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Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act

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DEMOCRATIZING CAPITAL: THE HISTORY, LAW, AND REFORM OF THE COMMUNITY REINVESTMENT ACT†

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The Community Reinvestment Act of 1977 ("CRA")[1] has made great progress in achieving its dual purposes: eliminating bank redlining[2] and promoting reinvestment in previously redlined neighborhoods. In doing so, the CRA has helped to democratize capital by giving more people a voice in bank lending decisions and including more people in the economic mainstream by influencing banks to make more loans to buy homes or open small businesses. Despite the CRA's success, the CRA has not reached its full potential. One of the main reasons for this is that the federal agencies that enforce the CRA are so fearful of allocating credit that they use vague and subjective criteria for evaluating bank lending, making it difficult to hold a bank accountable for a poor lending record or even to know what constitutes a poor lending record. In order for the CRA to reach its full potential, objective and quantitative criteria for evaluating a bank's CRA performance must be implemented. Such criteria will maximize both the public's voice in decisions about bank lending and the number of people who receive loans.

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1. 12 U.S.C. §§ 2901-2908 (2000).

2. *See* BLACK'S LAW DICTIONARY 1283 (7th ed. 1999) ("[Redlining is] credit discrimination (usually unlawful discrimination) by a financial institution that refuses to make loans on properties in allegedly bad neighborhoods."); GLENN B. CANNER, REDLINING: RESEARCH AND FEDERAL LEGISLATIVE RESPONSE 1 n.2 (Board of Governors of the Fed. Reserve Sys. Staff Study No. 121, 1982); Katherine L. Bradbury et al., *Geographic Patterns of Mortgage Lending in Boston, 1982-1987*, NEW ENG. ECON. REV., Sept.–Oct. 1989, at 3.

I. THE COMMUNITY REINVESTMENT ACT AND ITS EFFECT ON DEMOCRATIZING CAPITAL

The CRA imposes on banks a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered,"[3] including low- and moderate-income ("LMI") neighborhoods.[4] The purpose of the CRA is twofold. First, Congress intended the CRA to end the banking practice known as redlining, by which banks would refuse to lend in certain neighborhoods, especially older and inner-city neighborhoods and neighborhoods whose residents were predominantly minority or low-income. Second, the CRA was to encourage banks to lend more in redlined neighborhoods.

The CRA places enforcement of a bank's obligation to meet the credit needs of its local community in the hands of four federal administrative agencies that regulate banks (the "federal banking agencies" or the "agencies").[5] The CRA requires these agencies to examine each bank periodically to determine whether it is helping to meet community credit needs, to issue a written public report — including a rating — evaluating the bank's CRA performance, and to take the bank's CRA record into account when deciding whether

3. 12 U.S.C. § 2901(a)(3).

4. *Id.* at § 2903(a)(1).

5. The four federal banking agencies that enforce the CRA are the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of Thrift Supervision ("OTS"). *See* 12 U.S.C. § 2902(1). Each agency regulates a different type of bank and all the agencies have adopted virtually identical CRA regulations with one major exception. On August 18, 2004, the OTS announced a significant departure from the other agencies' regulations. It adopted a regulation that changed the definition of a small bank for CRA evaluative purposes from a bank with less than $250 million in assets to a bank with less than $1 billion in assets. *See* Community Reinvestment Act Regulations, 69 Fed. Reg. 51,115 (Aug. 18, 2004) (to be codified at 12 C.F.R. pt. 563e). The agencies, the banks they regulate, and their CRA regulations are:

AGENCY	JURISDICTION	REGULATIONS
OCC	National banks	12 C.F.R. pt. 25 (2003)
Federal Reserve	State-chartered banks that are members of the Federal Reserve System	12 C.F.R. pt. 228 (2003)
FDIC	State-chartered banks that are not members of the Federal Reserve System	12 C.F.R. pt. 345 (2003)
OTS	Savings and loans	12 C.F.R. pt. 563e (2004)

to grant certain bank applications to expand their business.[6] When a bank files one of these expansion applications, any member of the public may file comments with the federal banking agency that regulates the bank opposing the application on the basis that the bank has failed to meet its CRA obligations.

One of the CRA's unique contributions has been to "democratize capital." It has done so in two ways. The first may be analogized to voting. The CRA has democratized decisions about the distribution of capital by extending at least part of the decisionmaking "franchise" to previously "disenfranchised" people, in particular low-income and minority persons.[7] Second, the CRA has played a role in distributing loans to people — particularly low-income and minority individuals — who previously did not receive loans, thus including them in the economic mainstream and giving them the same economic opportunity as others.[8] The CRA has done this by influencing banks to make loans to low-income and minority individuals to purchase, refinance, or improve a home; to open or expand a small business; or to support a small farm.

By democratizing capital, the CRA has made great progress in eliminating redlining and promoting reinvestment in redlined neighborhoods. Despite the federal banking agencies' record of weak CRA enforcement, there is substantial evidence that supports the conclusion that the CRA has encouraged banks to lend more money to LMI and minority persons and neighborhoods than they would have without the CRA. The opportunity for disenfranchised

6. 12 U.S.C. §§ 2901(b), 2903(a)(2), and 2906.

7. *See* GREGORY D. SQUIRES, CAPITAL AND COMMUNITIES IN BLACK AND WHITE 69 (1994) ("More importantly, the law created organizing opportunities for community groups to influence mortgage lending policies of private financial institutions."); JOHN TAYLOR & JOSH SILVER, *The Essential Role of Activism in Community Reinvestment*, *in* ORGANIZING ACCESS TO CAPITAL: ADVOCACY AND THE DEMOCRATIZATION OF FINANCIAL INSTITUTIONS 169, 173 (Gregory D. Squires ed., 2003) (The CRA "has created a democratic dialogue between community groups and banks. It mandates that banks meet the credit needs of all the communities in which they are chartered and from which they take deposits. Ultimately, the only way banks can do this is to listen as communities articulate their credit needs."); Donald A. Lash, *The Community Development Banking Act and the Evaluation of Credit Allocation Policies*, 7 J. AFF. HOUS. 385, 398 (1998) (describing the early twentieth century movement to "democratize credit").

8. *See* TAYLOR & SILVER, *supra* note 7, at 182 ("The CRA achieves higher loans and investments for traditionally underserved communities through a process of information sharing, evaluation, debate, and compromise.").

members of redlined neighborhoods to comment on a bank's CRA record when it files an expansion application has given them a powerful voice in decisions about the distribution of loans.[9] Banks, which are generally sensitive to bad publicity and risk-averse in their expansion applications, are anxious to have good CRA records both as good public relations and to ensure approval of their expansion applications. Public comments, and the delay and risk they cause to bank expansion plans, have brought banks to the bargaining table with community groups resulting in bank pledges to lend more than one trillion dollars to LMI and predominantly minority neighborhoods nationwide.[10] Even if banks do not have expansion plans in the immediate future, their desire for good public relations, their discovery that CRA-related lending can be profitable, and their desire to prevent comments opposing future expansion applications have motivated banks to change their lending practices, introduce new loan products, and partner with community groups to make lending to LMI and minority persons and neighborhoods part of their business strategies.

Despite its success in democratizing capital, the CRA has not reached its full potential. For example, there remains a disproportionate distribution of subprime mortgage lending — mortgage loans at higher interest rates with more onerous payment terms than prime mortgage loans — in LMI and predominantly minority neighborhoods. There is also evidence that many recipients of subprime loans could have received cheaper prime loans. Additionally, a disproportionate percentage of low-income persons do not participate in the banking system.

II. The Reason the CRA Has Not Reached its Full Potential

There are several reasons the CRA has not reached its full potential for democratizing capital. One of the main reasons is that the federal banking agencies that enforce the CRA utilize subjective criteria for evaluating the CRA performance of banks. Such criteria limit the power of the franchise the CRA extends to LMI and minority persons and the amount of capital they receive because sub-

9. *See* Taylor & Silver, *supra* note 7, at 171.

10. *See* National Community Reinvestment Coalition, CRA Commitments 1997-1998.

jective criteria make it difficult to hold a bank accountable for a poor CRA record or to adequately determine a bank's capacity for lending. In contrast, quantitative and objective criteria for evaluating CRA performance would help maximize the CRA's potential. The reason the agencies have failed to adopt quantitative and objective criteria is their fear that such standards would allocate credit. The CRA's legislative history makes clear that Congress did not intend the CRA to allocate credit, and the agencies fear credit allocation could lead to unsafe and unsound banking practices.

Although Congress passed the CRA to end redlining and to influence banks to make loans to previously redlined neighborhoods, Congress also stated that it did not intend the CRA to allocate credit; another way of stating that the CRA was not to be used to create lending quotas. Congress did not ban quotas, but the legislative history indicates that quotas are not permissible under the CRA.

Reflecting its legislative history, the CRA is designed to influence banks to lend more money in underserved neighborhoods without allocating credit. A bank's CRA obligation to help meet community credit needs is enforced by periodic regulatory evaluations of the bank's CRA record, public disclosure of information about the bank's CRA record, and CRA-related scrutiny of the bank's expansion applications. The CRA does not, however, contain enforcement provisions that might lead to credit allocation, such as mandatory penalties for a bank that fails to satisfy its CRA obligations or a private right of action for individuals harmed as a result of CRA violations.

In the first CRA enforcement regime, which lasted from 1978 through mid-1997 when new CRA regulations replaced the original regulations, the federal banking agencies — all of whom had opposed the CRA — did not emphasize the portion of the CRA or its legislative history that focused on increasing lending to redlined neighborhoods. Instead, they focused on the portion of the legislative history that prohibited credit allocation. The agencies treated the CRA as a law that was intended to correct an information failure in the market. According to this theory, banks redlined because they decided it was not worth the expense or time to seek creditworthy borrowers in particular neighborhoods, especially

LMI, inner-city, or predominantly minority communities. The agencies' perspective was that the CRA requires banks to seek information about lending opportunities in redlined neighborhoods and market loans there. The first set of CRA regulations, which were in force from 1978 through mid-1997, reflected this position. The criteria for evaluating CRA performance under these regulations and the agencies' enforcement of the CRA emphasized the efforts a bank undertook to make loans in its local community. A bank's actual lending was of secondary importance to its efforts to lend. When the agencies evaluated bank lending, they used vague and inconsistent criteria and subjective standards that made it impossible for members of the public to know what a bank's CRA obligations were, let alone hold a bank to them.

Over time, the first CRA enforcement regime generated great dissatisfaction. The regime had the unfortunate distinction of generating dissension among the banks it regulated, the residents of redlined neighborhoods that it was intended to benefit, and the law's enforcers — the federal banking agencies themselves.[11] They all agreed that the CRA was enforced in an arbitrary and inconsistent manner. Bankers complained that it generated unnecessary burden and paperwork, and subjected bank expansion plans to undue delay and expense. Community groups asserted that the federal banking agencies did not fulfill their responsibility to enforce the CRA and that the criteria they used for evaluating bank lending

11. *Community Reinvestment Act: Hearing Before the Subcomm. on Financial Institutions & Consumer Credit of the House Comm. on Banking and Financial Services*, 104th Cong. 148 (1995) (statement of Eugene A. Ludwig, Comptroller, Office of the Comptroller of the Currency) ("[N]o other set of bank regulations was so universally criticized by bankers and customers than these regulations, criticized precisely because they created needless burdens on the one hand and failed to fulfill the promise of the Community Reinvestment Act on the other."), *reprinted in* 14 OFF. OF THE COMPTROLLER OF THE CURRENCY Q.J. No. 2 at 37 (June 1995); *Existing Efforts to End the Crisis: A Report Card: Hearing Before the Subcomm. on Consumer Credit and Insurance of the House Comm. on Banking, Finance & Urban Affairs*, 103d Cong. 55 (1993) (statement of Lawrence B. Lindsey, Member, Board of Governors of the Federal Reserve System), *reprinted in* 79 FED. RES. BULL. 285 (1993); *Plans and Progress to Date of Interagency CRA Regulatory Reform Effort: Hearing Before the Subcomm. on General Oversight, Investigations, & the Resolution of Failed Financial Institutions of the House Comm. on Banking, Finance & Urban Affairs*, 103d Cong. 36 (1993) (statement of Eugene A. Ludwig, Comptroller, Office of the Comptroller of the Currency), *reprinted in* 12 OFF. OF THE COMPTROLLER OF THE CURRENCY Q.J. No. 4 at 27 (Dec. 1993); U.S. GEN. ACCOUNTING OFFICE, COMMUNITY REINVESTMENT ACT: CHALLENGES REMAIN TO SUCCESSFULLY IMPLEMENT CRA 5 (Nov. 1995).

were too vague and subjective to allow them to hold a bank accountable for a poor record of meeting community credit needs.

In response to the many criticisms of the first CRA enforcement regime, the federal banking agencies began a rulemaking process in July 1993 that culminated in new CRA regulations in April 1995. These rules were fully phased in by July 1997. The new regulations made some improvements and some progress towards implementing objective and quantitative criteria for evaluating the CRA performance of a bank. Specifically, the second set of CRA regulations eliminated the criteria that evaluated bank efforts and replaced them with criteria that evaluated a bank's lending, investment, and service performance. The regulations require the federal banking agencies to consider the extent of the bank's lending in its community, the geographic distribution of its loans, and its lending to persons of different income levels. However, the regulations do not contain objective and quantitative criteria for measuring bank lending and community credit needs, or evaluating whether the lending meets credit needs. Thus, despite the improvement, the regulations fall short of fulfilling the capital-democratizing promise of the CRA.

The first proposed draft of the new regulations, however, came very close to utilizing objective and quantitative criteria for evaluating the CRA performance of a bank. It had a "market share" test, which would have evaluated a bank's record of meeting community credit needs by comparing a bank's market share of loans in LMI neighborhoods with its overall market share of loans. There was also a loan-to-deposit ratio ("LDR") test, pursuant to which the percentage of a bank's deposits that it returned to the community in the form of loans would be compared with an ideal 65% LDR. Finally, the regulations evaluated the percentage of a bank's loans in its community. If a majority of loans were in the bank's community, this was "appropriate." The banking industry criticized the market share and LDR tests as allocating credit, and the federal banking agencies dropped them from the final regulations.

The failure of the federal banking agencies to adopt CRA regulations that use objective and quantitative criteria for evaluating a bank's CRA performance means that the CRA still has a long way to go before reaching its potential for democratizing capital. Despite improvements in the second set of CRA regulations, the agencies continue to enforce the CRA in a way that makes it nearly impossible for community groups to hold a bank accountable for a poor lending record. In conducting performance evaluations, the agencies did not use a fixed set of CRA evaluative criteria; frequently employed criteria consisting of a quantitative measure of bank lending or a quantitative benchmark of community credit needs, but used subjective standards to compare bank lending with the benchmark; did not define the level of performance required to meet a particular subjective standard; used the subjective evaluative standards inconsistently and almost always in a way that favored banks; and did not define the weight each criterion had. The agencies' decisions on expansion applications similarly did not use a fixed set of criteria and used subjective standards for evaluating bank lending. The decisions generally listed facts about the bank's lending, emphasized strengths and excused weaknesses, and did not describe the reasoning the agency employed in reaching the decision.

III. Quantitative and Objective CRA Evaluative Criteria that do not Allocate Credit

In contrast to subjective standards for evaluating CRA performance, a fixed set of objective and quantitative criteria for evaluating a bank's CRA performance would maximize the CRA's potential for democratizing capital. Such criteria would make it easier to hold a bank accountable for a poor CRA record and would more clearly define how much lending a bank should be doing. Despite the federal banking agencies' fear of allocating credit with such criteria, it is possible to use such criteria without allocating credit.

Before describing the criteria, it is helpful to describe in more detail the difference between allocating credit and influencing banks to lend. "Allocation" is defined as the act of apportioning "for specific purposes or to particular persons or organizations," as in, for example, a governmental or economic control measure.[12] Based on this definition, "credit allocation" would take the form of governmental apportioning of bank loans for specific purposes or to particular persons. In fact, in the CRA's legislative history, CRA's

12. Webster's Third New International Dictionary of the English Language Unabridged 57 (1993).

opponents equated credit allocation with credit quotas. Anything less than a specific apportionment or a quota is not credit allocation, but an attempt to influence a bank to lend to particular persons. Even if the attempt to influence is a strong one, it is not credit allocation as long as it is not a specific apportionment or a quota.

There are several examples of governmental interventions in the credit markets that help elucidate the difference between allocating credit and attempting to influence banks to lend. As an example of credit allocation, the Department of Justice entered into several consent decrees requiring banks it had accused of violating the fair lending laws to make specific dollar volumes of loans to particular neighborhoods or borrowers. In contrast, the Home Mortgage Disclosure Act influences banks to lend to minority and low-income individuals and neighborhoods by requiring banks to disclose information about the race and income of their loan applicants and borrowers and the location of their loans. Somewhere in between consent decrees that allocate credit and laws that influence banks to lend through disclosure is a law that sets loan purchase targets for Fannie Mae and Freddie Mac and a law that sets reinvestment ratios for the out-of-state branches of interstate banks. While these two laws establish investment and loan targets, the targets are not quotas. The laws are based on the lenders' own market presence, the targets are easy to reach, and the penalties for failing to reach the targets are weak and remote.

Similarly, objective and quantitative criteria for evaluating a bank's CRA performance can strongly influence banks to lend without allocating credit. Specifically, criteria that compare a bank's lending record with the entire market and judge a bank to have satisfied its CRA obligations if it outpaces the market, but not to have satisfied its CRA obligations if it lags behind the market, influence banks to lend without allocating credit. For example, criteria could be established that compare a bank's percentage of loans to low-income or predominantly minority neighborhoods with the percentage of such loans by all lenders in the bank's community. If the bank's percentage is higher, it is meeting the credit needs of that community. If the bank's percentage is lower, it is not meeting that community's credit needs. For example, if a bank made 10%

of its loans to low-income individuals compared with 15% of loans to low-income individuals by all lenders in the bank's community, the bank has failed to meet the credit needs of low-income individuals.

Such criteria do not allocate credit because they do not set a quota of loans the bank must make to low-income individuals. They use the market for loans as a benchmark. The market is not a quota; it is what it is. While such criteria do not require a bank to make a certain number of loans, they certainly influence a bank to make loans in order to ensure that it satisfies its CRA obligations. Finally, such criteria are objective and quantitative, making it easier to hold a bank accountable for a poor lending record and to ensure it is doing its share to meet community credit needs, and will thus help maximize the CRA's potential for democratizing capital.