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THE COMMUNITY REINVESTMENT ACT AN OVERVIEW

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I. Overview

A. Congress enacted the Community Reinvestment Act (CRA) in 1977. At that time, the law's purpose was generally understood as being to require the federal bank regulators to assess depository institutions' lending performance in their communities, with an emphasis on learning how such institutions were serving their local communities' credit needs consistent with the institutions' continued "safe and sound" operations.

B. In the CRA's "statement of purpose," Congress "finds" that "regulated financial institutions have [a] continuing and affirmative obligation to help meet the credit needs of the local communities" they serve.[1] In addition, the federal bank regulators are instructed by the CRA's "statement of purpose" "to encourage [regulated depository] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[2]

C. Because of the broad language of the "obligation" imposed by the CRA's statement of purpose, many in the banking industry initially assumed that CRA obligations were merely hortatory to depository institutions. Over time, however, the federal bank regulators have come to view the law as imposing a substantive obligation on depository institutions, and they now enforce it routinely through their approval processes for various types of regulatory applications by banking organizations. In turn, this approach has produced significant disputes – both in connection with specific bank transactions and in connection with periodic legislative efforts to limit consideration of CRA issues within regulatory processes.

II. How the CRA Works

A. Implementing Agency Regulations. The CRA itself does not specify how to measure a depository institution's performance in meeting the credit needs of its "community." Under the CRA, however, Congress has given the federal bank regulators authority to promulgate regulations interpreting and implementing the

Act. These agencies have done so, jointly issuing comprehensive regulations detailing how regulated institutions are to be evaluated with respect to meeting their CRA obligations.[3]

B. Definition of Community. The focus of a depository institution's obligations under the CRA is helping to meet the lending needs of the institution's "community." As a result, the proper definition of what constitutes depository institution's "community" is a key issue.

1. Assessment area: Under the CRA regulations, a depository institution is obliged to designate an "assessment area delineation" to serve as the areas within which the federal bank regulators will measure the institution's performance in helping to meet the lending needs of its "community."

(a) The critical "assessment area delineation" is chosen by the institution itself, although the institution must make this designation of its community according to "principles" enunciated by the federal bank regulators.

(b) These "principles" that a depository institution must follow in designating its assessment area delineation require that an assessment area must be one or more metropolitan statistical areas (MSAs) (as defined by the Office of Management and Budget), or one or more contiguous political subdivisions; and that the assessment area delineation must include the "geography" (defined as a census tract, or a block numbering area) in which the institution has its main office, any branches or deposit-taking ATMs, as well as surrounding geographies in which the institution has originated or purchased a substantial portion of its loan portfolio.

(i) Because assessment area delineations are essential to the whole scheme of enforcing the CRA, assessment area delineations must consist of *contiguous* political subdivisions to prevent gerrymandering. In other words, regulators require that geographies included within an assessment area be adjacent in order to prevent regulated institutions from skipping over poorer areas when making their assessment area delineations.

(ii) The regulations also require that a depository institution must include an *entire* "geography" if it is required to include any part of the geography. (A "geography" is a subset (and thus smaller than) an MSA.)

(iii) A depository institution likewise cannot "arbitrarily exclude" low- and moderate-income geographies from an assessment area. The regulations, however, do not define the term "arbitrarily exclude," thus often leaving depository institutions and regulators at loggerheads over whether certain areas should be included within an institution's assessment area.

(iv) Depository institutions may find themselves with more than one assessment area delineation. But each such area is judged independently for compliance with the CRA.

(v) Internet banks have created a unique dilemma for regulators attempting to impose "community" lending obligations on such institutions. This area is very much in flux, with some institutions maintaining that their CRA obligations are only to the community in which their headquarters are located, while others delineate assessment areas based on areas that contain significant portions of their loan portfolios.

C. <u>Data Reporting</u>. The CRA regulations require that all depository institutions (other than those classified as "small banks," discussed below, *see* Part II.E.4) must submit annually the following data:

1. <u>Small business and small farm loans</u>: For each loan, the loan amount, loan location, and whether the business or farm had less than $1 million in gross annual revenues.

2. <u>Community development loans</u>: The aggregate number and amount of community development loans made or purchased.

3. <u>Home mortgage loans</u>: In addition to other requirements imposed by the Home Mortgage Disclosure Act (HMDA), a depository institution must report each home mortgage application, origination, or purchase of a home mortgage loan outside the MSA of a depository institution's home office or that of one of its branches.

4. <u>Consumer loans</u>: Depository institutions may also submit (but are not required to do so) information on various types of consumer loans (such as car loans, credit cards, and home equity loans), as well as community development lending by affiliates.

5. <u>Public disclosure report</u>: The reported data are used by the federal bank regulators to prepare an annual CRA disclosure report for each depository institution, summarizing the type, amount, location, and borrower

characteristics of the institution's lending in the previous year. This report is made publicly available.

D. Examination Requirements. In addition to reporting requirements, the Act contemplates that the federal bank regulators will examine each depository institution to measure compliance with CRA obligations. Aside from statutory constraints on the intervals between CRA obligations for small institutions (discussed below, Part III.C.2), each federal bank regulator sets its own schedule for the interval between CRA examinations of individual institutions.

1. Public CRA report: After an examination, the federal bank regulator conducting the exam must prepare a written report assigning a CRA rating to the depository institution and explaining the reasons for the rating.[4] This report must be made public (although the Act does provide for a confidential section, where the names of individual customers, employees or officers must be placed, as well as other information that the regulator deems too speculative or sensitive for public release). This examination report must be made available on request at the institution's main office as well as at each of its branches.

2. Public CRA file: In addition to the public report on the institution's CRA rating, the regulations also require a depository institution to maintain a public file containing (i) all correspondence in the previous two years to and from the community regarding the institution's performance in helping to meet the credit needs of the community; (ii) a list of all of the institution's branches, their hours of operations, as well as those opened and closed during the past year; (iii) a list of all of the institution's other remote service units (such as ATMs); and (iv) a map of the institution's assessment area(s). Most of this information need only be available at the depository institution's main office, although the public must be able to receive it at any branch within five days after it is requested.

E. Tests For Measuring Compliance With the CRA.

1. General tests: The federal bank regulators generally measure depository institutions' CRA performance using three separate tests. These tests include the "lending test," the "investment test," and the "service test." Each test is separately scored by regulators on a scale of "outstanding," "satisfactory" (or variants thereof, such as "high satisfactory"), "needs to improve," or "substantial noncompliance." The institution is also given an overall CRA rating on this scale, reflecting a combined, weighted average of the three individual performance measures.[5]

(a) *Lending Test:* The most important test (and the most highly weighted in the overall CRA score for the institution) is the lending test. Federal bank regulators use five criteria to measure how an institution is helping to meet the credit needs of its community through traditional lending activities. These include:

(i) The amount of the depository institution's consumer and small business lending in its assessment area(s).

(ii) The geographic distribution of loans within the depository institution's assessment area(s), including the proportion of loans in each assessment area, the dispersion of lending in each assessment area, and the number and amount of loans made in each assessment area to low-, moderate-, middle-, and upper-income geographies within the area.

(iii) The "characteristics" of the depository institution's borrowers, such as whether their annual income makes them "middle-class," or whether a "small business" borrower has less than $1 million in annual revenues.

(iv) The number and amount of the depository institution's community development loans, including the "complexity and innovation" of these loans.

(v) Particularly innovative or flexible practices by the depository institution "to address the credit needs of low- or moderate-income individuals or geographies."

(b) *Investment Test*: The investment test measures the institution's "record of helping meet the credit needs of its community" by "investing" or donating money for community development in its assessment area(s). For example, a grant of funds to a local organization that provides educational seminars and counseling for first-time homebuyers would likely count toward an institution's performance under the "investment test."

(c) *Service Test*: The service test measures the institution's distribution system "for delivering retail banking services" to its assessment area(s) ("or a broader statewide or regional area that includes a bank's assessment area(s)"); and also "the extent and innovativeness of its community development services."

2. <u>Evaluation of actual performance</u>: The lending, investment and service tests focus on an institution's *actual* performance. At the same time, the approach to measuring an institution's compliance with its CRA obligations is not one that provides a "safe harbor" in the sense if an institution meets certain benchmarks, it then necessarily receives a certain

rating; rather, the evaluation process involves considerable judgmental discretion by the regulator making the evaluation.

3. Strategic plan alternative: Under the CRA regulations, a depository institution may elect to file with its regulator, for pre-approval, a "strategic plan" for complying with its CRA obligations. Such a plan is required to set out "measurable goals" for addressing, as appropriate, the factors outlined in the lending, investment, and service tests. The goals are required to specify what level of activity is needed to meet a "satisfactory" rating, and what is necessary for an "outstanding" rank.

   (a) Because the regulatory approval process for a depository institution's strategic plan is required to be open to public comment, the attractiveness of the option may be limited for some institutions. The practical effect of allowing community involvement in the pre-approval of a depository institution's formulation of a strategic plan can be to encourage some of the same "hold up" problems as those that can occur when a depository institution files a regulatory application for approval (discussed below, Part III).

4. "Small bank" exemption: Reflecting their considerable political clout, small banks – those with less than $250 million in assets and not affiliated with a holding company having more than $1 billion in assets – are, by statute, exempt from the lending, investment and services tests outlined above. Instead, such small banks are given a CRA performance rating based on their loan-to-deposit ratio; other lending-related activities, such as community development loans; the geographic distribution of their lending; and their record of lending to borrowers of different income levels and to businesses and farms of different sizes. In short, small banks are subject to a much less in-depth evaluation process.

5. Wholesale and limited-purpose depository institutions: Depository institutions that do not engage in retail lending activities are also subject to less onerous regulatory CRA evaluation standards. Such institutions' CRA performance is measured based on their number and amount of community development loans or "qualified investments" in community development projects, their responsiveness to credit and community development needs, and the innovativeness of their community development undertakings.

6. Affiliate performance: The community development lending and investment activities of depository institutions' affiliates can also be counted toward the institutions' own CRA obligations.

F. Borrowers Served Within the Community – Women and Minorities.

1. When the CRA was initially enacted in 1977, Congress did not mention race or gender as criteria on which depository institutions should be evaluated in connection with their lending activities; rather, the focus of the CRA was solely on serving an institution's "community." As a result, if a depository institution were located in a non-minority community, it was presumed that the CRA did not obligate it to take affirmative steps to serve women and minorities outside its assessment area.

2. In 1992, however, Congress added to the CRA two sections that specifically focused on the race and gender of CRA beneficiaries. The first provision permits regulators to count a majority-owned institution's activities with minority-owned or women-owned institutions – for example, funding arrangements – toward the majority-owned institution's CRA obligations. The second provision permits depository institutions to count toward their CRA lending performance the cost of leasing a branch rent-free, or on otherwise favorable lease terms, to a minority- or women-owned depository institution. (For these purposes, minority- or women-owned institutions are defined as those institutions in which 50% or more of ownership or control is held by one or more persons who is a minority or a woman.)

3. In 1994, race and gender also were included for the first time in proposed new regulations detailing a regulated depository institution's CRA obligations. The proposed regulations did not impose any specific lending obligation with respect to minority and women borrowers, but the regulations would have required the collection of race and gender data for small business and small farm loans.

4. In the final 1995 regulations, these proposed provisions were ultimately replaced with a requirement that depository institutions report the geographical distribution of their small business and small farm lending. The 1994-95 CRA regulatory revisions brought to light a fundamental issue as to whether CRA's purpose is to encourage depository institutions to serve a particular geographic area or to lend to a particular set of borrowers.

III. Enforcement of the CRA

A. Scope of Regulatory Enforcement. The CRA is enforceable only through the regulatory application process, and not through direct judicial action. Specifically, under the Act the federal bank regulators are directed to take into account a depository institution's CRA performance whenever the institution or its holding company files an application for:

- A new charter
- Federal deposit insurance
- Establishment of a new branch
- Relocation of an institution's main office or a branch
- A merger, or purchase and assumption transaction, with another depository institution
- Acquisition of another depository institution

There is no statutory authority to fine an institution for failing to comply with the CRA or to enter a cease and desist order for failing to do so (bank regulators proposed to adopt such authority by regulation in 1994, but eventually dropped the idea when adopting their final rule in 1995). The only potential penalty is through regulatory denial or conditioning of a required approval of a covered application.

B. Regulatory Process. Under the current CRA regulations, the federal bank regulators "take[] into account any views expressed by interested parties," including community and local activist groups, when deciding whether an institution's CRA performance is adequate to approve the pending application.

1. In practice, community and local activist groups have often protested the applications of depository institutions and their holding companies on CRA grounds in an apparent effort to hold up the transaction until certain demands are met. On occasion, such protests have caused institutions or holding companies seeking regulatory approval for a transaction to modify particular business practices in order to satisfy such groups and/or the federal bank regulator, or even to agree to provide a protesting group with financial support for its particular projects. More often, however, the federal regulators have rejected these sorts of protests and proceeded to approve an institution's or a holding company's application.

2. When federal bank regulators have approved applications notwithstanding CRA protests, community groups have occasionally sued the regulator to block the approval. The courts, however, thus far have dismissed these actions on the ground that CRA protesters suffer no constitutional "injury" necessary to invoke federal jurisdiction.[6]

C. Gramm-Leach-Bliley Act 1999 Revisions to the CRA.

1. The Gramm-Leach-Bliley Act extended the reach of the CRA by requiring that, in order for a bank holding company to become a financial holding

company (and thus able to exercise the additional powers provided under the Gramm-Leach-Bliley Act), all of the company's subsidiary depository institutions must have an overall CRA rating of "satisfactory" or higher.

2. The Gramm-Leach-Bliley Act also limited the required cycle of CRA examinations for small institutions (those with assets of $250 million or less) to not more than once every five years for those small institutions that received an "outstanding" rating on their previous rating, and to not more than once every four years for those small institutions that obtained a "satisfactory" rating on their last evaluation. The Gramm-Leach-Bliley Act does permit, however, examinations before the expiration of such time periods if it is necessary for the approval of an application submitted by a small institution.

3. The Gramm-Leach-Bliley Act mandated the public disclosure of all CRA agreements between banking organizations and community groups or other private parties if such agreements provide grants or assistance of more than $10,000 annually, or more than $50,000 in loans annually (subject to certain exceptions).

   (a) Depository institutions that enter into covered CRA agreements must report annually to federal bank regulators the amount of payments, fees, or loans made to or from other parties. They also must report aggregate data on loans, investments, and services provided in the relevant community by each party pursuant to the agreement.

   (b) Community groups and other non-depository institution parties to covered CRA agreements must provide a detailed accounting of the use of funds received under such agreements. Willful or material failure to comply with these disclosure obligations can result in federal bank regulators' annulment of an agreement or an order to disgorge the funds received.

IV. Critiques of the CRA; and Suggested Reforms

A. <u>General Criticisms</u>. At the time the CRA was enacted, it was generally assumed that the obligations it imposed on depository institutions would not cost institutions anything. Congress expressed the belief that, to the extent CRA caused institutions to make additional loans (or other banking services) available within their local communities, institutions would be able to do so profitably.[7] CRA was not intended to alter the economics of banking, much less to convert depository institutions into public utilities.

1. Commentators have argued, however, that the practical effect of the CRA has been to impose an indirect tax on banking services that is ultimately

paid for by depositors and borrowers.[8] To maintain competitive returns on capital relative to non-depository institutions, depository institutions arguably must either charge more for other banking services or offer less services for the same price in order to support their CRA-related activities.

(a) In this regard, it bears noting that only depository institutions are subject to the CRA, while other lenders are not. Thus, depository institutions are arguably put at a competitive disadvantage relative to these other lenders to the extent that CRA compliance concerns drive them to make loans they would not otherwise make.[9]

(b) The social usefulness of such an "indirect tax" has been questioned on the ground that there are other, more direct ways to lend to low- and middle-income borrowers, such as direct governmental lending through community development banks.[10]

2. Commentators have also expressed concern that a perverse result of the CRA is that it likely causes depository institutions to stay away from underdeveloped and minority areas because if an institution locates near such an area, those areas will become part of the institution's assessment area. If the institution stays away from these areas, by contrast, it will entirely avoid an obligation to those borrowers. The result may be that depositors in poor areas pay more (or get less) because banking services are scarcer than would be the case if no CRA obligations were imposed. Of course, this result is exactly contrary to the CRA's goals.[11]

3. Finally, commentators have noted that the CRA enforcement mechanism – effectively enforcing CRA compliance only at the time a regulatory approval is necessary – taxes valuable economic transactions and gives depository institutions less incentive to undertake them.

(a) In this regard, it is not at all clear that only depository institutions with good CRA ratings should be the ones to undertake expansion. In fact, these institutions may be some of the most unsafe and unsound precisely because they are lending to borrowers who have higher risks of default.[12]

(b) More importantly, the CRA approval process has sometimes resulted in "holdup" efforts by community groups and local activists. Such groups may demand some form of payment in return for dropping their objections to what may otherwise be a profitable (and thus economically worthwhile) corporate transaction. Any resulting payments to local groups raise the price of these corporate transactions and thus may prevent, on the margin, some transactions that might otherwise occur.[13]

B. Proposals for Reform. At present, there are no major efforts underway to reform the CRA. Various commentators have suggested, however, the following steps, among others, to make the CRA more efficient in achieving its stated goals:

1. First, it has been suggested that the CRA might be reformed to shift the focus of depository institutions' lending obligations either away from a "community" focus and more to a "preferred borrower" focus, or *vice versa*. As it is now, CRA obligations often are at war with themselves, encouraging depository institutions to serve both communities and particular types of borrowers (*e.g.*, low- or middle-income, or women and minority) borrowers within that community. As a result, as noted, depository institutions are given the incentive to stay away from poorer communities, which likely would require the institution to make more risky loans.[14]

2. Second, a "safe harbor" approach has been advocated by some commentators. Under such an approach, the Act, or its implementing regulations, would specify what activities, if undertaken, would guarantee the depository institution a particular CRA performance rating. Such an approach would give depository institutions a clear set of standards to follow, and the resulting certainty would enable risk-averse depository institutions to operate more efficiently and more effectively.[15]

3. Finally, some academics have advocated tradable CRA obligations.[16] Such a program would not only afford depository institutions flexibility, it also arguably would show the true cost of CRA obligations. However, because there currently is no precise definition of what a depository institution must do to comply with the CRA (*i.e.*, there currently is no safe harbor), it would likely be impossible for the market to price such obligations.

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ENDNOTES

[1] 12 U.S.C. § 2901(a).

[2] *Id.* § 2901(b).

[3] *See, e.g.*, 12 C.F.R. part 228 (2000).

[4] As discussed further below, federal bank regulators assign an institution an overall CRA performance score on a scale of "outstanding," "satisfactory" (or variants thereof, such as "high satisfactory"), "needs to improve," or "substantial noncompliance."

[5] The CRA regulations prescribe a set of principles for assigning an institution's overall CRA rating based on the three individual performance measures. For example, the regulations provide that an institution may not be assigned an overall CRA rating of "satisfactory" or higher unless it receives a rating of at least a "low satisfactory" on the lending test.

[6] *See, e.g.*, *Inner City Press v. Board of Governors*, 130 F.3d 1088, 1089 (D.C. Cir. 1997); *Lee v. Board of Governors*, 118 F.3d 905, 911 (2d Cir. 1997).

[7] *See* Macey & Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 304 (1993).

[8] *See* Bierman *et al.*, *The Community Reinvestment Act: A Preliminary Empirical Analysis*, 45 HASTINGS L. J. 383, 406-07 (1994).

[9] *See* Macey & Miller, *supra*, at 295, 312-14.

[10] *See id.* at 296.

[11] *See id.* at 296, 340-41.

[12] *See id.* at 319-24.

[13] *See id.* at 323.

[14] *See id.* at 295.

[15] *See* Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993). Under the current CRA regulations, the only thing similar to a safe harbor is the pre-approved strategic plan, but even such a plan does not bar – does not provide a "safe harbor" from – a protest in the context of a regulatory application.

[16] *See* Klausner, *Market Failure and Community Reinvestment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561 (1995).

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