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By Hal S. Scott



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The Reinvented Community Reinvestment Act

By Hal S. Scott

The Community Reinvestment Act (CRA), enacted in 1977 during the Carter Administration, requires federal banking agencies to encourage banks and thrifts (banks, for short) to meet the credit needs of their local communities (including low and moderate income neighborhoods) consistent with safety and soundness considerations. Communities are the areas contiguous to bank offices.

At the outset, there are major flaws in the concept. First, absent racial discrimination—which is subject to attack under a variety of other federal laws including the Equal Credit Opportunity and Fair Housing Acts (see the Justice Department's action in the Chevy Chase case)—why wouldn't the market dictate that banks loan to their communities when it was consistent with safety and soundness? The Act can only be understood as pressuring banks to make non-market loans.

Second, why is this obligation put only on banks, as compared with other lenders—for example, finance companies or credit unions? If the idea is that banks should invest a portion of local savings in the communities from which they are taken, this flies in the face of the basic idea behind banking—to direct savings to their highest economic use. Only in this way can savers in poor communities get high rates of interest. Less profit for banks will translate into lower returns for savers who will eventually move their funds into other institutions (mutual funds, for example) without such reinvestment obligations. Moreover, poor communities are capital poor, not capital rich. Real development cannot be meaningfully financed from local savings.

If the idea is that banks should repay society for the benefit they receive from the federal safety net—deposit insurance, bailouts, lender-of-last resort facilities—those benefits have been vastly curtailed since the thrift crisis. Ken McLean, the key staffer for Senator Proxmire, the Chairman of the Senate Banking Committee in 1977 who pushed for CRA, has recently made this point. We now have risk-based deposit insurance, least-cost resolution requirements for bank failures, and restrictions on central bank support. Indeed, banks over the last few decades have become less profitable; many large U.S. banks' shares have traded at discounts from book value. The imposition of social lending requirements on banks will mean that capital will go elsewhere. Third, it discourages banks from locating in poorer communities where they will be saddled with legal obligations to loan money.

CRA Today

Under current regulations, four different CRA ratings are assigned to institutions based on examinations with regard to 12 very general assessment factors, many of which are procedural—for example, the extent of participation by the bank's board of directors in formulating and reviewing the bank's CRA policies. Some, however, are substantive—for example, the bank's participation in government-subsidized loans for housing, small busi-

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ness, or small farms. There is no specific mention of racial minorities, women, or poor people; the emphasis is on meeting the general credit needs of the community.

CRA performance is taken into account by banking regulators whenever a banking organization applies for permission to open a new branch or make an acquisition. Interest groups have used this requirement to file extensive protests against applications based on banks' alleged shortcomings in fulfilling their CRA obligations under the general assessment factors. These protests can lead to hearings and significant costly delays in approving applications. In many cases, groups have threatened to file oppositions unless the bank agreed to loan an agreed amount of money to certain groups or projects, a form of regulatory blackmail. While regulators have generally given banks high CRA ratings based on examinations—94 percent were rated in the top two categories in 1994—they have not relied exclusively on these examinations; instead they have been susceptible to the protests of interest groups.

The Clinton Administration Proposals

In December 1993, the Clinton Administration proposed a new set of regulations to reinvent the Community Reinvestment Act. It described its proposals as “performance”-based rather than “process”-based. Compliance was to be measured not by whether a bank had a process designed to achieve more community-based lending, but by whether such lending actually occurred. The proposals were also justified as providing more objective measures of CRA compliance in lieu of examiner discretion.

The proposals were actually put forward on a coordinated basis by the banking regulators. The Administration has political control over three of them: the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Office of the Comptroller of the Currency. The Fed, which is independent, has reluctantly gone along, some governors secretly hoping, I believe, that adverse reaction would derail the proposals.

When the December 1993 proposals were widely criticized by the industry as being too rigid and burdensome, and by community groups as being too lax, a new set of proposals were put forward in September 1994.

Under the revised proposals, CRA compliance for large retail banks (\$250 million or more in assets) is to be primarily measured by ratings under three performance tests—Lending, Investment, and Service Tests. Unlike the original proposal, performance is to be judged in “the context” in which the institution being evaluated operates. Thus, the agencies would take into account the demographics and credit needs of an institution's service area and the banks' product offerings, business strategy, and condition. The introduction of “context” represents a retreat from objectivity and a return to regulatory discretion.

The Lending Test

The objective of the Lending Test is to increase certain types of lending—small business and small farm (annual revenues of \$1 million or less), home mortgage, community development, and, at a bank's election, consumer loans (target loans)—to low- and moderate-income areas (target areas). “Community development loans” are explicitly defined as nonmarket loans for affordable housing or other community economic development needs.

Performance under the Lending Test is measured by a number of factors, including the proportion of an institution's lending within its service area and the extent to which such loans are made to preferred borrowers within that area. Five rating categories are formulated

to measure performance (Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, Substantial Noncompliance).

Under the original proposal, ratings were to be assigned primarily on the basis of a market share test: how a bank's market share of target loans in its target area compared with its market share of target loans in the rest of its service area. This test was heavily criticized. The measurement device did not insure more preferred lending. Suppose a bank had a market share of 20 percent in the target area and 40 percent outside. It could respond by decreasing its market share in target loans outside the target area, for example, by making more loans to large corporations, or increasing its loans within the target area by buying loans from banks with surplus target area loans. Deadweight compliance costs would be incurred with no benefit for low- or moderate-income areas. On the other hand, any real increase in target area lending could well lead banks to make riskier loans, given the limited pool of sound credits in these areas.

Having rejected an objective but flawed market share performance measure, the proposal now ostensibly uses a catalog of factors to arrive at a rating, all of which call for substantial discretion on the part of examiners. For example, among the factors leading to an "outstanding" rating would be "excellent responsiveness" to the credit needs of its service area, being a "leader" in making community development loans, or "extensive use" of innovative or flexible lending practices. However, one suspects market share calculations may still be used in the background.

The Investment Test

The Investment Test seeks to increase certain target investments that would benefit low- and moderate-income areas or persons within a bank's service area or a broader statewide or regional area that includes the service area. Target investments include investments (or grants) in support of affordable housing or other community economic development needs that are not being met by the private market. They also include investments that primarily benefit low- or moderate-income individuals and small businesses or small farms, as well as rent-free donations of branches in minority neighborhoods to any minority depository institution or women's depository institution.

Under the original proposal, Investment Test ratings would have been based on the ratio of target investments to capital. This would have penalized banks with high capital. For safety and soundness reasons we want to keep capital high; this would have given banks the opposite incentive. Under the revised proposal, the ratio test was dropped in favor of more discretionary criteria like those used for the Lending Test.

The Service Test

The Service Test would evaluate a bank's systems for delivering retail banking services. For example, it would look at the distribution of a bank's branches and ATMs among different income areas, and its record of opening and closing branches and ATMs, or the availability of alternative systems for delivering retail services (e.g., home banking) as between such areas. The Service Test would also evaluate the extent to which banks offer community development services—services provided to preferred groups (e.g., low- or moderate-income individuals) or small businesses or small farms. Again, a variety of discretionary criteria are used to arrive at a rating.

Composite Ratings

A complex two-step system is used to arrive at an overall CRA rating for retail banks. First, a bank's rating for each of the component tests would be assigned on the following basis:

Component Test Ratings	Lending	Investment	Service
Outstanding	12	6	6
High Satisfactory	9	4	4
Low Satisfactory	6	3	3
Needs to Improve	3	1	1
Substantial Noncompliance	0	0	0

Second, a bank's total points would be combined to reach an overall rating: Outstanding, 18 or more; Satisfactory, 9-17; Needs to Improve, 5-8; and Substantial Noncompliance, 0-4. At the urging of community groups who wished to put primary weight on lending, points assigned to investment and service cannot, in combination, exceed those for lending. For example, if lending was 5 and combined investment and service were 8, the total score would be 10 (5+5).

High ratings do not ensure regulatory approvals—they are not conclusive evidence of performance. Community group protests can still be taken into account.

Special Rules: Strategic Plans, Wholesale and Small Banks

The proposal would afford all banks an alternative to using the various Tests discussed above. A bank could have its CRA performance evaluated under a "strategic plan" submitted for public comment and approved by regulators. The plan has to specify measurable goals for lending, investment, and services. The rating would be based on whether a bank substantially achieved those goals.

Special rules are used to assess the performance of "wholesale" or "limited-purpose" banks, basically banks not engaged in the business of making retail loans. CRA performance for these banks is evaluated under a "Community Development Test" which focuses on community development loans and services in addition to application of the Investment Test. Banks will receive credit for loans, service, and investment both within and outside their service areas, but credit for outside the service area cannot normally exceed credit for inside.

Small banks (less than \$250 million in assets) are subject, at their election, to a streamlined CRA review. Their performance would be evaluated on the basis of a watered-down version of the Lending Test.

Data Reporting

Large banks would have new data reporting requirements with respect to target loans. Loan data would have to include the number of applications and denials and the number and amount of approvals for loans secured by properties outside a bank's mortgage service

area, data not presently required under the Home Mortgage Disclosure Act. While some of the additional reporting is less than originally proposed, the revised proposal requires, for the first time, that race and gender data be reported for small business and small farm loans.

Enforcement

The revised proposal, like the original, calls for new enforcement techniques. Enforcement of the regulations would no longer be done exclusively through the application review process. The proposal would allow the regulatory agencies to impose cease-and-desist orders and civil money penalties in cases of the lowest rating—Substantial Noncompliance. The Department of Justice, however, determined in December 1994 that there was no authority under CRA for these new enforcement measures.

Commentary

These proposals will impose serious new compliance costs. The Independent Bankers Association has estimated that current CRA compliance costs are \$1 billion annually, and the American Bankers Association's recent survey estimated that the original proposals would cost an additional \$100 million. Also, there is the potential for significantly higher loan losses. It is thus likely that, in the short term, the marginal cost of credit for all borrowers will increase (or the returns to savers will decrease) as banks pass on some of these new costs. And the amount of government tax revenue will decrease as banks become less profitable. In the longer term, bank safety and soundness may be significantly eroded. Credit allocation schemes have indeed bankrupted banking systems in other countries.

The Clinton Administration began reinventing CRA by trumpeting the virtue of performance- rather than "process"-based assessments. At first, many banks were sympathetic to the approach; given CRA, they wanted to make a reasonable amount of targeted lending and be done with it. The original proposals, however, imposed costly new requirements with no safe harbors. After being widely criticized, the agencies retreated into the more shadowy world of regulatory discretion. The proposal is full of vague concepts like "context" and "innovative" lending. The scoring system is arbitrary. For example, why does lending count less than investment and service for an Outstanding score (12 compared with 6+6) than it does for a High Satisfactory score (9 compared with 4+4)? The Clinton proposals demonstrate proverbial weaknesses of state planning—it is either too rigid or too discretionary. There is no way out of this dilemma short of discarding CRA entirely and permitting the market to determine who receives bank loans, investments, and services.

The original purpose of CRA—to encourage lending within the bank's local community—has been significantly distorted by the Clinton proposals. Now, only loans to preferred borrowers (low- and moderate-income, small businesses, and small farms) within the local community count. Rather than recognizing that wholesale banks have no "local community" but rather serve national and international markets, wholesale banks are directed to steer investments or grants to preferred recipients. And by asking for new data on the sex and gender of borrowers, a clear message is being sent as to which preferred borrowers or recipients may count the most. These initiatives are completely misguided. The entire class of targeted borrowers would be better served by loans made to the most productive enterprises because those firms can provide more jobs to everyone, including the targeted borrowers. It is wrong to require consumers to subsidize non-market (e.g., overly risky) loans by paying higher bank charges.

The original and revised proposals were importantly shaped by the input of community groups. These groups have been successful in securing their own piece of the pie in these

