
Community Reinvestment Act

Ensuring Credit Adequacy or Enforcing Credit Allocation?

Vern McKinley

In a July 15, 1993 speech on the South Lawn of the White House, President Clinton discussed the availability of credit to low and middle-income areas, and mentioned what has been a relatively obscure statute for most of its seventeen-year existence—the Community Reinvestment Act (CRA). This statute requires financial institutions to reinvest deposit funds back into the communities in which they are located. Clinton claimed that the CRA has not lived up to its potential. In line with this concern, the bank and thrift regulatory agencies, primarily under the leadership of Clinton-appointee Eugene Ludwig of the Office of the Comptroller of the Currency (OCC), have spent most of the past year and a half revising their regulations interpreting this statute. Even Alan

Greenspan, the Reagan-appointed Chairman of the Federal Reserve Board (Fed), has recently taken a more active role regarding CRA issues. He recently gave his first speech on the subject after seven years as Chairman, and cast an instrumental vote against an application for a proposed acquisition by Shawmut National Corporation of Massachusetts. The denial was based upon the powers granted to the Fed by the CRA.

Rather than being a positive trend, these recent actions allow government and special interest groups to influence and even dictate lending decisions. Instead of being expanded, the CRA should be repealed.

Statutory Authority

The CRA is based upon the underlying notion that institutions have a continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered. The federal supervisory agencies undertake a two-pronged effort to ensure that the obligation mandated under CRA is fulfilled. First, CRA requires that the appropriate federal supervisory agency use its authority when conducting supervisory examinations to

and Vern McKinley has worked at the Federal Deposit Insurance Corporation, the Federal Reserve Board, and is currently employed at the Resolution Trust Corporation. The opinions expressed in this paper are solely attributable to the author. This article was adapted from a more extensive paper available from the author at 1730 N. Lynn St., Suite A-67, Arlington, VA 22209.

encourage institutions to meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operation of the institution. The various regulatory agencies, such as the Fed and the OCC, give each institution a written evaluation of its record in meeting community needs and assign a rating of either "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance." A portion of the written report, as well as the rating, is released to the public.

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tution's record into account when they evaluate an application for a deposit facility such as the opening of a branch, relocation of a home office, a merger, or acquisition. This is the "stick" the agencies can wield to enforce the CRA. In short, the CRA utilizes fairly vague terms such as "convenience and needs" and "meet the credit needs of the local community," and then explicitly delegates to the individual agencies the power to define these terms, while using the threat of denying applications to assure compliance with the agency-created definition.

Closely related to the CRA are three sibling statutes, the Equal Credit Opportunity Act (ECOA), the Home Mortgage Disclosure Act (HMDA), and the Fair Housing Act (FHA), all aimed towards eliminating "discrimination" in the lending process. The close relationship arises from the near-automatic determination that if ECOA or FHA are violated, the institution is not serving its community. The Department of Housing and Urban Development (HUD) and the Justice Department complement the efforts of the bank and thrift agencies in enforcing the FHA and ECOA. The HMDA focuses on the

practice of "redlining," whereby lending institutions avoid doing business in certain geographic areas. The CRA was enacted as a follow-up to the HMDA, in part in response to instances in which a poor white applicant had a significantly better chance of getting a mortgage loan than a wealthy black applicant. These four statutes are designed to assure credit availability for persons of all income levels and demographic groups.

The Regulatory Record

The vagueness of the CRA is a direct result of the legislative process at work behind the development of the statute. The CRA was proposed during the Carter Administration by Senator William Proxmire (D-Wisc.), whose primary purpose in enacting the legislation was to eliminate the practice of redlining. The bill focused on this practice because of the perceived unfairness of "credit exportation," whereby money was taken from the community in the form of deposits, but lent to borrowers outside of the community. CRA supporters thought that institutions should avoid such credit exportation as part of the quid pro quo for deposit insurance and a government charter. Proponents of the bill compared this requirement to the FCC requirement that radio and TV stations serve the public in exchange for their licenses.

The original form of the bill that was to become the CRA has been described as having a substantive and a procedural section. The substantive section required institutions to serve the convenience and needs of the communities in which they were chartered. The procedural section detailed very specific procedures for institutions to follow in connection with an application for a deposit facility.

Ultimately, the procedural section was doomed by opposition from those who were concerned that the bill was thinly-disguised credit allocation and would represent a foot in the door toward the mandatory allocation of credit. Opponents of the bill feared that one day banks would be required to make unsound loans to meet their local credit quotas. An example of such criticism came from Arthur Burns, chairman of the Fed at the time, who noted that the proposed statutory language interfered with the first principle of the banking system model: to facilitate the market flow of credit from areas of supply to areas of demand. He argued that this

interference might inhibit lenders from opening depository institutions in locales where they would be cornered into maintaining certain levels of credit.

The final version of the CRA that was signed into law reflected deference to the concerns of those who feared mandated credit allocation. However, in a compromise move, the regulatory agencies were delegated the power to assess the institutions' records in meeting the needs of their communities, thus moving away from a results-oriented approach.

Early CRA regulations promulgated by the agencies directed institutions to define their communities, make available information about how they serve the financial needs of these communities, and post notices requesting public comments on their CRA performance. Quantitative targets were specifically rejected because it was believed they would inevitably result in credit allocation and uneconomic investments.

The Late 1980s

A number of actions by Congress and the regulatory agencies in the late 1980s signaled a turning point for the CRA. Expressing discontent at public hearings in March 1989, Senator Proxmire complained that, despite passage of the CRA, inner-city neighborhoods were "starving for credit."

A number of changes were made in response to these hearings. In March 1989, the OCC, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Fed issued a joint policy statement on CRA that set forth a more detailed framework to follow in formulating an effective CRA program. The statement gave general guidelines similar to those previously issued by the regulatory agencies, and also outlined highly detailed recommendations for institutions' CRA plans.

In August 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act. Representative Joseph Kennedy (D-Mass.) sponsored amendments to the Act which required a written evaluation by regulating agencies of the institution's record of meeting the credit needs of its community and required the agencies to disclose the institution's CRA rating to the public. Also in 1989, the Federal Reserve Board issued its first denial of a

bank acquisition based on CRA, an application made by Continental Bank Corporation and Continental Illinois Bancorp, Inc. to acquire 100 percent of the voting shares of Grand Canyon State Bank in Scottsdale, Arizona. The Fed claimed that Continental did not have a plan to meet its responsibilities under CRA, and that it made no effort to ascertain the credit needs of its community. The denial was issued despite the fact that between 1986 and 1989 the Federal Reserve had allowed Continental to acquire three banks in the Chicago area.

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CRA-related examinations by financial regulatory authorities. For example, examinations by the FDIC, the agency that conducts the largest number of CRA examinations, jumped from 1,251 in 1985 to 4,282 in 1988.

The 1990s: Studies and Surveys of Lending Discrimination

The trend toward utilizing the CRA more aggressively accelerated in the early 1990s. Consumer surveys show that recent homebuyers strongly believe there is bias in mortgage lending (whites-60 percent, hispanics-60 percent, and blacks-83 percent) though few had experienced it themselves (whites-3 percent, hispanics-7 percent, blacks-16 percent). Data collected under the HMDA continues to show that blacks are more than twice as likely to be rejected for mortgages as whites or asians, 34 percent versus 15 percent. Hispanics suffer denial rates of 25 percent, higher than whites, but lower than blacks. But the most far-reaching and oft-cited analysis of mortgage lending bias is an October 1992 study by the Federal Reserve Bank of Boston.

The Boston Fed Study sought to discover whether differences in mortgage loan denial rates could be explained, controlling for factors

such as financial, employment, and neighborhood characteristics. The study concluded that overt discrimination, whereby minorities with unblemished records are denied credit, is not pervasive—97 percent of such applicants are approved. However, the study concluded that even controlling for these other factors, there remained a “statistically significant” gap associated with race.

The Regulatory Response

Since the Boston Fed Study, the Federal Reserve Board has intensified its scrutiny of applications. A high profile case underscoring this scrutiny was the Fed’s December 1993 denial, the result of a three-to-three tie vote, of Shawmut National Corporation’s proposal to acquire New Dartmouth Bank. Chairman

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Greenspan, Vice^JChairman Mullins, and Governor Lindsey voted to deny. Shawmut was under investigation by the Justice Department as a result of data compiled under the Boston Fed Study. The Fed later reversed its disapproval after Shawmut settled the case for approximately \$1 million to compensate black and hispanic applicants turned down for mortgages by the bank, and acted to take further steps to prevent future discrimination.

The New Concepts of Discrimination

As noted previously, the Boston Fed Study found that overt discrimination, such as redlining, is not pervasive. Thus, in recent years, regulators have targeted what they maintain are more subtle forms of discrimination, usually classified either as “disparate impact” or “disparate treatment.” In a case of disparate impact, a lender applies a practice uniformly to all applicants. Yet the practice results in a distribution of loans to designated protected groups below

their proportion in the population of the community. Furthermore, the practice is not strictly justified by business necessity or because other, less disparate criteria are not available. Examples of disparate impact practices include: minimum loan amounts; property standards such as size and age that exclude homes in minority and low-income areas; commissions for lending officers that shift their efforts toward high balance as opposed to low balance loans; the existence of application fees; and the lack of minorities as front-line employees.

The other form of agency-defined discrimination, disparate treatment, is said to occur when a lender who has loan applicants that may be described as marginal or close calls treats applicants differently. One of the more colorful examples of this form is the “thick loan file” phenomenon. Under this scenario, a non-minority loan officer has two potential borrowers of roughly equivalent credit quality: one minority, and one non-minority. The loan agent will “coach” the non-minority applicant, that is, suggest ways that the applicant might make a better case for the loan. The applicant will usually gather more supplemental material to support his loan request. The result will be a flood of documentation and paperwork which will be noticeable in a much thicker loan file. Thus, it will be more likely that the non-minority borrower will be approved for a loan. This phenomenon has been described by Fed Governor Lindsey as fairly solid, albeit anecdotal, evidence that white marginal applicants have thicker loan files than marginal black applicants.

The Results of Increased Enforcement of CRA

Advocates of a strengthened CRA maintain that stronger enforcement has had an enormous positive impact. For example, Allen J. Fishbein, in a *Fordham Urban Law Journal* article, claims that CRA has resulted in new credit commitments of \$30 billion; and this figure is cited by regulators as an indication of how their efforts are paying off. A December 1993 proposed CRA rule accepts this premise when it notes that tens of billions of dollars have flowed to low- and moderate-income areas as a result of CRA. Such results have led some to believe that the CRA should be expanded to include credit unions, insurance companies, and other nonbank and thrift companies such as mort-



gage banks. This would “level the playing field” among institutions subject to CRA and those not subject to CRA.

Increased lending levels resulting from CRA come from two sources: commitments from institutions having CRA problems as a result of complaints by community groups or regulators, and commitments made by banks during the course of application procedures that fall under CRA, especially mergers. In perhaps the most ambitious community reinvestment plan yet, Fleet Financial Group of Rhode Island announced that it would lend \$8 billion over three years to low-income people throughout the country. Fleet had recently reached settlements in Massachusetts and Georgia after charges of unfair lending to low-income borrowers had been made. The high-profile announcement was made in the presence of Clinton staffers, community activists, and lawmakers, including Senator Edward Kennedy (D-Mass.), not in the home of Fleet, but in Washington, D.C.

Lending commitments have also been extracted by community groups in connection with merger applications, when banks are most

vulnerable to CRA protests, a phenomenon described as “megamerger CRA megapledges.” These commitments range from a few hundred thousand dollars up to the largest CRA megapledge of \$12 billion by Bank of America, made when it sought to purchase Security

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Pacific Corporation. There is even a rule of thumb for calculating such CRA commitments of around one half of 1 percent of assets per year.

The Clinton Administration

The Clinton administration favors expanded use

of the CRA, believing that a governmental response to economic problems in inner cities is generally more effective than a market solution. Eugene Ludwig, Comptroller of the Currency and head of the OCC, has been a strong proponent of expanding the reach of CRA and its sibling statutes. He said in his confirmation hearing that his first priority as Comptroller would be to eliminate "discrimination from our financial system, root and branch." Recently, he told bankers that "If you seize this issue as an opportunity, you will reap the benefits in the form of new business and heightened respect from the press, the Congress, and your communities. But if you reject it as a burden, you run the risk that

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fair lending concerns will spread like a cancer across the industry's reputation." His imprint on a December 1993 proposed rule to make CRA more performance-based was especially noticeable in a speech given July 15, 1993, the day Clinton announced that he wanted the CRA regulations revised. In the speech, Ludwig laid out almost verbatim the three tests that were to become the core of the agencies' proposals. This was a full five months before the first joint proposal was announced by the financial agencies.

Clinton administration appointees at agencies responsible for enforcing the ECOA and the FHA have also indicated an intensified interest in the issue of lending discrimination. At the Justice Department, Janet Reno appeared at a number of high-profile press conferences announcing fair-lending settlements. At one such press conference in January 1994, announcing a settlement with the First National Bank of Vicksburg and the Blackpipe State Bank, Reno said that "today's actions demonstrate that we will tackle lending discrimination wherever and in whatever form it appears. No loan is exempt, no bank is immune. For those who thumb their nose at us, I promise vigorous enforcement."

But the most interventionist members of the Clinton Administration in this area are HUD Secretary Henry Cisneros and Assistant Secretary Roberta Achtenberg. Cisneros' department has developed rules for lenders that encourage them to increase approval rates for loans to minority applicants by 20 percent within one year; increase minority hiring by 5 percent; increase the purchase of goods and services from minority and female-owned businesses; and adjust compensation structures to award staff who effectively serve lower-income applicants or those applicants unfamiliar with the lending process. Achtenberg, a former civil rights lawyer, has pushed for a new arsenal of weapons to combat what HUD sees as discrimination, including new regulations under the FHA. Among these weapons are: new rules for government-sponsored enterprises, a program to encourage fair-lending agreements between lenders and HUD, and a new unit of HUD dedicated exclusively to banking issues.

The December 1993 and September 1994 CRA Proposals

The Clinton administration's first attempt at revising CRA regulations came in December 1993, in the form of a proposed rule issued jointly by the OCC, the Fed, FDIC, and the OTS. The new approach they proposed was decidedly more performance-based, judging an individual financial institution's CRA compliance based on lending, investment and service tests.

A lending or "market share" test was proposed to determine whether a retail institution (which lends more to the general public for purchases of homes, automobiles, and other consumer products) makes sufficient loans in low- and moderate-income areas by evaluating its performance in comparison with other lenders subject to CRA in its service area. An investment test judges an institution's level of "qualified" investments that benefit low- and moderate-income areas for institutions characterized as wholesale (which lend more to businesses). A service test requires a showing that the percentage of branches located in or readily accessible to low- and moderate-income areas is sufficient. Small institutions would be eligible to choose a more streamlined assessment method by maintaining a reasonable loan-to-deposit ratio, with 60 percent suggested as a benchmark.

Finally, under this proposal, larger institutions would be required to collect and report data on the geographic distribution of housing, consumer, small business, and farm loans along with application, denial, origination, purchase, sale, and retirement information.

In September 1994, the Clinton administration modified its earlier proposed rule, changing the lending test to reduce emphasis on the market share analysis. Rather than using the market share test as the sole measurement of lending performance, other measures such as the level of community development loans would be assessed. Community development loans include those that address the need for affordable housing or other community development needs even if such loans are not made within the institution's community. The exact mix of the assessment factors would largely be left to the judgement of the individual examiner assessing the CRA performance of the institution. The 60 percent loan-to-deposit ratio for small institutions was dropped and replaced with a reasonableness test to be administered by examiners. Reporting on the geographic distribution of housing, consumer, small business, and small farm loans was altered in favor of reporting on the geographic distribution, race, ethnicity, and gender of small business and small farm borrowers.

Critical Analysis of the Recent CRA Developments

The clearest indicator that the CRA has become a system of credit allocation is the market share approach, which implements a quota-based system intended to change lending behavior. This was, of course, the inevitable result of President Clinton's desire to move from a process-based system to a performance-based system. Consider an example of how the system would function if the agencies' proposals are adopted.

Assume that a community has five banks. The shares of total low-income loans that each bank makes in the community are 35, 30, 20, 10 and 5 percent, respectively. The imposition of the market share test, at a minimum, would mean that the banks with only 5 percent and 10 percent of the market would seek to bring their share up to 20 percent, the average of the five banks. A premium would likely be placed on low-income lending and the 5 percent market share institu-

Table 1

Application Denial Rates at Minority-Owned Banks

Race of Applicant	Rejection Rates
asian	7 percent
black	25 percent
hispanic	26 percent
white	16 percent

Source: Glenn Canner to Griff Garwood, 1991 HMDA Data for Minority-Owned Commercial Banks, Memo-Board of Governors of the Federal Reserve (March 9, 1993).

tions will try to bid away such lending from the 35 percent market share institutions. The market share test presumes the desirability of one-size-fits-all regulation, whereby a formula-driven system dictates that every institution in the relevant market should lend roughly the same portion to the lower-income market as all other institutions in the relevant market. Such a sys-

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tem would leave little room for those who want to specialize in low-income lending or those who choose not to specialize in low-income lending.

The September 1994 proposal backs down from the strictness of the earlier market share proposal but tries to straddle both sides of the issue by reducing reliance on formula-driven assessments while still allowing their use at an examiner's discretion. Such discretion will likely lead to uneven application across the regulatory

system. Under either approach, the regulatory agencies will dictate the desired mix of lending for an institution to follow.

The investment test is another method by which allocation choices are dictated to institutions. Such a method of channeling the makeup of the asset portfolio is a clear instance of micro-managing the investment process by setting forth a blanket statement that certain "qualified investments" are more desirable than others. As Professors Macey and Miller have noted, most such investments are of a "politically correct" nature.

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The service test, which judges community reinvestment performance based upon the location of branches and delivery of services to market segments, is yet another form of government credit allocation. Such a step is well beyond the CRA's initial requirement of reinvestment in the community from which deposits are drawn, as the proposals actually dictate the choice of community served.

Finally, even though President Clinton is supposedly committed to reducing paperwork, the proposals impose an entirely new reporting requirement.

The American Banker, a trade publication, made clear its assessment in a headline after the September 1994 proposal was released: "CRA Proposal Would Mean More Jobs for Examiners." Obviously, it takes a lot of bodies to implement a government credit allocation system.

A Rebuttal: Another Look at the Boston Fed Study

Not only is the proposed regulation unworkable,

the entire underlying justification for taking such an interventionist stance is flawed. Analysis of the raw data compiled under HMDA, which reveals that rejection rates for blacks and hispanics are higher than those for whites and asians, on its own does not prove that racial discrimination is occurring. The loan denial rate for blacks and hispanics is also significantly higher than for whites and asians at minority-owned banks (see Table 1). Merely analyzing acceptance rates, unadjusted for income, net worth, and credit history, ignores the reality of the credit evaluation process.

The Boston Fed Study took such factors into account and still found that black and hispanic mortgage applicants in the Boston metropolitan area are roughly 60 percent more likely to be turned down than whites. Yet despite the authors' warning that the study had a limited focus, many community groups, banking consultants, regulators and, of course, the media have hailed it as conclusive proof of racial discrimination. The comments of bank consultant Kenneth H. Thomas, for example, are typical, "[This] landmark study documented that racial discrimination in mortgage lending is a widespread phenomenon." But the Boston Fed study is open to question, since there has been no confirmation of the findings by other studies.

Critics of the study have found a number of serious problems with its methodology and quality (see *Regulation* 1994, No. 2). For example, David Horne, an economist with the FDIC, sought to resolve the seeming paradox between the fact that 90 percent of the institutions in the Boston Fed study received satisfactory or better CRA ratings and the study's purported proof of lending discrimination. The FDIC analysis covered the seventy institutions under its supervision that were among the 131 institutions in the Boston Fed study, and checked the loan files of these banks for accuracy and to determine whether the data were interpreted consistently and appropriately. Overall, 57 percent of all applicant files contained data errors, including critical information that could not be verified, debt that was underreported, inaccurate income figures, and assets that could not be verified. The FDIC analysis concluded that it is not possible to establish whether the racial discrepancies identified in the Boston Fed Study reflect racial bias or methodological problems with the study's statistical approach. Unfortunately, the

FDIC study has not received very much attention. The Federal Reserve Bank of Boston has made no formal response to the FDIC study.

Shawmut and Chevy Chase Cases

If the Boston Fed Study's underlying premise is questionable, so are the criticisms of a lack of community reinvestment put forth against Shawmut National when it sought permission to merge with New Dartmouth Bank. The Shawmut referral to the Justice Department was prompted by findings in the Boston Fed Study. The only statistics contained in the Justice Department's complaint were raw HMDA data that show that blacks and hispanics are roughly twice as likely to be denied for applications as whites. What the complaint failed to mention was that these rates are comparable to nationwide statistics for financial institutions and that they do not take into account income or other financial attributes of borrowers. The Shawmut case clearly would have been an excellent opportunity for the Justice Department to clarify its more interventionist stance under Janet Reno. But instead, Justice extracted a \$1 million settlement from Shawmut.

The case of Chevy Chase Federal Savings took the Shawmut precedent one step further. Chevy Chase was criticized by the Justice Department for not having enough branches in minority communities. This expands the ever-changing definition of lending discrimination to the point of dictating the communities in which institutions must locate their facilities. Furthermore, Bernard Siskin, a statistics consultant the Justice Department enlisted during its pursuit of Shawmut, prepared a study of Chevy Chase that did not reveal lending bias.

Questionable Lending Discrimination Doctrines

The two forms of discrimination on which most charges of lending bias rest are disparate impact

Table 2
Megapledges (Billions), # Years, and Final Year

Institution	Amount of Commit.	Over X years	Final Year
Bank of America	\$ 12.0	12	2003
NationsBank	10.0	10	2001
Security Pacific	2.4	10	2000
First Interstate	2.0	10	2000
Total	\$ 26.4	NA	NA

Source: Center for Community Change, Thomas.

Note: These four represent most of the \$30 billion of such commitments. These commitments were made in 1990-1991. The Fishbein article was written in 1993 but no adjustments were made for actual lending.

and disparate treatment. Each of these rests on questionable ground. The disparate impact doctrine reaches beyond intentional discrimination, as actions widely recognized as common, racially-neutral financial decisions are labeled as discriminatory.

In the employment context, where the disparate impact doctrine originated, an employer accused of implementing policies that have a disparate impact can argue that there is an underlying business necessity for having a particular selection policy in place. Similarly, a financial institution may, for example, establish

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a minimum loan amount, arguing that profits from smaller loans would not cover the cost of paperwork, staff time, and credit risk involved; or it may charge higher interest rates to less creditworthy borrowers because of the higher risk of losses. Yet these legitimate business practices come under attack under the disparate impact doctrine if it is found that these practices exclude low income borrowers. Such policies may be unwise from a business standpoint if there is a profit opportunity available and financial institutions are foregoing it. It is, however, quite a stretch to label as discriminatory policies

Table 3**Percentage of Resolutions Resulting in Payoff-1989-1993**

Type of Institution	Banks	Thriffs
Minority-Owned	27 percent	19 percent
Non Minority-Owned	5 percent	13 percent

Source: FDIC Annual Reports, RTC Review, GAO Study on Minority-Owned Financial Institutions.

which on their face are clearly racially neutral and supported by business necessity.

In fact, the existence of the CRA in conjunction with the fair lending laws effectively precludes an institution from successfully asserting a business necessity defense. For example, Chevy Chase had the choice either to endure years of expensive litigation with near-certain

The CRA tells a financial institution that if it moves into such an area, financial regulatory agencies and community groups will dictate how its "community" will be defined, how its performance will be judged, and most importantly, how it will make its lending decisions.

denials for any applications that fall under CRA; or settle with the government quickly and with less expense. The prospect of no branch or merger approvals for a number of years in the current environment of industry consolidation, when mergers and consolidation often are essential to a bank's survival, is not very enticing. The choice was simple: Chevy Chase chose settlement.

Finally, implicit in the disparate impact analysis is an assumption that minority status is equated with low income status. Such logic follows from the reasoning that if an action has an adverse effect upon low income individuals then it is discriminatory, because minorities make up a disproportionate share of low income borrowers. Such an assumption ignores the individual-

ized nature of the lending process by making broad assumptions about potential borrowers, based upon their racial or ethnic status, before they even apply for loans.

The evidence in support of the existence of disparate treatment is largely anecdotal, as is illustrated by the thick loan file phenomenon. But even if this practice were commonplace it does not follow that the best solution is to establish quotas that force bankers to lend because they somehow cannot "identify" with certain borrowers. A market solution would be to make it easier to have niche institutions available that specialize in minority or low-income lending, as black members of the House Banking Committee such as Floyd H. Flake of New York, Bobby L. Rush of Illinois and Albert R. Wynn of Maryland, all Democrats, have urged.

Community-Based Organizations and Their Tactics

The loan commitments that community groups set forth as proof of the positive economic impact resulting from active CRA enforcement are labeled by them as "regulation from below" or "negotiated settlements." A more accurate characterization would be codified extortion. In fact, comments by those who utilize such agreements to extract negotiated settlements often resemble utterances of organized crime figures. Typical is a statement by Bruce Marks, executive director of Union Neighborhood Assistance Corporation and self-styled "urban terrorist," who threatened that, if banks aren't willing to meet the new standards of community investment, then, "we'll have to start making it in their interest [to do so]."

The CRA sets up the conditions for a classic case of handing out other people's money. Bankers distribute loan dollars for a living, taking on risks that can get them fired, cost them their investments as stockholders, or subject them to lawsuits from the FDIC. No similar discipline constrains the community groups or regulatory agencies. Coercion enters the picture because these community groups know that time is of the essence in merger transactions, and that any source of delay means more time and, thus, money, is consumed. As a representative of the Association of Community Organizations for Reform Now (ACORN) put it, "When you're talking a billion-dollar merger,

every day of delay costs lots of money. It's cheaper to negotiate than to fight."

The community groups that negotiate these commitments are simply well-organized political interest groups that have a clear stake in the outcome of their negotiations. For example, one of the recent high profile announcements of such commitments involved Fleet Financial Group. Bruce Marks showed up at the announcement to praise the commitment, which included a \$140 million initiative to be administered by Marks' own organization. The group was to be paid a sum to administer the program but the exact sum was not disclosed. Marks denied that his enthusiasm for the initiative had anything to do with the resources his organization stood to gain.

Regulators and politicians also profit from these tactics. With high-profile press conferences to announce big-dollar commitments and settlements, they can look tough and grandstand without having to spend much money. However, such tactics amount to a tax on lenders, and even those innocent of discrimination will be willing to pay such a "regulatory tax" in order to avoid the costs of investigations and adverse publicity.

As bank robber Willie Sutton would say, big banks are targeted because that's where the money is. Unfortunately, the implicit assumption in this approach is that larger institutions such as Fleet, Bank of America, Shawmut, and Chevy Chase Federal Savings, the primary targets of CRA action, are the best institutions to make these loans to lower-income or minority groups. This increase in lower-income lending by larger institutions is potentially at the expense of smaller, niche institutions that would not be involved in a merger or are not large enough for such groups to get involved with. These agreements result in clear instances of government credit allocation brought about by the existence of CRA. As Glenn Canner, a member of the staff of the Fed, recognized over a decade ago, "Negotiated CRA settlements in the future are likely to continue to involve some elements of geographic credit allocation."

Is It Really \$30 Billion of New Lending?

Regulators and community activists claim that CRA has resulted in \$30 billion in new lending. This figure comes from a community group called Center for Community Change and was

highlighted in Alan Fishbein's law review article, which urged tougher enforcement of the law. The article clearly notes that these are merely "commitments by lenders." But supporters of a strong CRA have distorted these commitments to represent actual lending resulting from CRA. Although community groups may be knowledgeable about the various agreements that have occurred, accepting their evaluation of the actual amount lent as a result of CRA is analogous to letting a schoolboy fill out his own report card. In fact, the \$30 billion figure was derived by totalling up commitments made in several dozen agreements between community groups and lenders between 1978 and 1993.

There are some serious methodological problems with merely totalling up the individual lending agreements in this manner, as it appears that the individual estimates are highly overstat-

The CRA should be repealed. Altering the underlying regulation merely leaves the way open for future administrations to utilize the statute as a government credit allocation scheme.

ed. Even Kenneth H. Thomas, a bank consultant who is sympathetic to a strengthened CRA, discusses what he calls CRA "megapledge inflation." Thomas questions whether these banks are meeting the pledges with actual CRA loans. In his book *Community Reinvestment Performance—Making CRA Work*, he cites one case in which a bank counted every retail, business, or other loan normally made in a low- and moderate-income area as a CRA loan, even though many of those loans would have been made without CRA.

Another problem with the \$30 billion figure is that much of it represents future commitments, that is, lending that has not yet taken place (See Table 2). Further, as in the case of the bank cited above, even if these loans are made, they might not be the result of CRA. The General Accounting Office (GAO) has brought attention to the difficulty in estimating the results of CRA, noting in an analysis that it is impossible to establish the extent to which changes in lending patterns are the result of CRA, as opposed to other factors.

In addition, loans supposedly made as a result of CRA might otherwise have been made by other institutions, ones that specialize in low-to moderate-income lending. Thus, there is no definitive showing that low-income or minority lending in the aggregate has been increased. Finally, the formulaic approach whereby institutions are encouraged to make megapledges of one half of 1 percent of assets per year is yet another example of the one-size-fits-all regulatory system whereby institutions are encouraged to look and act alike with no diversity or specialization.

Many of the negative effects of CRA, while not fully documented, can nonetheless be identified as a burden to the economy. For example, CRA undoubtedly causes many financial institutions to avoid opening facilities in lower-income or minority areas because of the probable CRA burdens awaiting them. The CRA tells a financial institution that if it moves into such an area, financial regulatory agencies and community groups will dictate how its "community" will be defined, how its performance will be judged, and, most importantly, how it will make its lending decisions.

The recent, highly/publicized example of Freedom National Bank of Harlem, which was resolved by paying off depositors, has been cited as support for such a view. If an institution is resolved by paying off depositors, it is a good indicator of the undesirability of locating in that area, as no acquirers are even willing to take on the deposits, much less the assets, of the failed institution. In fact, over the past five years, the timeframe of enhanced enforcement of CRA, two other minority-owned banks and five minority-owned thrifts have had their depositors paid off in a manner similar to Freedom National Bank. This compares unfavorably with all bank and thrift closings during a comparable time period (See Table 3). These disparities occurred despite the implementation of aggressive legislative initiatives to maintain ownership of financial institutions in minority areas, especially in the case of RTC thrift resolutions. These initiatives likely account for the smaller gap for such thrift resolutions.

A Market Response to Lack of Investment

The strangest result of the CRA is its treatment of minority-owned institutions that target low-income or minority groups, a market solution to

the problem of a lack of community reinvestment. One would assume that such institutions would do well under the CRA, as they are essentially engaging in "reverse redlining." However, the reality is that a number of minority-owned institutions, including the largest black owned bank, Seaway National Bank of Chicago, the largest black owned thrift, Carver Federal Savings of Harlem, and a disproportionate number of asian-owned institutions, have been criticized by regulators over the past few years. Such institutions have come under criticism primarily because they have not been aggressive enough in lending to low-income borrowers within their communities. These institutions have also been criticized by regulators for focusing on too narrow a segment of the "community."

Remove Governmental Barriers to Low-Income and Minority Lending

Many governmental barriers exist that prevent lending in low-income and minority areas by discouraging the chartering of small financial institutions. These regulations are especially harmful to lower-income areas, because they place a greater weight on smaller institutions, the very type of institution most likely to open in such neighborhoods. Eliminating very small institutions leads to a large gap in size between non-regulated institutions (currency exchanges, pawn shops, and second mortgage operations) and the smallest of institutions existing in the current environment. These barriers have been increased over the past five years, as the regulatory pendulum has swung back with a vengeance. Among these barriers are: barriers to entry erected by the compliance costs imposed by laws such as CRA and fair-lending statutes; the administrative burden of organizing a bank or a thrift; dollar-denominated capital requirements that go well beyond the level dictated by safety and soundness concerns; and the recent aggressiveness and expanded powers utilized in pursuing suits against directors.

Repeal CRA

The CRA should be repealed. Altering the underlying regulations merely leaves the way open for future administrations to utilize the statute as a government credit allocation scheme. CRA has discouraged entrepreneurs who seek to open

financial institutions in lower, middle income or minority communities; has led to criticism of minority institutions for targeting an underserved segment of their community (the very segment the creators of CRA had targeted); it has created incentives to bid away market share from institutions that specialize in low-income lending; and it has prevented institutions from asserting the business necessity defense when accused of implementing policies having a disparate impact upon borrowers. Repealing CRA would level the playing field between those subject to and those not subject to its provisions by assuring that no institutions are required to follow a scheme of reinvestment rules.

CRA was established under the faulty economic premise that the equivalent of a wall should be built up around the ill-defined notion of a "community," preventing an outward flow of deposit dollars, and forcing inefficient and contrived reinvestment. The statute ultimately leads to an economic balkanization that is truly an anachronism in our complex, interrelated, global economy. Similar geographical barriers, such as state and interstate branching laws, have tumbled over the past decade because they have been recognized for what they are: arbitrary geographical limitations on the flow of

financial resources from where they are available to where they are needed.

Meeting the convenience and needs of the community is more appropriately left to market mechanisms. Financial institutions should strive to satisfy convenience and needs as defined by their customers and the marketplace around them, not community organizations or regulators.

Selected Readings

Fishbein, Allen J., "The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement Is Needed," *Fordham Urban Law Journal* (Volume 20-1993).

Macey, Jonathan R. and Miller, Geoffrey P., "The Community Reinvestment Act: An Economic Analysis," *Virginia Law Review* (Volume 79, March 1993).

Thomas, Kenneth H., Community Reinvestment Performance-Making CRA Work for Banks, Communities and Regulators, 1993-Probus Publishing.

is this a book?