loss. The results of the Federal Reserve's study undermine the often-heard claim that CRA lending is good business that, prior to the CRA law, banks had ignored.

–Senator Phil Gramm, Chairman, Senate Banking Committee, press release, July 17, 2000

About the Authors

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Editor's Note

The complete study can be found at www.federalreserve.gov/boarddocs/surveys/craloansurvey/

Participation in the Survey

Participation by banking institutions in the Federal Reserve Board's Survey of the Performance and Profitability of CRA-Related Lending was voluntary. On January 21, 2000, each prospective respondent was mailed a questionnaire accompanied by a cover letter from Federal Reserve Board Chairman Alan Greenspan explaining the purpose of the survey and seeking voluntary cooperation in the study. The sample of institutions selected to participate in the survey consisted of roughly the largest 500 retail banking institutions-400 commercial banks and 100 savings associations. The sample was limited to the largest banking institutions because they account for the vast majority (estimated at more than 70 percent) of CRA-related lending nationwide. Survey responses were received from 143 banking institutions—114 commercial banks and 29 savings associations. Despite their relatively small number, the 143 survey respondents accounted for about one-half of the assets of the more than 10,000 U.S. banking institutions in existence as of December 31, 1999.

Response rates varied markedly by the asset size of the institution. More than 80 percent of the largest surveyed banking institutions (assets of $30 billion or more as of December 31, 1999) returned a survey (27 out of 33 sampled institutions in this asset category). In contrast, only about 19 percent (72 out of 363) of the smallest surveyed banking institutions (assets of between $0.950 billion and $4.999 billion) responded. Institutions with assets of between $5 billion and $29.999 billion had a response rate of about 40 percent.

The Big $core!

by John Galligan

Finally, there will be no more talking behind your back, financially speaking. As of March 2001, every consumer can know what bankers, creditors, and loan officers could access about their applicants—their credit scores. Lifting the veil on credit scores is a big deal. When it comes to getting a credit card or business loan, or buying a car or a house, a credit score looms large. It may influence both the likelihood of your getting the loan and the interest rate you will be charged. This release of information comes after the United States Congress started thinking about making credit scores public to consumers applying for credit.

Consumers often sit in auto dealerships or mortgage bankers' offices and wonder (or agonize) about whether they will qualify for a loan. Now that consumers are able to know their credit scores, their agonizing should abate. However, it will now be incumbent upon consumers to understand how they got their credit scores and how to keep them as high as possible. The release of credit scores is also beneficial to consumers who may not know that they have good credit and, therefore, are eligible for low-interest loans through traditional lenders.

First of all, it's important to know the source of the credit score and who has access to it. The most frequently used credit score in the mortgage industry is called a FICO® score, named after the company that devised it, Fair, Isaac and Company Inc. Fair, Isaac derives the score based on financial information from your creditors, such as your history of paying bills on time. The score acts like an amalgam of financial information about you. In return, mortgage lenders, finance companies, and landlords can access your FICO score when making decisions about extending credit to you. The credit score is used as a measure of how risky a credit consumer you are, based on your patterns of financial behavior. Keep in mind that factors other than your credit score, such as your employment history and income, also influence creditors' evaluation of your creditworthiness.

The Five Factors

Having covered the basics, the following is a listing of five factors that contribute to your credit score, with a brief explanation of what each factor means, how to improve it, and its relative importance in the overall score. The results of these five factors added together compose a score ranging from roughly 300 to 850, with an inverse relationship between your credit score and the predicted level of risk you pose to the creditor. A high credit score (700-850) means that you are a relatively low credit risk, and a low credit score (300-500) means that you are a relatively high credit risk.

1 Track Record

Your history of paying bills on time figures prominently in determining your credit score. Your recent track record counts more than your dated track record. While a 30-day late payment won't affect your score as negatively as a 90-day late payment, the bottom line is to make your best effort to pay your bills on time because this factor has the greatest single influence on your credit score. It is important to know that timely payment of bills such as those for phone and electricity service will not influence your score. Only credit accounts are followed by Fair, Isaac, unless one of your accounts, such as your electricity bill, gets sent to collection. *Percentage of your total credit score: 35 percent*

2 Amounts Owed

If you have high balances on a number of credit cards and installment loans, this situation is hurting your credit score. Even if you have numerous credit cards that don't have high balances, your credit score could be impaired. Numerous credit cards heighten the "potential" for accumulating high balances that could jeopardize your ability to repay your creditors at any given time. Optimally, own one credit card, use it judiciously, and pay it off monthly. It is also best to keep installment loans, if you have them, at manageable levels. *Percentage of your total credit score: 30 percent*

3 Length of Credit History

The longer you have had a credit history, the more likely you are to score better in this category. If you are relatively new with credit, however, you can still score well on this factor if the rest of your factors score well. To determine your length of credit history, Fair, Isaac looks at the age of your oldest credit account and averages the ages of all your credit accounts. This is why new credit, mentioned below, can be detrimental to your score. *Percentage of your total credit score: 15 percent*

4 New Credit

If you have applied for or have obtained new credit cards recently, you are reducing your credit score. Again, the potential for getting into trouble with multiple cards is at play here. Low introductory rate offers swell the mail and numerous retailers offer discounts with the opening of an account. Yet with these offers you are also getting another listing on your credit report that could count against you. Retail store credit, in addition, is often provided by finance companies, and a number of these accounts may reduce your credit score. It is best to open new credit lines only when necessary. *Percentage of your total credit score: 10 percent*

5 Type of Credit in Use

This factor reflects whether you have a "healthy" mix of credit. Here's what an "unhealthy" mix of credit would look like: numerous credit cards with outstanding balances, plus large mortgage and auto loans. Doing well with this factor means not overextending yourself with credit. A "healthy" mix of credit would entail managing a reasonable number of credit card accounts and other loans with timely payments. It does not mean having one of each type of credit account. Using credit cards responsibly, rather than not having them at all, is a boost to your score. *Percentage of your total credit score: 10 percent*

For Further Information

www.myfico.com
www.advantagecredit.com

Credit Reporting Agencies:
Experian
1-888-397-3742
www.experian.com

Equifax
1-800-685-1111
www.equifax.com

Trans Union
1-800-916-8800
www.tuc.com

Also, the Spring 2000 and Winter 2001 issues of *Communities & Banking* feature in-depth articles about credit scoring.

Cleaning Up My Credit History

FICO scores are only as good as the information they are based on, which is why it's important that the three national credit bureaus, Equifax, Experian, and TransUnion, have the correct information about you. Each of these credit bureaus can produce FICO scores based on the information they maintain about you. And as I found out, they may be inaccurately representing your current financial position.

In anticipation of securing a loan with the best rate possible to buy a vacation property on Cape Cod, I checked into my credit reports to certify that everything was in good order. To get started, I ordered reports online from the three national credit bureaus, Equifax, Experian, and Trans Union, paying $8.50 for each. (Massachusetts and Vermont are two of the six states that have enacted legislation requiring the three major credit bureaus to provide consumers with one free credit report per year. In addition, you are entitled to one free credit report every year if you: believe your report is inaccurate due to fraud, have been denied credit within the past 60 days, are on welfare, or are unemployed and plan to seek employment within 60 days.)

Reading through the reports was disturbing because they showed accounts as "open" that I was confident had been closed years ago, showed accounts as "open" that were with stores that had gone out of business years ago, and showed a mortgage as "active" that had been paid off through a refinancing completed two years ago. In all, I identified a dozen errors among the three reports. It's important to note that simply closing accounts does not erase them from your credit report, and they may still influence your credit score.

I went to work to correct these errors. I wrote to each credit reporting bureau explaining the items in question, and invested a substantial amount of time and effort in the process. As required, each bureau mailed me corrected versions of the reports within 30 days.

Leaving nothing to chance, I then ordered my credit score from www.myfico.com. I paid $12.95 for the information, and received the report online the next day showing that my score was in the high 700s—enough to qualify for the best rates possible, according to the analysis provided with the score. Armed with this information, I am ready to scour the market, confident that I am a consumer with the power to shop around for the most competitive offerings. You might say that I should be given credit for my due diligence!

About the Author

John Galligan is Director of Electronic Banking Services at the United States Treasury. He recently completed a five-week internship with the Federal Reserve Bank of Boston as part of Treasury's Senior Executive Service Candidacy Development Program. At the Boston Fed, Galligan worked to develop a financial literacy publication.