Business Week

Community Reinvestment Act had nothing to do with subprime crisis

Posted by: Aaron Pressman on September 29

Fresh off the false and politicized attack on Fannie Mae and Freddie Mac, today we're hearing the know-nothings blame the subprime crisis on the Community Reinvestment Act — a 30-year-old law that was actually weakened by the Bush administration just as the worst lending wave began. This is even more ridiculous than blaming Freddie and Fannie.

The Community Reinvestment Act, passed in 1977, requires banks to lend in the low-income neighborhoods where they take deposits. Just the idea that a lending crisis created from 2004 to 2007 was caused by a 1977 law is silly. But it's even more ridiculous when you consider that most subprime loans were made by firms that aren't subject to the CRA. University of Michigan law professor Michael Barr testified back in February before the House Committee on Financial Services that 50% of subprime loans were made by mortgage service companies not subject comprehensive federal supervision and another 30% were made by affiliates of banks or thrifts which are not subject to routine supervision or examinations. As former Fed Governor Ned Gramlich said in an August, 2007, speech shortly before he passed away: "In the subprime market where we badly need supervision, a majority of loans are made with very little supervision. It is like a city with a murder law, but no cops on the beat."

Not surprisingly given the higher degree of supervision, loans made under the CRA program were made in a more responsible way than other subprime loans. CRA loans carried lower rates than other subprime loans and were less likely to end up securitized into the mortgage-backed securities that have caused so many losses, according to a recent study by the law firm Traiger & Hinckley (PDF file here).

Finally, keep in mind that the Bush administration has been weakening CRA enforcement and the law's reach since the day it took office. The CRA was at its strongest in the 1990s, under the Clinton administration, a period when subprime loans performed quite well. It was only after the Bush administration cut back on CRA enforcement that problems arose, a timing issue which should stop those blaming the law dead in their tracks. The Federal Reserve, too, did nothing but encourage the wild west of lending in recent years. It wasn't until the middle of 2007 that the Fed decided it was time to crack down on abusive pratices in the subprime lending market. Oops.

Better targets for blame in government circles might be the 2000 law which ensured that credit default swaps would remain unregulated, the SEC's puzzling 2004 decision to allow the largest brokerage firms to borrow upwards of 30 times their capital and that same agency's failure to oversee those brokerage firms in subsequent years as many gorged on subprime debt. (Barry

Ritholtz had an excellent and more comprehensive survey of how Washington contributed to the crisis in this week's Barron's.)

There's plenty more good reading on the CRA and the subprime crisis out in the blogosphere. Ellen Seidman, who headed the Office of Thrift Supervision in the late 90s, has written several fact-filled posts about the CRA controversey, including one just last week. University of Oregon professor and economist Mark Thoma has also defended the CRA on his blog. I also learned something from a post back in April by Robert Gordon, a senior fellow at the Center for American Progress, which ends with this ditty:

It's telling that, amid all the recent recriminations, even lenders have not fingered CRA. That's because CRA didn't bring about the reckless lending at the heart of the crisis. Just as sub-prime lending was exploding, CRA was losing force and relevance. And the worst offenders, the independent mortgage companies, were never subject to CRA — or any federal regulator. Law didn't make them lend. The profit motive did. And that is not political correctness. It is correctness.

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