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The Past, Present and Future of Community Reinvestment Act (CRA): A Historical Perspective

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Abstract

This paper takes a historical approach to understand the evolution of one of the most controversial banking regulations in recent history, the Community Reinvestment Act (CRA) of 1978 and its effects on access to credit and banking services to community borrowers. The paper lays out the historical milieu of credit markets in the late seventies and describes the early justification of this legislation. The paper explores the implementation of the act through regulations on lending institutions and the effects of the regulations on depository lenders and community borrowers. Detailed description of the reactions to CRA regulations by different parties involved in the act is provided. This reaction and consequent revisions to the regulations have contributed to keep the act effective and relevant. In addition to the reactions, the act has responded to the structural reorganization and regulatory changes in the banking sector and mortgage markets in particular. The paper illustrates this dynamic nature of implementation, reactions and revisions that has shaped CRA regulations over last quarter century. The paper argues that historical understanding and justification is important to formulate future changes to the regulation. This understanding is important to keep the act objective, measurable and enforceable. While inclusion of all possible requirements that may enhance community lending is not the correct approach to future changes in CRA, keeping the act static to its initial requirements is also not appropriate from public policy standpoint. A balance between the two should guide the future changes to the act. Finally, the paper points out the trends in community lending and suggests some of the future changes to the regulation.

Journal of Economic Literature Classification: K2, G21, H81

Keywords: Community Reinvestment Act (CRA), Redlining, CRA reforms, Access to credit

I. Introduction

In the mid-1970's, a view was taking shape among certain members of the United States Congress. This view attempted to explain the economic decline of inner city neighborhoods through a process of disinvestment. According to this view, financial institutions that accepted deposits from households and businesses in these inner city locations focused their lending activities elsewhere. In other words, certain lenders outlined, later termed as redlined, these areas by systematically denying credit based on the perceived characteristics of these neighborhoods rather than actual creditworthiness of borrowers who lived there. The dominant populations in these outlined areas were often minority and/or low- and moderate-income (LMI) groups. Once the credit flow dried up in redlined areas, the next step was stagnation and depreciation of property value and quality due to lack of maintenance and mortgage credit. Lower house values attracted low-income, generally credit constrained, and often minority borrowers into these areas and led higher income households to move out. With house value depreciation, neighborhood quality in terms of public amenities, schooling, crime rates and such other measures also deteriorated. This deterioration completed the self-fulfilling prophecy of the initial disinvestments or redlining decision by certain lenders. This view, therefore, suggested that initial neighborhood disinvestment led to future disinvestments that caused yet further disinvestments until the community loses its viability.

Broadly speaking, CRA wanted to deter this redlining practice. The act was an addition to the previously existing anti-redlining legislations. "The act was adopted as a one of a series of statutes designed to address the problems faced by minority, and low- to moderate-income groups in obtaining credit and to put a end to redlining - the refusal by lending institutions to lend or invest in certain geographic areas, frequently the result of racial or economic discrimination [Regan 1979]." The principal author of CRA, Senator William Proxmire clearly stated, "The main purpose of the CRA is to eliminate the practice of redlining by lending institutions [Proxmire 1977]."

Redlining was referred to as a practice whereby "depository institutions would literally or figuratively draw a red line around certain geographic areas, and decline to make loans in those areas on the basis of the racial composition, age of the housing stock, or other factors, regardless of the creditworthiness of the individual loan applicants [Congressional Record 1977]." Renne [1976] provided a broader definition of redlining as encompassing other forms of adverse treatment to real estate properties in a designated geographic area including refusal to accept applications, denial of applications, requiring added insurance and approval with onerous credit terms[1]. In short, redlining occurs when lenders discriminate against a specific area within its larger service area by modifying the quantity (number of loans) or quality (terms of loans) of loans granted to borrowers in the specific area. Although initially redlining was defined in the context of mortgage lending, in the later years redlining referred to all forms of credit discrimination against a geographic location as a whole.

The objective of this paper is to understand the historical evolution and future direction of CRA. Specifically, this paper will follow the debates and controversies over CRA legislation to assess the present status and future trends of the act. This paper is organized in six sections. In section II, I explore the historical justification of CRA. In doing so, I describe the effectiveness and limitations of pre-CRA legislations that attempted to deter redlining. In section III, I focus on the original CRA statutes, and the regulations that were designed to implement the act. In this section, I first describe the original CRA statutes in an objective fashion. Since these statues required the regulators to form implementing regulations, next I look at how regulators reacted to the act and interpreted it to structure CRA assessment and enforcement criteria based on the statutory requirements. In section IV, I look at the forces that brought about reforms to CRA. In doing so, I describe the reactions to the original CRA legislation, and to the regulations that implemented the legislation by different groups affected by the act. Major groups affected by the act include the lending institutions and the community groups. Reactions to CRA by opposing groups formed the primary basis for future reform to the act. In addition to these reactions, changes in the financial sector and mortgage markets have also contributed to the need to modernize CRA. This section describes these changes. The focus of section V is to chronologically describe the past revisions and modifications made to CRA. In section VI, I synthesize an assessment of the present status and future trends of the act. Finally, the paper concludes by summarizing what we have learned about the act and what remains to be known.

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[1] According to Renne [1976], "A mortgage lender redlines a specific geographic area located within the larger area normally serviced by that lender when it adopts one or more of the following investment policies:

a. Refusal to accept any loan application for real estate loans secured by real property within the designated area.
b. Refusal to make any real estate loans secured by real property within the designated area.
c. Refusal to make any real estate loans secured by real property within the designated area unless the loan is guaranteed by some form of mortgage insurance either private or public.
d. Granting real estate loans secured by real property within the designated area only on terms and conditions more onerous than those for loans on residential property outside the designated area. These include lower loan to value ratio, larger down payment, higher rate of interest, and shorter loan duration."

II. Pre-CRA, Anti-Redlining Legislations

The United States Congress passed CRA in 1977. In order to understand the essence of the act, and to create a framework of analysis, it is important to understand pre-CRA federal statutes that attempted to resist the practices of redlining. The following statutes constitute pre-CRA, anti-redlining legislation[2]:

1.Civil Rights Act of 1866
2. Civil Rights Act of 1964
3. Fair Housing Act of 1968
4. Equal Credit Opportunity Act (ECOA) of 1974
5. Home Mortgage Disclosure Act (HMDA) of 1975

Civil Rights Act of 1866

The Civil Rights Act of 1866 states that every citizen of the United States has the same right to inherit, purchase, lease, sell, hold or convey property, both real and personal [42 U.S.C. § 1982]. In Jones Vs Alfred H. Mayer Co., the Supreme Court found that section 1982 of this act bars both *public* and *private* racial discrimination in the sale and rental of property [392 U.S. 409, 1968]. Unlike discrimination against an individual, redlining is a form of discrimination against a *geographic neighborhood*. Whenever the basis of redlining is racial composition of the redlined neighborhood, it may be considered as *public* racial discrimination – a form of discrimination prohibited in the Jones Vs Alfred H. Mayer Co. case. However, in light of the expansive reading of the legislation, legal experts contended that applicability of section 1982 was limited. "It does not appear that any court has ruled precisely on section 1982's applicability to redlining practices, and it appears that such an expansion of the statute is unlikely [Regan 1979]."

Civil Rights Act of 1964

Title VI of the Civil Rights Act states, "No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefit of, or be subjected to discrimination under any *program of activity receiving federal financial assistance* [42 U.S.C. section 2000d]." In the United State District Court decision of Laufman Vs Oakley Building and Loan Co., the court held that the extension of home mortgage money was an activity receiving federal assistance. Thus, denial of a loan based on the racial composition of the neighborhood is discriminatory within the meaning of section 2000d. Although there was no discussion by the court as to how it determined that the extension of home mortgage loan was a

[2] These five acts mentioned below will be termed henceforth as "pre-CRA legislations"

federally assisted program, "it would seem to be a correct conclusion in view of the substantial federal involvement in the home mortgage market [Regan 1979]."

Some, however, argued that use of title VI of Civil Rights Act to address redlining would be inappropriate since most of the mortgage loans do not receive direct federal financial assistance. According to their view, although Federal Housing Administration (FHA)[3] and Veteran Administration (VA)[4] loans receive indirect federal support, these loans do not receive federal finance. Therefore, they should not be covered under section 2000d of the Civil Right Acts. "Because most mortgages are not funded by the federal government and because federally insured mortgages, including Federal Housing Administration (FHA) and Veteran Administration (VA) loans are excluded from coverage, the provision's usefulness as a redlining remedy is limited [Regan 1979]." Therefore, applicability of the Civil Rights Act of 1964 in prohibiting redlining practices remained unclear and unresolved.

Fair Housing Act of 1968

Title VIII of the Civil Rights Act of 1968 is commonly known as the Fair Housing Act [42 U.S.C. §§ 3601-3619]. This act prohibits conduct that makes housing "unavailable" to any person on the basis of race, or that discriminate on the basis of race, color, religion, sex, familial status, or national origin in provision of services or facilities in connection with the sale or rental of housing. The act declares that it is unlawful "to refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin [42 U.S.C. §§ 3604(a)]." The law covers discrimination in all forms of residential real estate transactions including discrimination in the *terms* of the transaction. "It shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction [42 U.S.C. §§ 3605(a)]."

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[3] The Federal Housing Administration (FHA) loans are intended as a means to facilitate borrowers, usually LMI and/or first time buyers, to get a loan with less down payment and liberal qualifying standards. The federal government does not *finance* these loans but *insures* them by means of a Mortgage Insurance Premium (MIP) See endnotes (FHA loans) for details.

[4] More than 29 million veterans and service personnel who served on active duty during World War II and later periods are eligible for VA loan benefits. Similar to FHA loans, these loans are made by traditional lenders and guaranteed by the federal government against default. This guaranty encourages lenders to offer veterans loans with more favorable terms. The Veteran Administration sets guidelines, including the need for *veteran's certificate of eligibility* and *VA-assigned appraisal,* and maximum limit of the guaranty. Unlike FHA loans, VA loans do not have a minimum down payment requirement or monthly Mortgage Insurance Premium (MIP). In addition, VA loans may qualify for lower interest rates than ordinarily available with other kinds of loans.

In 1988, the Congress passed the Fair Housing Amendments Act that significantly expanded the scope of the original legislation and strengthened its enforcement mechanisms. Under the amended act, the enforcement of the Fair Housing Act may involve an individual, the Secretary of the Department of Housing and Urban Development (HUD), who holds the primary authority and responsibility to administer the act, or the Attorney General of the United States. Under the law, an aggrieved person could file a complaint with the Secretary of HUD alleging the discriminatory housing practice within one year after the alleged practice has occurred or terminated. The Secretary may also file such a complaint on his own initiative. In either case, the Secretary was required to make an investigation of the alleged practice and complete such investigation generally within 100 days after the filing of the complaint. The case would then be tried in a administrative court by an Administrative Law Judge (ALJ), and if the judge finds that the alleged party had engaged in a discriminatory housing practice, the judge could issue an order for appropriate relief. The relief may include actual damages suffered by the aggrieved person, an injunctive order or other equitable relief, or a civil penalty to vindicate the public interest. Under the act, an aggrieved person may also commence a civil action in an appropriate United States district court or State court not later than 2 years after the occurrence or the termination of an alleged discriminatory housing practice. In addition to these individual remedies, whenever the Attorney General has reasonable cause to believe that any person or group of persons have engaged in a *pattern* of practice of resistance to, or denial of the full enjoyment of any of the rights granted by the act, and such resistance or denial raises an issue of general public importance, the Attorney General may commence a civil action in any appropriate United States district court. For a review of the Fair Housing Amendments Act, see Schill and Friedman [1999].

Although the Fair Housing Act of 1968 and its amendments in 1988 provide substantial remedy by prohibiting discrimination in housing *sale or rental* by the owner or the real estate agent, it provided no remedy for discrimination against individual or geographic area by the lending institution. Despite the inapplicability of the Fair Housing Act to discrimination in mortgage lending, the act is related to redlining two broad ways. First, it separates redlining like outcome that may occur due to discrimination in sales and rental by the owner of the property from the redlining outcome that occurs due to geographic discrimination by the lenders. Second, by separating the ways in which redlining like outcome may occur, this act clearly shows the link between the housing market discrimination and the discrimination in financial or credit market.

This separation also allowed policy makers to focus on discrimination in lending market through subsequent legislation.

Equal Credit Opportunity Act (ECOA) of 1974

Housing market discrimination can be closely linked with the discrimination in financial or credit market. The ECOA [15 U.S.C. §§ 1691-1691f] prohibits financial institutions from discriminating between otherwise creditworthy borrowers on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance funds or the exercise in good faith of the rights guaranteed under the Consumer Credit Protection Act[5]. According to Taibi [1994], the ECOA may serve two main purposes. First, similar to consumer credit protection legislations, such as the Truth in Lending Act [15 U.S.C. §§ 1601-1677] and the Fair Credit Reporting Act [15 U.S.C. §§ 1681-1681t], it can serve as a consumer protection statute designed to provide accurate information to or about consumers involved in credit transactions. Second, the ECOA can be viewed as an antidiscrimination statute like the Equal Employment Opportunity Act [42 U.S.C. §§ 2000e-2000s-17] and the Fair Housing Act [42 U.S.C. §§ 3601-3619] that seeks to promote wider credit availability by prohibiting the use of stereotypes in credit decisions.

The Act authorizes the Federal Reserve Board to formulate regulations to specify statutory provisions to achieve the purpose of the legislation. Regulation B, the implementing regulation for the act, covers all phases of the credit transaction, including the application process, the evaluation process, and the reporting of reasons for adverse action. Federal Trade Commission (FTC) administers the overall enforcement of the act. ECOA compliance is enforced by FTC through issuance of cease and desist orders against non-complying lenders, or by private litigation through damage actions.

Home Mortgage Disclosure Act (HMDA) of 1975

Under the leadership of Senator William Proxmire, congress enacted the Home Mortgage Disclosure Act (HMDA) in 1975 [12 U.S.C. §§ 2801-2809]. The goal of HMDA was "to provide the citizen and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located [12 USC 2801(b)]." HMDA

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[5] Consumer Credit Protection Act is a federal legislation establishing rules for the disclosure of the terms of a loan to protect borrowers. For example, *truth in lending Act,* which requires lenders to disclose the true cost of loans and the actual interest rates and terms of the loans in a manner that is easily understood.

required depository institutions and their subsidiaries to provide the total number, and dollar amount of mortgages originated and purchased in the local market segmented by census tract.

The 1989 amendment to HMDA required lenders to report information regarding race, gender, and income along with details about the disposition[6] of the application at the *individual loan application level*. The reporting requirement of HMDA extended beyond depository institutions to all lending institutions with assets of more than $10 million and with an office in a Metropolitan Statistical Area (MSA) (for depositories) or loan activities in MSA (for non-depositories).

Although disclosure requirements may have influenced lenders' behavior, HMDA was not intended to be a prohibitive law. The act did not outlaw any specific actions on the part of lenders, nor did it impose any penalty for any discriminatory behavior. Instead, the primary purpose of the act was to monitor and detect patterns of lending behaviors. "While HMDA provided no mechanism for imposing sanctions on depository institutions, the data were being collected precisely for the purpose of monitoring lending patterns and detecting neighborhood redlining [Evanoff and Segal 2001]."

The other key role of HMDA was to provide lending information that could be used in cases of racial discrimination and redlining. After its passage in 1975, the act has played a significant role in the enforcement of anti-discrimination and consumer protection acts such as, ECOA and CRA. The HMDA data have been a key tool for community groups, researchers, and regulators in assessing the CRA records of depository institutions and the lending records of other reporting institutions not covered by the CRA [see Litan et. al. 2000].

The Community Reinvestment Act (CRA) of 1977

In the previous paragraphs, I have looked at the pre-CRA, anti-redlining legislation. These bills, however, remained *indirect or inadequate* in addressing redlining. The Civil Rights Act of 1866 and 1964 addressed redlining in an indirect fashion. The Civil Rights statutes were read very broadly to address only some specific types of redlining. For example, it was required to show that mortgage loan as a form of government assistance to make redlining illegal under the Civil Rights Law of 1964. The Fair Housing Act of 1968, on the other hand, prohibited discriminatory practices exclusively in rental and sales components of housing market. The Fair Housing Act did not encompass discriminatory practices in mortgage lending or other forms of credit such as

[6] Disposition of application includes acceptance, denial, withdrawal or closing of the file and must include the reasons for denial.

consumer loans, small business and farm loans. The Equal Credit Opportunity Act (ECOA) became the most appropriate statutory tool among all the existing pre-CRA legislations in dealing with redlining. Despite this appropriateness, the link between ECOA and redlining remained indirect. ECOA prohibited use of eight criteria in the credit lending decision. Those criteria were: race, color, religion, national origin, sex, marital status, age, receipt of public assistance funds and the exercise in good faith of the rights guaranteed under the Consumer Credit Protection Act. Under ECOA, none of these prohibitive factors can affect lenders' decision to approve credit to *individual* borrowers. Redlining, on the other hand, was a form of geographic discrimination against a *neighborhood*. Therefore, ECOA could not be a *direct* remedy for redlining.

Besides the problem of protecting individual, but not the group (neighborhood residents), there were other difficulties in the application of ECOA in redlining cases. One of these difficulties involved showing the basis of redlining. It is almost impossible to show the exact basis of redlining, since the ways in which redlining may occur are often inter-connected and correlated. For example, when a lender's racial prejudice towards minority borrowers is generalized and reflected as prejudice towards the neighborhood with high concentration of minorities, and the lender acts on this prejudice by engaging in redlining, then we may call this a race-based redlining. Since 'race' is a prohibitive basis under ECOA, the act might have potential application in this circumstance. However, there can be at least two reasons why ECOA may not be useful. First, minority populations are often *low-income* groups who live in *older houses*. In other words, minority status is highly correlated with low-income borrowers residing in older houses. However, neither 'income' nor 'age of the house' is prohibited as a basis for credit denial under ECOA. Thus, race-based redlining can be correlated and indistinguishable from 'income' or 'age of the housing units' based redlining making the application of ECOA very difficult. Second, in a race-based redlining, geographic discrimination takes place against minority-dominated neighborhoods. Therefore, non-minority who live in the minority-dominated, redlined neighborhood cannot seek remedy by using the protection of ECOA. The non-minority, however, suffers equally from geographic discrimination.

Lending standards[7] that are discriminatory in *effect* violate the ECOA even in the absence of any intent to discriminate, unless the standards "achieve a genuine business need which cannot be

[7] These standards include bases that are not prohibited by ECOA such as lending based on income or the age of house.

achieved by means which are not discriminatory in effect or less discriminatory in effect [12 C.F.R. § 531-538].” This is known as *disparate impact* discrimination. This provision of ECOA may address some aspects of redlining in an indirect fashion. In that, implementation of the standards that are not prohibited by ECOA but disproportionately affects minority in the redlined neighborhood are discriminatory and illegal unless lenders show a genuine business need in favor of these standards. The difficulty that arises when applying this provision is with the interpretation of what constitute a genuine business need. Moreover, when lenders shows a legitimate business need the burden to show the existence of other lending standard that are non-discriminatory or less discriminatory in effect, but achieves the same business need shifts to the party that accuses the lender for disparate impact discrimination. Finally, this indirect way to address redlining prohibits the *effect* on minority population but not the *action* directly.

The original Senate bill of CRA, sponsored by Senator William A. Proxmire, was introduced in January 1977 to provide a more direct legal mechanism to address the economic deterioration of communities through disinvestments and to encourage lenders to invest in the LMI communities. What the proponents of CRA wanted to achieve by passing this bill can be summarized in two parts. Part a, lenders need to *serve their local community* in which they are chartered by looking for sound, profitable and suitable investments in the community. Part b, in doing so lenders must invest in the *entire* community, including low- and moderate-income (LMI) neighborhoods.

According to part a, CRA was enacted to *encourage* banking institutions to help meet the credit needs of their local communities. The principle of serving "the convenience and the needs" of the communities was embodied in the federal law of deposit insurance, bank charters, and bank mergers long before CRA was passed into law. Moreover, in acting on acquisitions by banks and bank holding companies, the Bank Holding Company Act of 1956 requires the Federal Reserve Board (FRB) to evaluate how well ‘the convenience and the needs’ of the communities were met within the limits of safety and soundness. Thus the encouragement to financial institutions to serve their local community and help meet credit needs in the community as required in part ‘a’, is in many respects an existing responsibility of depository institutions. Part ‘b’ of the act deals with redlining or geographic discrimination by requiring lenders to invest in the entire community.

The CRA statute provides a broad outline for the federal supervisory agencies to implement the act. The Act specifies some general directions on how the encouragement to serve the needs of the entire community should be provided and how the act can be enforced when lenders fail to act on the encouragement. The most significant enforcement mechanism to tie the requirements of meeting the credit needs of community to the consideration of lenders' application for *federal approvals* [see endnotes]. In the next section, I take an objective look at the provisions of CRA, and analyze how regulators reacted to it and formed regulations to implement its goal.

III. The Original Act, Reactions and Implementing Regulations by the Regulatory Agencies.

This section describes the original CRA statutes as passed by the Congress and implementing regulations formed by the regulators as objectively as possible. In this section, I will also describe the reaction of regulators toward the original statues. CRA statutes were directed at two relevant groups: the lenders, and the federal regulators. I will shortly define lenders that fall under the coverage of CRA, and according to the lending activities of these lenders, which regulatory agency supervises those lenders.

<u>The Original Act</u>

In simple terms, the act required lenders to "help meet credit needs of the ***entire*** community, including low- and moderate-income neighborhoods in a manner consistent with safe and sound operation of the institution[8]." This is the ***goal*** or objective of the act. The success or failure of the act can be evaluated in relation to this objective. The act imposed three responsibilities on the regulatory agencies. First, to 'encourage' lenders to achieve the goal of the act, second, to 'assess' lenders' performance in achieving that goal, and finally, to 'consider' the CRA performance when evaluating lender's application for mergers, expansions and other regulatory approvals.

Coverage of CRA: CRA covers almost all depository-lending institutions. All state member banks, state nonmember banks, national banks, savings and loan associations (S&Ls) and wholesale and limited purpose institutions[9] fall under the coverage of CRA. There are certain lenders that are excluded from CRA coverage. CRA rule specifies that "special purpose institutions, such as banker's banks [12 U.S.C. 24], that are not organized to grant credit to the public in the ordinary course of business and institutions that provide only cash management and

[8] Title VIII of the Housing and Community Development Act of 1977, Pub L 95-128; 91 Stat. 1147, 12 USC 2901-05].

[9] An institution is a *wholesale institution* if it is not in the business of extending home mortgage, small business, small farm, or consumer loans to retail customers. A *limited purpose institution* offers a narrow product line, such as credit card or motor vehicle loans, to a regional or broader market.

controlled disbursement services be excluded from CRA coverage [60 FR 22156].” Lenders that are exempt from CRA coverage are mortgage companies, trust companies, credit unions, correspondent banks and clearing agents. Mortgage banks are not traditional depository lenders and are exempt from CRA coverage. The other exempted lenders are either ones that do not extend credit to broad general public, such as trust companies and credit unions, or the ones that provide only cash management and disbursement services to lending institutions such as correspondent banks and clearing agents. Therefore, although some exemption to CRA obligation exists, the majority of depository lenders are covered under the act.

CRA Regulators: The following federal regulatory agencies are required to enforce the CRA:

1. The Federal Reserve Board (FRB)
2. The Office of the Comptroller of the Currency (OCC)
3. The Federal Deposit Insurance Corporation (FDIC)
4. The Office of Thrift Supervision (OTS)

These federal regulators were responsible for examining the financial condition, and safety and soundness of operations of the banking industry long before the enactment of CRA. In addition to their regular supervision and examination, the CRA responsibilities were included based on the preexisting allocation of responsibilities. Original CRA statutes clearly identify the part of banking industry that will be supervised by each of the above four agencies[10].

After a considerable debate and a defeated attempt to delete the provisions of CRA in the House Banking Sub-committee, the provisions of CRA were finally included in the Housing and Community Development Act of 1977. After its passage by the senate in the October of the same year, the act required the regulatory agencies to devise appropriate regulations to carry out the responsibilities directed upon them. “Regulations to carry out the purposes of this chapter [CRA] shall be published by each appropriate Federal financial supervisory agency, and shall take effect no later than 390 days after October 12, 1977 [12 USC 2905].”

[10] The statute states, “the appropriate federal financial supervisory agency means -

(a) The Comptroller of the Currency with respect to national banks;

(b) The Board of Governors of the Federal Reserve System (FRB) with respect to State chartered banks that are members of the Federal Reserve System and bank holding companies;

(c) The Federal Deposit Insurance Corporation (FDIC) with respect to state chartered banks and savings banks that are not members of the Federal Reserve System and the deposits of which are insured by the Corporation; and

(d) The Director of the Office of Thrift Supervision (OTC), in the case of a savings associations (the deposits of which are insured by the Federal Deposit Insurance Corporation) and a savings and loan holding company [12 USC 2905].”

The Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions. This body makes recommendations to promote uniformity in the supervision of financial institutions by the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). This Council was made responsible to promote consistency of the implementation of CRA regulations as well.

Regulators' Reaction to the Original Act

In broad terms, the responsibilities of regulators were of three fold. First, to *encourage* lenders to help meet entire community credit needs (Section 802(b)). Second, to *assess* the CRA performance or CRA compliance of lenders in meeting that credit needs (Section 804(1)), and third, to *consider* this performance when evaluating lenders' applications for federal approvals (Section 804(2)). The difficulty faced by the supervisory authorities in carrying out their responsibilities can be grouped under following categories.

Vagueness of the Responsibilities: CRA requires banks to help meet the entire community credit needs by a safe and sound lending practice. This requirement is, in simple terms, the *goal* of the act. The act requires regulators to *encourage* banks to achieve this goal. The act also requires regulators to *assess* the success or failure of banks in achieving this goal and if it is found that a bank failed to achieve the goal, it requires regulators to *consider* this failure when bank seeks federal approvals.

In order for regulators to perform their duties as required by the act, regulators must encourage lenders to help meet the credit needs of entire community. Before the encouragement is provided, the regulators, however, need to know whether encouragement is at all needed. In other words, regulators must assess if there are unmet needs for credit in the community and if lenders can meet that demand in a safe and profitable way. However, "the congress did not provide any standard for determining whether a bank is meeting the local community's credit needs [Marisco 1993]." If it is discovered (by some hypothetical standard) that certain banks are failing to meet the community's credit needs, regulators are required to provide encouragement to meet the need. The Congress, however, does not provide what the nature of the encouragement would be. "The act states that banks should be encouraged to 'help' meet community credit needs but does not specify how such encouragement is to be provided or how much help in meeting credit needs is expected [Lindsey, February 1993].”

From regulators point of view, the vagueness of the responsibility stems from the fact that *encouraging* banks to do something or to undertake some venture does not necessarily mean *requiring* them to do it. “It (the act) encourages but does not require action by financial institutions. It reminds banks and thrift institutions about their charter obligations but does not mandate any particular activities [Lindsey, February 1993].” The word ‘encourage’ in the act is rather vague and ambiguous that makes the other regulatory responsibilities such as assessment of performance and enforcement of CRA obligations, more difficult. If encouragement were to mean some specific affirmative obligations then encouragement could have been done effectively, and assessment and enforcement of the act could have been much easier.

The act also remains unclear when it requires regulators to consider CRA performance in assessing lender’s application for mergers, expansions and other regulatory approvals. This really does not help regulators much with regards to what the consequence of poor performance should be. What is clear from the language of the statute is that poor CRA performance will negatively impact future regulatory approvals. The act, however, does not say how much weight must be given when poor CRA performance determined. “It leaves to the agencies the task of determining what the consequences of poor performance will be and when and how those consequences will be applied” [Lindsey 1995]. Moreover, federal approvals such as mergers and acquisitions have separate criteria and justifications. For example, an acquisition might be justified to rescue a failed institution. However, it was not clear where the poor CRA performance falls among the already existing criteria. In other words, if the failed institution or the acquiring institution has a poor CRA record, would approval for acquisition still be justified?

Lack of guidelines: CRA statutes were framed very broadly, and in its guidance towards regulators, it lacked completeness. “Even on some simple but important matters such as what constitutes as institution’s community, whether banks should be judged on credit extended to low- and moderate-income *persons* or only to borrowers in low- and moderate-income *neighborhoods*, the act provides little help to regulators, bankers, or community representatives. [Lindsey 1995]” The act provided little guideline on assessment and enforcement of the statute. “Despite the lofty pronouncements, the act provided little guidance as to how bank regulators should evaluate bank performance in this regard and how often these examinations should take place. [Apgar and Duda 2003]” Other researchers noted, “The act sets no criteria or guidelines for assessing the performance of an institution. It does not explain how an institution’s “community” should be selected, how credit needs are to be determined, how to define low- and moderate-income neighborhoods, or what constitutes satisfactory compliance. [Garwood and Smith 1993]”

The act left specific details of assessment and enforcement to be formulated by supervisory agencies. In order to form implementing regulations from such broad guidance from the legislature, the supervisory agencies sought public opinion. They held public hearings in 1978 to gather suggestion on possible interpretation and implementation of CRA. The suggestions received from different groups varied widely. While consumer groups favored specific rules, such as loan-to-deposit ratio for evaluation purpose, the lending institutions expressed concern about the possibility of federally mandated credit allocation. Although public hearings did not provide complete guidance, it helped the regulators understand the varied viewpoints concerning CRA.

Lack of Definition of Terms: As mentioned earlier, although the terms like ‘encourage’, ‘community’, ‘low- and moderate-income neighborhoods’, or ‘community credit needs’ stated in the act were not new to the regulators, they needed precise regulatory definition. “Four agencies have been particularly troubled by the absence of statutory definitions for such terms as ‘entire community’, ‘credit needs’, and ‘low- and moderate-income neighborhoods’ [Jackson 1978].” Furthermore, “the CRA directs the supervisory agencies to assess bank performance in helping meet community credit needs, but it does not define good CRA performance [Lindsey, February 1993].” These terms were essential components of CRA enforcement.

The precise definitions of those terms were fundamental for community activists as well. In order for the activists to raise substantial protest, they needed to know how banks were suppose to operate as far as their CRA responsibilities were concerned. “The operative terms are ‘encourage’, ‘consistent with safe and sound operation’, ‘local communities’, and ‘meet the credit needs’. The CRA does not contain further definition of these terms [Marisco 1993].”

In order to determine some measurement criteria for the degree of compliance or non-compliance, these important terms must have precise and consistent interpretation. Regulators had to define these terms and certain other concepts such as good CRA performance. They developed twelve performance factors, as discussed under Regulator’s Responsibilities below, by which CRA compliance would be measured.

Conflicts in the Objective of the Act: The objectives of CRA examinations might involve conflicting goals. On the one hand, the act needs to be flexible that allows considerable judgment on the part of the examiners to account for unique characteristics of the institutions and its community. On the other hand, for the effective enforcement, CRA examination needs to be consistent. The federal regulators describe the need for flexibility as "preservation of examiner judgment to take into account the unique characteristics and needs of an institution's community and the institution's own capacity and relevant constraints are essential for a workable rule [60 FR 22156]." Flexibility and consistency, however, can be contradictory when regulators achieve flexibility by compromising consistency of the examinations.

This conflict may be related to another conflict of CRA objectives. Specifically, the conflict between flexibility and consistency can take the form of a conflict between 'desire for objectivity' and 'dislike for credit allocation'. An objective, quantifiable criterion for assessing CRA performance is a desirable public policy objective that contributes to the consistency of the CRA examination. Strict enforcement of the quantifiable rules for performance assessment, however, may turn out to be a governmentally mandated credit allocation scheme, which is not intended by the act. As Lawrence B. Lindsey, member, Board of Governors of the Federal Reserve System, puts, "Consistency and objectivity are laudable goals. But to be implemented in a regulatory scheme, they require both a set of statistical data and a formulaic basis for evaluating those data. The more rigid the formulas that are applied, the greater the consistency but the lower the variety of outcomes and allowance for local circumstances that is permitted. [Lindsey 1995]" Therefore, objectivity and not mandating credit allocation can be two competing goals, in that one cannot be achieved without compromising the other.

CRA Regulations

The regulators developed detailed CRA regulations to implement the intent of a simple and broad act of only a few pages. Although each of the regulatory agencies has supervisory responsibility for different parts of the lending community, all of them have adopted similar regulations to implement CRA. To formulate regulations for the act, all four regulatory agencies announced a series of hearings[11] on the regulations. Both oral and written testimony was taken in March 1978 and the proposed regulations[12] were published in July 1978. After receiving and considering voluminous written comments on the proposal, final regulations[13] were adopted in 1978.

[11] For details of these hearings see 43 Federal Register 3370-3372 (1978), 43 Federal Register 7243-7244 (1978) and 43 Federal Register 13074(1978).
[12] See 43 Federal Register 29918-29924, 1978.
[13] See 43 Federal Register 47144-47155, 1978.

All four regulatory agencies jointly published almost identical regulations. The purpose of these regulations was to encourage and to provide further guidance to lenders as to how agencies will assess lenders' records in satisfying their continuing and affirmative obligations to help meet the credit needs of the local communities. The regulations required every lender covered under CRA to prepare and maintain two items as a part of disclosure requirement. Those are:

(1) CRA Statement

(2) CRA Public Comment File

CRA Statement: CRA statement is a set of documents concerning each lender's community lending efforts. Under the requirement of the act, lenders are required to prepare and publish a formal CRA statement for each community it serves.[14] Documents included in a CRA statement can be divided into two components: (a) Essential components and (b) Suggested components.

(a) Essential Components The CRA statement must include at least the following three items:

1. The delineation of the community
2. A listing of specific credit programs the lender presently offers to its community including any limitations on availability of such programs.
3. A copy of CRA public notice.

(b) Suggested Components In addition to the essential item, regulators also encouraged the lenders to expand CRA statement by including some or all of the following items:

1. A description of how lender's current efforts, including special credit-related programs help to meet community credit needs.
2. A periodic report regarding its record of helping to meet community credit needs.
3. A description of lender's efforts to ascertain the credit needs of its community.

CRA regulation required that each bank's board of directors must review its CRA statement at least once annually, and act upon any changes to the statement in its first regular meeting. Every thing enclosed in the CRA statement was made available to public. The CRA statement was readily available for public inspection at the home office, and at each branch office of the bank except off-premises electronic deposit facilities. Copies of current CRA statement must be provided to the public upon request, and bank may charge a fee that must not exceed the cost of reproduction. Next, I will look at three essential documents of the CRA statement more closely.

[14] Although the word 'community' was referred in the act on numerous occasions, no precise definition of the word was given. To enforce CRA and to assess lenders' performance the word community, however, needs a precise and clear definition. The regulators defined community by requiring lenders to delineate their respective community. The community delineation was a component of CRA statement and is discussed in the following paragraph.

Community Delineation: This is the first item of the CRA statement. CRA regulation required each lender to create a map that delineates its local community with reasonable clarity. This delineation would be a boundary of operation that outlines the areas around each branch or group of branches in which a lender offers services. Each branch or a group of branches of a bank must have one local community. One community, as a whole or a part of it, however, can be included in the community delineation of two or more different banks or branches of same bank. Banks were allowed to make adjustments in their community boundary in the case of operation areas that were divided by state borders or significant geographic barriers or areas that were extremely large or of unusual configuration. The lenders were required to review its delineation at least once in a year. The regulators in their annual CRA performance evaluation would closely examine the reasonableness of the delineation.

The crucial factor in the examination of community delineation was the exclusion low- and moderate-income (LMI) [see endnotes] neighborhoods from their local community. Since the goal of CRA is to encourage lenders to meet the credit needs of the entire community, the delineation of community can have a fundamental impact on the evaluation of CRA performance and on the enforcement of CRA obligations. A lender's CRA compliance is evaluated on the basis of its lending activities *inside* the local community. If some neighborhoods were not included in lenders' community delineation, lenders were not required under CRA to extend its service in those neighborhoods. Therefore, categorical exclusion of certain minority or LMI neighborhood from lender's community - an act known as 'redlining' - was carefully examined by regulatory agencies.

List of the Credit Programs: Lenders were asked to be as specific as possible when listing the credit programs that they were prepared to extend within its local community. For example, "residential loans may be broken down into residential loans on single-family homes, residential loans on one- to four-unit properties, and residential loans on properties with five or more units. The breakdown can be even more detailed by listing whether such loans are offered in an insured or uninsured basis [Schieber and Replansky 1991]." Banks were also asked to be specific about the type of loans that were currently offered including any limitation that applies. The types of loans include housing rehabilitation loans, home improvement loans, small business loans, farm loans, community development loans, consumer loans etc.

CRA Notice: CRA regulation required public posting of CRA notice in a specific form mandated by the regulatory agencies. This notice provided community borrowers with information on how to obtain current CRA statement of the particular lender. It also provided instructions on how an individual can make signed and written comments about the lender's CRA statement, or its community lending performance. The notice clearly stated where the public comments file (the second item maintained by the lender) containing all signed and written comments received by the lender, responses to these comments made by the lender, and effective CRA statements of past two years are located. The notice explicitly stated how any interested individuals could access the public comment file. The notice also stated how to obtain the regulator's CRA-related comments on the lender's CRA performance, and how to request an announcement of applications for federal approvals currently filed by the lenders from the respective regulator. CRA notice, a component of publicly available CRA statement must also be separately posted in the main lobby of each lender's branch offices and at its main office.

Beside CRA statement, the other document maintained by the bank or designated branch of the bank[15] is a public comment file. Similar to the CRA statement this is also a publicly available document. This file contains "any signed, written comments received from the public within the past two years that specifically relate to any CRA statement or to bank's performance in helping to meet the credit needs of its community or communities. [Federal Register vol. 43 No. 198. October 12, 1978]." In this comment file, lenders will also include any responses to the public comments, and effective CRA statements of past two years. The public comment file, in its entirety, is maintained at the main office of the bank, and materials relating to each local community are maintained at a designated office in that community.

Regulators' Responsibilities under CRA: The responsibilities of the regulators can be divided in three major parts:

a. Information Gathering
b. Performance Assessment and
c. Enforcement of the law in case of non-compliance

Information Gathering: The original CRA imposed only a limited disclosure requirement[16] on lenders, data reported under Home Mortgage Disclosure Act (HMDA, see endnotes) served the primary source of information for the purpose evaluating home mortgage loans in CRA

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15 In case of multiple branches in one local community only the designated branch maintains the public comment file. Note, if two branches of one bank operate in the same community, then besides bank's main office, only one of the two branches (the designated branch) maintains the public comment file that has comments pertaining to the whole community.

16 Further data reporting requirements were imposed as a part 1995 modification to CRA. The new reporting requirements are discussed in section IV.

assessment. Under HMDA, the lenders were required by their respective supervisory agencies to collect information on the residential mortgage loans made in its' community. This information included loan amount, volume, location and borrower characteristics such as, racial origin, and income level. The location of the borrower and of the property provided important information about the neighborhood characteristics (low-, moderate- or high-income neighborhood). The coverage of lending institutions under HMDA is larger than that of CRA. The broader coverage of HMDA allowed regulators to impose no reporting requirements under CRA with regards to residential mortgage lending. A list of relevant information used by the regulators and the sources of that information is given below.

Table 1: A list of relevant information used in the CRA examination

Relevant Information	Source
Loan amounts, number and types	HMDA
Loan location and some borrower characteristics	HMDA
Distribution of loans across the neighborhoods i community, racial and income groups.	HMDA
Public comments on CRA statement and CRA performance, and bank's response	CRA Public comments file
Appropriateness of the delineation of bank's lending community.	CRA statement
Specific credit programs offered by the bank	CRA statement
Proactive effort of the bank in fulfilling CRA obligations.	CRA statement
Bank's involvement in the community	Direct contact with community groups and Members.

The above table gives a general idea about the sources of information for the regulators. Generally, CRA examiners gathered lender-specific information from HMDA data, and information reported under the CRA public disclosure requirements[17], through communications with local community leaders and development organizations, and through outreach and marketing efforts of the banks. Guttentag and Wachter [1980] mention some sources of information that are also used by the regulators including "the public file in the CRA statement, board of directors' minutes, interviews with officers and community groups, HMDA reports,

[17] Under public disclosure requirements, lenders were required to maintain *CRA statement* and *public comment file*. Components of CRA statement include community delineation, specific credit program and public notice.

loan policy statements and manuals, application logs and other records."

Information collection and disclosure by the lender may serve two purposes. First, lending information is used in the assessment of CRA performance. Second, since the law requires that part of the information be disclosed to the public, the disclosure may make banks more accountable to its depositors. Negative public comments or poor CRA performance may damage the reputation of the depository institutions and consequently may cause the loss of deposits. For example, some local governments have established programs in which they have required the deposit of public funds to be made with only institutions having satisfactory or better CRA performance [GAO 1995].

Performance Assessment: The act remained exceptionally broad and general in its instruction to the regulators with regards to their responsibility of assessing CRA performance of lending institutions. The regulatory agencies were required by the act to evaluate the community lending records of the institutions they supervise as part of their examination process. In their evaluation, the act asked them to assess the *degree of compliance* with the goal of the act, where the goal of the act is to help meet the credit needs of entire community with safe and sound business practice. Therefore, it can be assumed that the higher the degree of compliance, the better would be the CRA performance. The act, however, gave no indication how the agencies were to accomplish these tasks. In this section, we will see how the regulators formed uniform interagency CRA regulation to facilitate the assessment process.

To help facilitate the assessment of CRA performance, the regulators jointly instituted CRA examination procedures. A regulatory agency would review an institution's CRA performance at different time frames depending on the past performance record of the particular institution. While lenders with satisfactory or better CRA performance were reviewed at the regular scheduled examination, or once in every two years, lenders with lack of compliance could be reviewed on a yearly basis, or even more frequently. CRA compliance was evaluated on twelve specific factors. These factors were organized into five categories as listed below. Detailed performance factors under each category are listed in the endnotes:

Category A: Ascertainment of community credit needs.

Category B: Marketing and types of credit offered and extended.

Category C: Geographic distribution and record of opening and closing offices.

Category D: Discrimination and other illegal credit practice.

Category E: Community development.

Regulators were required to assign ratings on a scale of one to five for each of these twelve factors, where one implies the highest rating. Banks receiving composite ratings of three, four, and five were to subject of scrutiny and frequent examinations. Although the individual lender's composite rating was not released to public, supervisory agencies prepared and released a summary of each lender's overall CRA performance ratings in the *region,* and it was posted in the CRA public file.

Institutions were not required to adopt a particular activity just because it was a factor for evaluation of CRA performance. The performance factors were not designed to serve as rigid lending rules, rather they were to provide lenders with some suggestions and guidelines for community lending. "While we do not favor the imposition of extensive and rigid guidelines, it is helpful to provide covered financial institutions with suggested assessment factors as guidelines to enable them to comply with the act. Given the great variety of local conditions, the list of factors is intended to be illustrative. [Jackson 1978]" The rigid guidelines were not suitable for CRA lending since "responsibility under the CRA may be met in a variety of ways, including lending for business, agriculture, education, consumer, home purchase and home improvement and to finance state and local governments [Federal Register, 1989]." In fact, CRA regulations were designed to give banks maximum flexibility in determining how they can best meet the credit needs of their communities. "Considerable latitude is given to the banks and thrifts to choose the ways in which they will fulfill their obligations to their communities [Jackson 1978]."

The regulation encouraged banks to become innovative in marketing their products and to devote valuable resources for research on finding the potential investment opportunities in their particular community. "The Agencies believe that appropriate consideration should be given to an institution that makes ongoing efforts to ascertain the needs of its entire community, develop products and services, and market those products and services throughout the community [Federal Register 1989]." In order to gain understanding of these investment potentials, lenders were expected to develop closer relationships with community groups and individuals and to participate in community development activities. Therefore, regulators rightly stated that "It (CRA) compels us (regulators) to look beyond what happens within the bank itself, focusing on the role the bank plays in the community. We must look at a bank's participation in fostering economic growth and revitalization [Garwood and Smith 1993]."

In conducting a CRA performance evaluation, the examiner is expected to judge the performance of each bank on a case-by-case basis. Examiner needs to consider two specific factors:

1. Bank-specific factors
2. Community-specific factors

The bank-specific factors would imply characteristics such as, size, net worth, type, expertise, capability or any legal impediments of the bank in serving the credit needs of the community. The institution has the "discretion to develop the types of products and services that it believes are best suited to its expertise and business objectives and to the needs of its particular community, as long as the institution's program is consistent with the objective of the CRA [Federal Register, 1989]." A bank with a large net worth and capital will be in a better position to devote resources to community outreach and to understand growth potentials of the community compared to some other smaller bank in the community. Therefore, an examiner may justifiably put heavier burden on these banks with regards to community outreach efforts towards local government, business, organizations and community members.

The community-specific factors imply the characteristics that are associated with local community such as, size of the community, its potential for economic growth, existing local businesses, and potential for commercial and residential developments. In addition, the examiner needs to consider that two different banks may address the same need in a community differently. Therefore, the examiner must take a balanced approach in determining compliance to CRA. A poor performance in one factor should not imply non-compliance, and similarly an excellent performance in one assessment factor may not constitute successful compliance.

CRA did not prohibit any activity of the lenders, nor was it intended to encourage unsafe lending and credit allocation. In designing CRA legislation, the Congress understood that direct interference in the market process to *allocate* credit would cause distortion and potential inefficiency in lending markets. They also realized that each community is different in terms of its economic potentials. In dealing with two relevant issues[18] the Congress had to give up some clarity in their guidance. This lack of guidance may make the distinction between what constitutes the 'encouragement to meet community credit needs' and what implies 'federally mandated credit allocation' harder. This lack of clarity forced regulators to work between a fine line of encouraging institutions to extend CRA credit and that they do so in specified amounts or types, or under prescribed terms [Garwood and Smith 1993]. In order to maintain this subtle, but

[18] The issues are (a) to allow competitive and free market process to work and (b) to exploit community-specific differences and unique economic potentials.

important distinction, "supervisory agencies adopted joint regulations that reflected two principles: 1) the regulation should not require lenders to allocate credit, and 2) financial institution should be free to meet their CRA obligation in different ways to reflect the needs of their communities, their own capabilities, and the activities of their competitors [Canner and Passmore 1995]."

Enforcement of CRA: Enforcement of CRA obligations is accomplished through three different mechanisms. These are: (1) denial of application, (2) disclosure of performance and (3) public comments and protests. In the denial of application, regulators were directed to consider past CRA performance of the lenders when evaluating applications for federal approvals [see endnotes] by these lenders. Denial or conditioning of approval on the ground of poor CRA performance constitutes the primary enforcement mechanism of the act. Therefore, this enforcement mechanism does not affect the poor CRA performers immediately, but rather it affects the lenders only when they need to apply for expansion or consolidation of the scope of their business or product lines.

Disclosure is another vital component of CRA enforcement. Community-lending records of the lenders in a region are summarized and disclosed to the public in the public portion of the performance evaluation[19]. This disclosure of performance and consequent loss of reputation was intended to contribute in changing the lending pattern of the CRA-covered institutions.

Public or local community plays a key role in the third enforcement mechanism. The provision of public comments on lenders' community lending performance and protests related to pending applications for federal approvals makes the lender accountable to its local community. At the same time, these comments and protests bring out important information about the needs of the community. This information and interaction between lender and community also make the enforcement process possible. In the absence of this interaction, it would have been impossible for federal regulators to discern the vastly diverse needs and perspectives of the community members and lenders operating in the community.

Section IV: The Forces behind the CRA Modernization

Over the years, CRA regulations have undergone many revisions, amendments and

[19] In the later years, the scope of this disclosure provision was extended; 1989 modernization of CRA required disclosure of composite ratings for each individual lender. GLB sunshine requirement further required lenders and other parties receiving CRA related grants from the lender to disclose the transfer in a specific format. These new disclosure requirements are discussed in section IV.

modifications. To understand the future of CRA, it is important to understand these revisions and their basis. One of the effective ways to understand the basis for these revisions is to identify the forces behind the revisions. This section identifies three broad forces that influenced past revisions, and will continue to affect future modifications of the act. These forces are: (1) Reactions of the lending institutions, (2) Reactions of the community groups, advocates and individual, and (3) Changes in the trends of the lending industry. Details of these forces is summarized in the following table:

Table 2: Forces of CRA modernization

Forces of CRA Modernization	Short Description
1. Reaction of the Lending Institution	a. Subjective nature and vagueness of the act
	b. Unfairness of the act 1. Unfairness among banks and non-banks 2. Unfairness within banks a. Due to location b. Due of specialization c. Due to future expansion plans
	c. Burdensome and expensive 1. Pre-protest expense 2. Post-protest expense
	d. Discourages banks to serve the depressed neighborhoods.
	e. Acts as a form of regulatory tax
	f. CRA induced lending may conflict with the safety and soundness standards
	e. Ignores specialization and may become inefficient
2. Reaction of the Community Groups	a. Lack of enforcement
	b. Misplaced emphasis on documentation
	c. Protective behavior and grade inflation
	d. Lack of authority
	e. Lack of public disclosure
	f. Inadequate examination
3. Trends of the Lending Industry	a. Weakening link between branch-based deposit gathering and mortgage finance.
	b. Technological advancement and breakdown of financial barriers.
	c. Growing importance of securitization and expanding shares of loans originated through mortgage banking operations.

Discussion in this section is organized under these three forces. First, I will examine the reactions of the lending institutions. In that, I describe at how CRA was welcomed or criticized by the lending institutions by looking at their reactions to the original act, and to the regulations passed by the regulators to uphold the goals of the act. Second, I consider the reactions of community members, groups and advocates. Finally, I identify the changes in the trends of lending industry and mortgage market that made the modernization of CRA inevitable.

IV.A. Reactions of the Lending Institutions

Original CRA was directed towards the *lending institutions* and the *regulators* of these institutions. Based on the original act, all four regulatory agencies formulated almost identical implementing regulations for the CRA-covered lenders. Therefore, the lending institutions expressed their reactions to both the *original act* as passed by the congress and its *implementing regulations* designed by the regulators. Some of the reactions of the lending community to the *original act* were similar to the reactions of the regulators described in the previous section. The lenders' reactions to the *original act* that were not similar the regulators' reaction and the reactions to the *implementing regulation*s of CRA can be addressed under following headings:

Subjective Nature and Vagueness of CRA The lenders thought that essential provisions of the original CRA and implementing regulations were essentially subjective and vague. Some of the basic difficulties faced by lenders concerning CRA can be summarized in questions like, 'how to determine community needs?', 'how to meet those needs?' and 'how much help to be rendered?' These are questions are subjective and judgmental. In his statement before the subcommittee on financial institutions and consumer, Lawrence B. Lindsey points out that "The act says that banks should 'help' meet community credit needs, but it does not specify what kind of help, or how much help, is necessary or appropriate [Lindsey 1995]." What is appropriate for lenders, may not be enough for regulators, or not acceptable for community groups.

One of the difficulties in implementing CRA is related to the conflicts of subjective judgments of the lenders, the community groups and of the regulators. Given the limitations of community characteristics and the lenders' resources and capabilities, what the lenders should do within the boundary of safe and sound operations to fulfill CRA responsibility relies heavily on their subjective judgments. The nature of the law recognizes and allows such judgments. This judgment, however, will be examined and rated by the regulators and may be protested by the community individuals, who may have a conflicting judgments about the lenders community lending activities. I believe the lack of clarity in the original act is a primary source of these conflicting judgments.

The lending institutions thought CRA regulations remained vague in many respects. CRA requires lenders to help meet the entire community credit needs by safe and sound operation. In order to fulfill this responsibility, lenders need to know their community. First, they need to determine the credit needs in the community they serve. Although CRA regulations and assessment factors for CRA examination provide some guidelines, they do not provide specific details on how 'community credit needs' should be determined. Communications with community leaders, advocates and developers may provide the bank officials some sense of the community credit needs, but there is no specific rule or criteria to single out these needs. As some researcher points out that "following passage of the act, bankers frequently complained about the vagueness of the requirements, including the lack of a specific ranking or weighting scheme for the assessment factors to guide the allocation of resource [Evanoff and Segal 1996]."

Second, if needs determined by the lenders are more than the credit currently provided, the lenders are required to determine a safe and sound way to address this need. As described earlier, due to conflicting subjecting judgments, the way and extent to which the credit needs should be met may vary from the lenders to the community groups, or the lenders to the regulators. Finally, lenders need to know how different means to address theses needs are weighted in the evaluation process. However, the act does not specify in what order, and to what extent helping to meet these needs is required by the act.

The vagueness and lack of clarity exacerbates the problem of subjectivity described earlier. Specifically, the vagueness of the provisions adds subjectivity to the compliance. In the absence clear guidance, the lenders comply according to their subjective judgment, but the regulators assess the compliance with their own, but different subjective judgment. The lack of clarity and consequent conflict of the subjective judgments makes the compliance to CRA controversial and may transform CRA into an open ended lists of demands by the community groups. "The vagueness of the term "credit needs" easily lends itself to an open-ended "wish list" approach by community organizations that lobby regulators [White 1993]."

Although the regulators provided guidance in terms of the documents that must be maintained and assessment factors upon which lenders will be assessed during examination process, some researchers consider that the broad nature of and lack of clarity in the *original act* made the regulatory responsibilities difficult to undertake. "The vagueness of the affirmative responsibilities placed on the lenders by the congress has made it difficult for the regulatory agencies to determine compliance with CRA [Canner and Passmore 1997].” In many circumstances, while working with the broad guidelines, the regulation designed by regulators remained vague as well. Therefore, the source of this ambiguity experienced by the lending institutions can be traced back to the vagueness in the original act.

Unfairness of CRA The lenders argued that CRA was unfair legislation for certain lenders because it did not cover the entire lending institutions in a uniform fashion. The alleged unfairness can be addressed under two following grounds:

1. Unfairness among banks and non-banks.
2. Unfairness within banks.

Unfairness among banks and non-banks Although CRA covers a substantial portion of depository lenders, it did not include the whole lending industry. Generally, the lenders covered under CRA are: commercial banks and thrifts[20]. This coverage was not made arbitrarily. Sound logic existed for imposing CRA obligations on certain type of lenders as opposed to all lenders in general. Depository charters already required banks and thrifts to serve the “convenience and needs” of the local communities in which they were allowed to do business. One can identify the four justifications for imposing CRA obligations on depository lenders. They are: (a) these lenders receive deposits from their community, (b) they are the primary source of credit to their community, (c) they enjoy protection from federal deposit insurance, and (d) they enjoy access of credit from Federal Reserve System who acts as a lender of last resort.

Statement of senator Proxmire, the main author of CRA, identifies this justification. “This public obligation (The CRA) was the quid pro quo for the substantial economic benefits conveyed on chartered depositories: a franchise to do business in a geographic area, federal deposit insurance, access to the payment system, and access to low cost credit through the Federal Reserve Banks or the Federal Home Loan Banks [U.S. congress 1977a].” Others involved in the regulatory process have offered similar justification, “although they are privately capitalized, banks and savings institutions are subject to an underlying charter obligation to serve the banking needs of their local communities. These public obligations form the quid pro quo for the extensive government backing that is provided to these types of financial institutions [Fishbein 1993].”

Opponents of CRA have attacked all four justifications mentioned above. They argue that these justifications or ‘charter-benefits’ have lost their substance under present financial environment

[20] Savings and loan associations (S&LA) and savings banks are commonly known as thrifts.

where banks and non-banks are hardly distinguishable in terms of financial operations. Imposing CRA obligation on banks but leaving non-banks out of the obligation renders banks into a seriously disadvantageous position. This, according to the opponents of CRA, is the unfairness among the banks and non-banks. This section explores these unfairness arguments.

In the late seventies, when CRA was enacted, the depository institutions benefited from an effective monopoly in the consumer checking and savings markets. Federally chartered depository institutions did not have to pay interest on checking accounts. “At that time banks and savings and loans operated under a system of below-market prices for deposits - no interest for checking accounts and an administrative ceiling for time and savings accounts, with savings and loans allowed to pay a little more than banks - that can aptly be described as a cartel administered and enforced by federal government [Macey and Miller 1993].” Things have changed drastically since then. Increased competition has broken the so-called cartel. Banks and thrifts now compete with other non-banks for consumer savings. “The most significant of these non-bank competitors are mutual funds, many of which today offer extensive checking privileges. Other firms - even industrial corporations - are offering services that perform most of the same functions as the checking account at the bank [Macey and Miller 1993].”

The growing sophistication and modernization of the capital markets fostered vigorous competition among banks and non-banks. Big mergers and acquisitions throughout last decade have produced giant financial companies. Currently, the distinction between banks and large non-bank financial companies is eroding. Both types of institutions are allowed to perform similar activities in terms of accepting consumer savings and making loans. For example, General Electric (GE) capital can fund itself with short-term money costing about the same as bank deposits.

The ability to raise deposits that have explicit government guarantee is one the exclusive charter-benefits enjoyed by depository institutions. This guarantee comes with the cost of insurance premiums and heavier regulatory supervision. This federal insurance of deposits forms the primary building block for the overall safety and soundness of depository institutions. The opponents of CRA argue that even the exclusive benefit of government safety net is not exclusive any more. Other non-banks, especially the larger non-banks, also fall under the safety and soundness umbrella of government. In that, although these non-banks don’t benefit from an *explicit guarantee* of government, they receive an implicit guarantee.

The implicit guarantee flows from the public responsibility of Federal Reserve Board to mitigate financial panic, and to restore trust in the overall financial institutions. Out of this responsibility, the Fed undertook the massive bailout of Long Term Capital Management in 1988. Most people now believe that many large institutions are probably protected under the category of "too large to fail." This belief is crucial for the safety and soundness of financial system, and must have contributes to GE's ability to acquire funds at approximately the same cost as federally guaranteed deposits by banks.

The fourth benefit, 'the lender of the last resort' notion of Fed has been used very rarely, and only under special circumstances. The *implicit* guarantee of federal safety net, and the ability to raise deposits allow non-banks to compete with the banks without worrying about CRA obligations, examinations or associated CRA protests. According to the opponents of CRA, the act is unfair for banks, since it puts banks into a competitively disadvantageous position that might have serious safety and soundness implication. "An increasingly serious difficulty with the CRA is that the fact that it burdens certain types of institutions while favoring others - thus impairing the safety and soundness of those that suffer disproportionately under the act [Macey and Miller 1993]."

Unfairness within the bank Within the depository institutions, CRA compliance costs are not same for all covered banks. The cost differential and consequent unfairness may come from following sources:

1. Location of the bank
2. Specialization of the bank and
3. Future expansion plan of the bank.

Location of the bank CRA requires banks to serve the credit needs of the entire local community including LMI neighborhoods. Since CRA was designed to prohibit banks from practicing redlining, the word community, which is dictated by some reasonable delineation of bank's service area, is critical here. For example, banks located in wealthy areas with no LMI neighborhood in its local community do not have to serve LMI neighborhood located outside their local community. Since LMI neighborhoods are the primary source of CRA protests, these banks would face lesser CRA challenges than banks that have one or more LMI neighborhoods in their service area. In this way, CRA provides an unfair advantage to banks that do not serve LMI neighborhoods, and penalizes banks that do serve. Due this disparate treatment, banks with future expansion in mind would choose to avoid areas with LMI neighborhoods. In the very early days of the act, regulators realized that under the legislative environment of CRA, banks might be inclined to take such a strategy. In his 1977 letter to senator Proxmire, Robert R. Barnett, Chairman of the FDIC warns about this impact of CRA by following statements: "The practical effect of the bill could be to discourage financial institutions from making applications for offices in neighborhoods where funds are badly needed because of the reexamination that this would entail. ……The result of this would be to increase present concentration of financial institution offices in more affluent neighborhoods [Cincotta 1977]."

Specialization of the bank If all depository institutions are treated alike with regards to their CRA obligations, and are expected to perform equally well in their community reinvestment efforts then banks that provide specialized services, such as wholesale and limited purpose banks, will find themselves in a competitively disadvantageous and economically inefficient position.[21] To perform equally well in CRA examination with lenders that deliver full range of financial services, these specialized banks will have to incur additional cost. The excess cost for not being equipped with manpower, expertise and community knowledge might well be considered as unfair burden for their specialized nature.

Future expansion plan of the bank Banks that are planning to expand and grow through merger, acquisition, opening and relocating branches need federal approval for such activities. CRA regulation requires regulators to consider prior CRA performance of the bank seeking such approvals. At the same time, community activists in the bank's service area take this impending approval as an opportunity to thoroughly scrutinize a bank's CRA efforts. This stringent scrutiny and therefore increased threat of CRA protest put expanding banks in disadvantageous setting. The expanding, or reorganizing banks would need to devote more resources and services than other banks to receive comparable CRA score. If the degree of scrutiny and threat to protest becomes too high then this threat might act as an effective entry barrier favoring larger banks that has already expanded. The cost differential for between banks with no intention to expand or already expanded, and banks that are planning to expand or reorganize might be considered as unfair for the latter.

Costly documentation and protest resolution Complying with CRA obligations can be expensive. CRA related expenses could be divided into two parts:

1. Pre-protest expenses and
2. Post-protest expenses.

[21] The 1995 CRA revision directly responded to this reaction by formulating CRA examinations specific to the lenders' specialized nature of business.

Pre-protest expenses These expenditures are associated with the cost of compliance to CRA and its regulations. These expenses include the cost to maintain, report and disclose CRA related documents. The federal banking regulators have estimated the annual paper work burden of the CRA at approximately 600 hours for large institutions and 10 hours for small institutions [Federal Register 1999]. While documents, such as CRA public notice, CRA statement, and public file are strictly required by law, many other documents are also maintained as supportive materials to convey positive CRA performance. These supportive materials may include minutes of meetings of the bank's board members, communications with community groups and organizations, clippings of articles announcing or recognizing the lender for participation in the community programs, thank-you notes and acknowledgements for bank's CRA related efforts, and awards and certificates of appreciation. Federal regulators during their CRA examination may have to rely on these documents. "Enforcement agency examiner will frequently have nothing to go on other than the documentation provided be the bank. If the documentation is spotty or raises more questions than it answers, the examiner will be forced to go elsewhere for documentation. To avoid this, a lender should make a special effort to collect and retain all documents or other materials supporting its positive CRA performance [Schieber and Repansky 1991]."

The other type of pre-protest expense is associated with lender's time and efforts devoted activities that seek to understand the community credit needs. These activities include enhanced marketing efforts, community outreach, special program and innovation of new product to suit the community's needs. One study estimates "labors--including staffing to pinpoint areas and investments that meet these requirements--can cost an institution with $500 million or less in assets 4.5% of their pretax profits [Thakor and Beltz 1994]." Although these activities demand time, efforts and expense on the part of lenders, they may have positive contribution to the profit and good will of the lenders. Therefore, it is not straightforward to measure the cost or benefit of these activities; in the compliance-cost calculation, one must account for the benefits of these activities. Some argue that CRA compliance cost should include the costs of developing and maintaining formal CRA policies, including employee training on anti-discrimination, and other requirements of fair housing laws. According to some researchers, however, such training and policy statements are not exclusive requirement of CRA. As Litan et. al argue that "..costs that institutions incur to comply with related statutes, such as the anti-discrimination laws and Home Mortgage Disclosure Act may not be considered as a part of CRA compliance costs [Litan et. al.

2000].” According this view, anti-discrimination, fair housing and civil rights laws require these activities, and lenders should provide the training to comply with these laws for their own interests.

Post-protest expenses Expense in this category arise when any interested individual or group such as a single individual borrower, a community group or the appropriate federal regulator protests a bank application under CRA grounds. The cost of post-protest expense depends on the amount of time it takes to resolve the protest, the bargaining powers of the protesting entity, and how urgently the bank finds its application for federal approval needs to be processed. Historically, CRA related post-protest expenses have not been excessive. “Based on the data provided by the four banking regulators from 1995 through 1998, less than one percent of total bank and thrift institution applications covered by the CRA received adverse comments (roughly 600 out of 86000 applications). Furthermore, only one percent of the applications that received adverse comments were denied by the regulators, 94 percent were approved, and the other five percent were withdrawn or returned for additional information [Litan et. al. 2000].” Delay in the approval of application may cause loss to the banks actively seeking growth and expansion. The opportunity cost of delay is the loss of profit that accrues from the expansion. In addition to opportunity cost, there is post-protest expense include cost of negotiation with protesting groups, which includes additional manpower, paper work, lawyers, and sometimes commitment of assistance in terms of loans and grants to achieve a compromise. In recent years, the bargaining powers of community groups, which negotiate as professional collective bargainers, have become quite strong. Since 1993, banks and thrifts have pledged to make over $1 trillion in home mortgage, small business, and community development loans for LMI neighborhoods and borrowers. Since then banks and thrifts have made well over $600 billion of such types of loans [Litan et. al. 2000]. In addition to these accounting costs, another significant post-protest cost is the damage to reputation and public image of the protested institution.

Discourages Banks to Serve the Depressed Neighborhoods It has been argued that CRA provisions can be counter productive by discouraging banks to enter in credit-depressed, generally LMI neighborhoods, in which the banks would otherwise enter in the absence of CRA regulations. In that, protest provision of CRA makes it difficult for banks to close branches in distressed neighborhoods. While this may benefit some people, it has an unintended negative effect. It discourages other regulated institutions from entering and offering banking services to the neighborhoods that are often dominated by LMI and minorities borrowers. Consequently, people who could benefit from checking, savings, consumer loans, and other banking services may be denied of these benefits. Antonakes [2001] in recent years finds some support of the negative relationship between the concentration of minority population in the tract and the number of banks that serves the tract. Using 1995 data for the state of Massachusetts, he finds that as the percentage of minority in the census tract increases, the number of lenders that include the tract in their assessment areas falls.

CRA induced loans may help some borrowers in the short run, but these loans may hurt other lenders in the neighborhood and consequently, the borrowers in the long run. The loans made by banks attempting to obtain approval for merger or acquisition may simply draw customers from other lenders who otherwise would have made them, perhaps, on less beneficial terms. "In particular, minority-owned banks have complained that they suffered from having to compete with subsidized lending by banks that are willing to make unprofitable loans to obtain regulatory approval for a merger or acquisition [Ferguson 2000]." Once the approval is received these lenders would reduce their CRA lending, but in the meantime other existing lenders in the neighborhood might not survive in the competition for subsidized lending.

Acts as a Form of Regulatory Tax CRA has been viewed as a form of regulatory tax imposed on depository institutions. CRA enforcement mechanism allows interested parties to cause considerable loss through delay or denial of applications. As argued earlier, if the damage caused by potential delay or denial is higher than the loss in making CRA- induced subsidized loans, the lenders will prefer making subsidized and often unprofitable loans. As Lacker [1995] argues, "by tilting banks' profit-loss calculations, the CRA regulations give banks an incentive to make loans they would not otherwise have made. To the extent that banks are induced to make loans and investments they would not otherwise have found profitable, the CRA regulations encourage banks to subsidize lending in low-income neighborhoods." Lacker [1995] cites Senator Proxmire's justification for CRA obligation on banks that "there is no way the Federal Government can solve this problem [of revitalizing the inner cities] with its resources", and argues that CRA imposes a tax on banks to avoid an explicit general tax increase. However, a general tax increase is usually less costly to society than an equal-sized tax on a single industry because spreading the burden over a wider base minimizes the resulting distortions in economic activity. Similar arguments of cross subsidy appear in other research. "Banks cannot meet their CRA obligations to provide such services [CRA induced loans] unless they are able to earn above-normal profit elsewhere, thereby making up for the losses in the CRA-induced area. In essence, banks must be able to cross-subsidize internally the CRA-induced services; otherwise, the banks will incur overall losses or inadequate profits [White 1993].” However, some researchers find that although CRA-eligible loans by CRA covered institutions carry lower mortgage spreads than other loans by the same institution, after controlling risk and benefit effects this spread becomes economically and statistically insignificant [see Canner et. al. 2002].

CRA Induced Lending May Conflict with the Safety and Soundness Standards Although CRA regulation required lenders to make safe loans to fulfill their CRA objectives, according to some scholars CRA-induced credit enhancement objectives aimed at increased supply of loans to low-income neighborhood might conflict with financial safety and soundness criteria. In that, aggressive banking strategies tend to help CRA ratings but may hurt safety and soundness ratings[22]. Gunther [2002] study finds evidence of conflict between CRA compliance, and safety and soundness standards especially for smaller lenders. In particular, the study shows that concentrating bank’s assets in loans tends to help CRA ratings but hurt CAMEL ratings, holding management quality constant. This study also finds limited evidence to suggest that greater focus to low-income neighborhood helps CRA ratings, but at the expense of safety and soundness.

CRA might have induced less than safe underwriting standards. CRA induced pledges and lending commitments are often directed toward a national network of bank protest groups who receive the underwriting authority on behalf of a bank. This process has provided a pool of capital at the disposal of these protest groups. Opponents of CRA have raised concerns about the soundness of these groups’ underwriting performance. One such group is Neighborhood Assistance Corp. of America - a Boston-based community organization. This group has received "delegated underwriting authority" by Bank of America for more than $3 billion in mortgage funds. “In the mid-1999, 8.2% of all mortgages that this group had arranged with Fleet Boston were delinquent, compared with the national average of 1.9% [Ferguson 2000].” Similar concerns were expressed by the last Senate Banking Chairman Phil Gramm when he comments, "CRA lending is significantly less profitable than ordinary lending, and the most unprofitable CRA loans are those that are made through special deals with CRA specialists and other third parties [Congress Daily].”

The non-profit lenders have also been blamed for their lax and often unsafe underwriting standards. Opponents of CRA believe that to the extent these loans are CRA induced, the act is

[22] Federal regulatory agencies evaluate safety and soundness of regulated lenders by examining six factors: capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L) and sensitivity of market risk (S). This CAMELS ratings system existed before CRA examination was introduced in 1978.

responsible for unsafe lending, which in the long run may hurt the neighborhoods and its borrowers. “Nonprofit lenders--whose experience, of course, does not lie in judging credit risk--are unabashed in their goal of qualifying just about anyone who walks into their offices. The result? When one or two or three houses on a block go into foreclosure, or even if they don't get the paint job they need because the buyer is overextended, the original CRA goal of neighborhood revitalization is undermined, not advanced [Ferguson 2000].” According to these opponents, easy credit only transforms good neighborhoods to become bad neighborhoods and bad neighborhoods to stay that way.

Ignores Specialization and may become Inefficient Although lenders’ rights of exercising the discretion over the type of loans and the degree of risk to be assumed have been affirmed by federal regulations, CRA provisions indirectly tends to undermine this right. “The community groups do not accept the right of lenders to specialize by not offering the full range of services within their legal authority [Guttentag and Wachter 1980].” Furthermore, CRA regulation requires lenders to fulfill their CRA obligation in a uniform fashion. This might have implication on efficiency of providing banking services. “CRA-enforced homogenization of services reduces the ability of lenders to specialize, and is therefore likely to reduce operating efficiency, particularly for smaller banks [Guttentag and Wachter 1980].” According to some researchers, this uniform requirement may undermine and underutilize the informational skills of the efficient lender and fails to exploit the expertise of the lenders who are efficient in certain types of lending [see Richardson 2001].

IV.B. Reaction of Community Groups, Advocates and Individuals

Community groups, advocates and individuals have reacted to the provisions of CRA. Similar to lenders’ reactions, these reactions are also directed toward the original CRA statutes as well as the regulations implemented by the regulators. Many of the reactions of the community groups and individuals are identical to the reaction of lending institutions including vagueness of the act, lack of definitions, and excessive burden of paperwork and documentation. These common concerns are discussed in the reaction of the lending institutions. Besides these common concerns, the reactions of the community groups and individuals can be grouped under the following categories:

Table 3: Reaction of the community groups

Forces of Modernization	Short Description

Reaction of the Community Groups	a. Lack of enforcement
	b. Misplaced emphasis on documentation
	c. Protective behavior and grade inflation
	d. Lack of enforcement authority
	e. Lack of public disclosure
	f. Inadequate examination

Lack of Enforcement Community groups have complained about the lack of aggressive enforcement of CRA provisions, and argued that this lack has contributed to the lack of credit in the LMI neighborhoods and consequent disinvestment of these neighborhoods. "Community advocates argued that the acts were either inadequate or inadequately enforced and that banks continued to channel deposits away from local communities, resulting in inadequate financing for the areas most in need [Evanoff and Segal 1996]." Indeed, in its first decade of CRA, most lenders have received satisfactory or better rating and no application of lenders were denied on CRA ground. In 1988 Senator Proxmire, Chair of the Senate Banking Committee, reports in a public hearing that "despite the apparent rigor of the criteria, fully 97 percent of the institutions examined over the period received one of the two highest ratings (on a five-point scale) [Ford Foundation 2002]." In 1989 after twelve years since the passage of CRA, the first application was denied on CRA grounds. It was the merger application of Continental Bank Corporation to acquire Grand Canyon Bank of Scottsdale. In another report, "there were only 11 CRA denials of more than 50,000 branch and merger applications from 1977 to 1989; by 1996, there were just 31 denials out of nearly 105,000 applications [Thomas 1998]."

Although consideration of the CRA ratings during the application approval process constitute the primary enforcement mechanism for CRA, the prevalence of favorable ratings, and the small number of CRA-related denials does not provide conclusive evidence of lack of enforcement. Although these two criteria may provide an initial indication of lax enforcement, we need to account for other factors as well. Reasons for not observing denials may depend on other factors including actual performance of lending institutions in terms of providing credit to LMI neighborhoods, and a financial and regulatory environment that permits and promotes consolidation of the industry. Other legal, financial and economic considerations for federal approvals, ability of lenders to improve its lending records before the application is submitted, and negotiation with the protesters after the application is submitted can also reduce the number of denial of application on CRA ground[23]. Although these pre- and post-application considerations affect the number of denials and may explain the lack of actual denials, most community advocates and members believe that “it is not the lack of laws, but rather lackluster enforcement of the CRA, that has contributed to the continuance of neighborhood disinvestment and lending discrimination [Fishbein 1993].”

Misplaced Emphasis on Documentation Federal regulators, in their guidance towards lenders, often emphasized the importance of maintaining documentation of lenders’ CRA related efforts or strategies. “Regulatory agencies would periodically issue policy statements providing guidance to institutions as to how the assessment criteria were scored and discussing elements of effective CRA programs. Most of these statements emphasized efforts, and the documentation of such effort [Evanoff and Segal 1996].” In the assessment of performance, regulators have taken of both the effort and the result of the efforts into consideration. Effort to comply with the act includes strategy used to serve the local community, and maintenance of convincing documents reflecting that effort had been made to assess the needs of the community. “CRA performance evaluations focused on the processes used and efforts made by institutions to serve their local community as well as on the result of those efforts [Bostic and Canner 1998].” Both the lenders and community groups have criticized the amount of documentation involved in CRA compliance, although for different reasons. For the lenders burden of documentation is of primary concern. “Lenders contended that CRA enforcement was needlessly burdensome because it was focused on process and paperwork, and that the examination standards were unclear and inconsistently applied [Bostic and Canner 1998].” For the community groups, on the other hand, the documentation is ineffective and has diminished regulators’ ability to distinct good lending performance from the poor performance, “Community groups believed that the examination process failed to create meaningful distinction between depository institutions with good performance and those with poor performance [Canner and Passmore 1997].”

Protective Behavior of the Regulators and CRA Grade Inflation Community groups and individuals have criticized the protective behavior of regulators toward the banking institutions. “Almost from the outset, community advocates criticized the way in which the regulators enforced the CRA. The agencies were viewed as being too cozy and too protective of the

[23] Often times we do not see a lot of actual denial of applications because lenders who submit applications for regulatory approval take adequate preparation by improving their CRA lending record. Further, these lenders may commit for loans and grants, before the application is submitted or during the protest and negotiation phase, to the neighborhoods in which they do not have satisfactory lending records.

institutions they supervise to enforce the new requirements effectively [Fishbein 1993].” In recent years, complaints about these protective behaviors and the instances of grade inflation in CRA performance evaluation have become frequent. According to some scholars, certain changes in the 1995 CRA reform[24] have contributed to the grade inflation. These scholars think that reform that has instituted three separate tests - lending, investment and service test - for large retail banks have taken fifty percent weights away from the lending performance and provided that weight to investment and service performance. By proving independent weights to investment and service test, CRA evaluation process has inflated the ratings. Specifically, they claim that investment test is the primary cause of overall CRA grade inflation. An analysis actual CRA examination shows that under the new tests, “large banks finds 71 percent of the ratings were inflated by one grade on the investment test, compared to 32 percent and 29 percent comparable inflation rates for the lending and service tests, respectively [Thomas 1998].”

Lack of Enforcement Authority As discussed earlier, regulators are required to consider prior CRA performance of the lenders who apply for expansion through merger, consolidation, closing or relocation of branches. This forms the primary enforcement mechanism of CRA. This, however, is an indirect form of enforcement in the sense that the poor CRA performance adversely affects the lenders only when they apply for federal approvals. Further, approval of application has other considerations besides the CRA performance, and it is not clear how these considerations are weighed. Community groups have complained about the limited enforcement authority. “Community groups have raised concerns about limited CRA enforcement, particularly against poor performers that have no plans to expand, and insufficient disclosure of information on banks’ community lending performance [GAO 1995b].” Some scholars have attributed the lack of authority as a primary reason for reduced effects of CRA by saying “The failure of the CRA to have a more pronounced effect on lower income lending lay largely in its failure to provide regulators with tools to punish poor performers or reward successful behavior [Apgar and Duda 2003].” In response to this indirect enforcement process, community advocates have proposed to enhance CRA enforcement through direct sanctions. The Department of Justice, however, issued an opinion in late 1994 stating that such actions are not within the scope of CRA statues. Consequently, the proposal for direct action for noncompliance with CRA was

[24] Community groups have complained about the grade inflation associated with the CRA evaluations process that are based on the original CRA regulations. After the 1993 reform, some scholars claim that the reform has contributed to further grade inflations. Details of 1995 CRA reform initiatives have been discussed in the next section.

dropped from the consideration.

Lack of Public Disclosure of Information on Performance Evaluation Until 1989 modernization of the act[25], the CRA rating and how the rating was derived were not disclosed to public. Although people could participate in the community lending process by commenting on an institution's lending record, or protesting against an impending merger, they had no way to know how the regulators had evaluated the institution. The lack of disclosure of information has important consequences. First, when the performance rating is not available to the public, *reputational risk* of lenders is limited. This reduced risk may diminish lenders' incentive to improve their CRA performance. As some scholars put, "reputational risk and public scrutiny faced by lenders for poor performance was minor because examiners' ratings were not made public [Apgar and Duda 2003]." Second, *accountability of the examiners* is absent or limited when public has no way to know the rating or how a particular rating is derived. Finally, non-disclosure of rating may render *participation of community* incomplete or ineffective. For effective participation in the community development, that intends to improve the flow of credit into a disinvested community through comments and protests, community groups, advocates and individual need to know and understand the evaluation process.

Inadequate CRA Examination that may have contributed to the Growth of Abusive Lending Practice Proponents of CRA have expressed their concern about abusive lending practices generally known as predatory lending[26]. The growth of subprime lending that has the potential to become predatory has been substantial in recent years. According to some scholars, CRA examination process may have indirectly helped the growth of such lending practices. The subprime lending are primarily concentrated in low-income and minority population, and therefore, have the potential to score positive points in CRA lending test. "The sub-prime market has experienced dramatic growth over the last decade, and research indicates that the sub-prime market includes a significantly higher percentage of minority, particularly African-American borrowers; a significantly higher percentage of low-income borrowers; and a higher share of borrowers of living in underserved areas [Haag 2000]." However, CRA examination process rarely looks into the *price and terms* of these loans. Therefore, loans to LMI borrowers with

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[25] The 1989 CRA modernization required public disclosure of ratings and performance evaluation explaining the basis of the ratings. This provision directly addressed these concern.

[26] *Predatory lending*, according to Immergluck and Wiles [1999], are mortgage lending practices that may include charging excessive fees and interest rates; fraudulent, high-pressure, or misleading marketing; and 'flipping' or overly frequent refinancing with repeated fees being rolled into the loan, resulting in increased debt and reduced owner's equity.

abusive terms and hidden fees may get as much CRA credit as, or in some cases better CRA credit than other community development loans. To fulfill CRA obligations, and to enhance CRA ratings, rational lenders may find it more profitable to purchase these loans or Mortgage-Backed Securities (MBS) that include these loans. Inadequate CRA examination allowed lenders to extorts high-risk borrowers and still receive credit in the CRA evaluations. This provision of CRA and it unintended effects are criticized by the community advocates.

IV.C. Changing Trends of the Financial Industry

The past decade has experienced a dramatic restructuring of the lending industry and mortgage market operations. These changes have directly affected many aspects of how CRA obligations are defined, and how CRA assessment and enforcement are implemented. In this section, I look at these changes, and analyze how they affect CRA under following categories:

Table 4: Trends of the lending industry

Forces of Modernization	Short Description
Trends of the Lending Industry	a. Weakening link between branch-based deposit gathering and mortgage finance.
	b. Technological advancement and breakdown of financial barriers.
	c. Growing importance of securitization and expanding shares of loans originated through mortgage banking operations.

Weakening Link between Branch-Based Deposit Gathering and Mortgage Finance

Restructuring and streamlining of the mortgage lending operations, and consequent growth of mortgage bankers, mortgage brokers, independent mortgage companies and other secondary market players have revolutionized the way mortgages are originated and financed. One aspect of this restructuring is a weakening of the link between mortgage lending and branch-based deposit gathering. In 1980, thrift institutions originated approximately 50 percent and commercial banks originated 22 percent of all one-to-four family home mortgages. In that year, mortgage companies and other lenders originated the remaining 28 percent. This indicates the importance of branch-based deposits and deposit-taking institutions in mortgage finance. In recent years, however, branch-based deposits no longer serve as the primary source for mortgage funds. By 1997, mortgage companies became the dominant player in the market for one-to-four family home mortgages by originating 56 percent of all loans. In that year, thrift institutions originated only 19 percent, and commercial banks captured 25 percent of the same market [HUD

1997]. Yezer [1994] points out, "The notion that local depository institutions should be the primary mortgage lenders in a local area is outmoded. The rise of the secondary mortgage market has eliminated the relation between the originator of mortgages and the ultimate mortgage investor, whose identity is merged into national mortgage pools."

This shift of the dominant role from branch-based, deposit-taking institutions to mortgage companies has implications on the rationale, and the enforcement of CRA. The CRA obligation was imposed on depository institutions, and this obligation had a geographic dimension. Depository institutions were required to serve the credit needs of the community in which they maintain *branches*. Banks' community, where banks were obligated to serve, was defined according the location of its branches. The rationale for branch-based community definition was based on a strong link between branch-based deposits and community lending. During the time when CRA was enacted, the depositors/savers did not have many savings options besides saving with their local depository or savings bank. At the same time, local borrowers did not have many options to raise funds other than borrowing from local savers. CRA recognized this close link or inter-dependency, and attempted to prohibit the channeling of deposits from local community to elsewhere. As some scholars put, "The CRA's initial focus on areas where CRA-regulated institutions maintained branches made sense because restrictions on interstate banking and branching activities were limiting the geographic scope of mortgage-lending operations [Apgar and Duda 2003]." Over the years, however, this link has eroded. With the erosion of this link, the rationale for branch-based community definition and geographic scope of CRA obligation has lost its ground.

CRA enforcement mechanism was also designed with this link in mind. Currently, CRA regulations require most stringent examination of lending performance for the covered institutions *inside* their assessment areas, where the assessment area is defined in relation to the location of branches. CRA examination is much less strict for the covered institutions *outside* their assessment areas. However, given the gradually weakening link between branch-based deposits and all lending, under this present enforcement system, the major participant in the mortgage origination market remain outside the regulatory reach of CRA. "To the extent that the geographic focus for evaluating banks' CRA performance continues to be the area surrounding physical facilities (even if they be more modern incarnations such as supermarket kiosks for ATMs), then a growing portion of bank lending and other activities will fall outside the purview of CRA review [Haag 2000]."

Clearly, although the link between branch-based deposits and mortgage lending has weakened over the years, CRA examination has continued to focus on this already-eroded link. Under the present financial system, deposits simply are not the *only*, or even the major, source of mortgage funds, and depositories are not the only institution successful in attracting deposits. The argument that deposit-taking lenders receive all the deposits and these lenders are the primary source of mortgage funds, therefore, they should be required to serve their community is not very relevant any more. Changes in the mortgage markets and future trends in the industry structure call for modernization of CRA. Some have suggested the redefinition of bank's assessment areas that is not strictly branch-based and expansion of CRA coverage to include lenders that currently dominate the mortgage lending market these suggestions are discussed in the section VI.

Technological Advancement and Break down of Financial Barriers Leading to Large Financial Institutions. In the previous discussion of the weakening link between branch-based deposit gathering and community lending, we saw that one of the rationales for requiring depositories to serve the credit needs of the community was that these local depositories had enjoyed a near monopoly in terms of attracting deposits and making loans. As the importance of deposits as the primary source of mortgage capital was diminishing, the monopoly nature of local banks was also changing. Technological advancement accelerated the pace of this change. With the advent of sophisticated computing power, database management capability and superior information technology, physical *distance* between lender and the consumer is no longer a significant barrier in providing banking services. Online banking, ATMs, bankcards, and electronic commerce have begun to fulfill most banking needs including banking services, mortgages and investments. Consequently, competition from non-local and out-of-state banks became fierce.

Banking legislation responded to this changing trend and relaxed the interstate branching restrictions by passing Reigle-Neal Interstate Banking and Branching Efficiency Act in 1994. In conjunction with interstate branching, common ownership of traditional banks and other non-bank institutions such as insurance companies, investment and financial companies, mutual funds, pension funds have became a reality with the passage of Financial Modernization Act (FMA) in 1999[27]. One consequence of relaxing the interstate branching restriction and the removal of financial barrier to participation by other types of financial institutions was the

[27] Implications of the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 and of Financial Modernization Act of 1999 are discussed in Section V.

emergence of large-scale, universal financial institutions. These large institutions were able to afford superior technologies with high fixed cost, but very low marginal cost. These institutions could then offer banking services to more people at less cost. Consequently, smaller, local banks faced increased competition. Although many smaller continue to thrive in today's banking environment, others have lost their market share to large, distant lenders and many have merged with or acquired by larger institutions, giving rise to even larger financial giants.

Growing Importance of Securitization and Expanding Shares of Loans Originated through Mortgage Banking Operations The emergence of non-depository lenders like mortgage bankers to capture the dominant position in mortgage origination has been possible because of the growth of securitization of mortgages. Securitization has reduced the need for these non-depository lenders to hold deposits to fund mortgages. Standardization of loan contracts through streamlined documents, uniform underwriting standards and standard risk assessment criteria has contributed to this securitization process. Government-sponsored enterprises (GSEs) like, Fannie Mae and Freddie Mac and other private conduits package mortgages into Mortgage Backed Securities (MBS) and sell these securities to third party investors in the secondary market. The majority of conventional, conforming[28] loans are sold to Fannie Mae and Freddie Mac. Non-conforming loans are pooled and sold by the investment bankers as private securities. Ginnie Mae, the other GSE, does not purchase loans, but guarantees the timely payment of principal and interest for privately issued securities backed by FHA-insured and VA-guaranteed loans. The federal government's involvement in the securitization and guarantee of payments in case of default not only diminished the need for deposits to fund mortgage and allowed non-depository lenders to capture mortgage origination market, but also provided a massive inflow of capital into the housing market. Consequently, securitization has contributed to the availability and affordability of mortgage credit to homebuyers.

The securitization and consequent inflow of credit to mortgage borrowers, including LMI borrowers has significant implications for CRA lending. Increased securitization of CRA-covered lending has facilitated increased community lending. Although the trend to securitization has largely affected the market for prime mortgages, efforts have been made to securitize subprime, and CRA covered loans, which imposes greater challenge. "Because of the lower down payments, flexible underwriting standards and lack of mortgage insurance on typical

[28] Loans that meet GSE imposed terms and standards including maximum loan to value ratio, monthly debt to income ratio and loan size limitations such that these loans are eligible for GSE purchase

'CRA loans,' traditionally they have not been saleable in the mainstream secondary market [Haag 2000]." Despite these challenge, securitization of CRA lending had been realized. In 1997, First Union Corporation securitized 384 million worth of mortgage loans originated by First Union's CRA program. By selling CRA assets, depository institutions can free up part of their balance sheets for more community lending. Mainstream secondary market may play a significant role in serving the LMI housing and community development needs, and thus further the purpose of CRA.

CRA revision in 1995 has created investment test as a component of CRA evaluation for large retail institutions. In that, lenders may receive CRA credit for purchasing CRA securities or investing in the Community Development Financial Institutions (CDFI) that invest in community developments. The federal government has also sought to create a secondary market for LMI loans through other legislation. The Federal Housing Enterprise Financial Safety and Soundness Act required HUD to set annual affordable loan-purchase targets for Fannie Mae and Freddie Mac. Despite growing market for securitization and its implication for CRA, the most significant developments in the financial market that have directly affected CRA are the growth of non-bank lender and removal of financial barriers. As Hagg [2000] puts, "Two principal alterations in the financial marketplace may limit the reach and effectiveness of the CRA regime. First, the proliferation of non-branch delivery systems for banking products and services such as internet banks, e-commerce, the U.S. mail, and the telephone, have challenged the definition of the 'community' to be served for purpose of CRA compliance. Second, the combination of interest rate and other banking deregulation, increased competition in the financial services industry, and technological innovation has resulted in a shift of financial assets out of depository institutions that are subject to the CRA's mandate and into non-bank financial services providers such as insurance companies, mutual funds, pension funds and finance companies."

V. Reforms and Modernization of CRA

In this section, I will trace out the major reforms of CRA since its inception and analyze some of the underlying causes and implications of these reforms. CRA is a simple, short and general statute. With a little involvement from the government, the act brought community residents and the depository institutions into an atmosphere in which they can negotiate and pursue their self-interests. Due to this simplistic nature of the act, however, it received an intense criticism, strong comments and numerous questions seeking clarifying interpretations. In response to these criticisms, questions, and comments, the regulators have issued clarifying statements and interpretive guidance. The simplicity and general nature of CRA and subsequent dynamic process of questions and answers have made CRA one of the most flexible and adaptive acts that survived the test of time and remained relevant for last quarter century.

Background of Past Reforms

In the first decade since the passage of CRA in 1978, the act remained largely dormant. The strongest CRA enforcement provision - the ability of regulators to condition or deny merger applications of lenders with poor CRA performance - was rarely used. The decade with a few number of mergers in the banking sector explained, in part, why CRA enforcement provisions were implemented so infrequently. In addition to lack of consolidations, limited lenders' accountability might have influenced lax enforcement. Under original CRA provisions, lenders' accountability for CRA performance was limited because performance was evaluated based on the documentation of plans or proposed strategy as opposed to actual outcome of these plans. Furthermore, in its first decade, CRA ratings and evaluations were not disclosed to the public. Due to this limited disclosure, lenders might not have worried about the damage to reputation for poor CRA performance. Limited disclosure might have also limited the effective participation of community groups in the CRA examination process.

From this dormant status, CRA had emerged as a vibrant and influential act after its first decade. Several independent events accelerated the modernization of CRA. One such event was the failure and subsequent bailout of savings and loan associations in the late 1980. This bailout required federal regulators to exert stricter supervision over depository institutions. Around the same time, Pulitzer prize-winning 'Color of Money' series [Dedman 1988] in the Atlanta Journal and Constitution documented the widespread racial disparities in mortgage lending in Atlanta. Although CRA does not have a direct racial component, increased awareness of the race-based discrimination in mortgage credit market helped establish the link between the CRA and racial discrimination. "This (race-based disparity in mortgage lending) not only stimulated discussion of the failure of banks to serve 'community needs,' but also linked CRA and Fair Lending in the public debate [Ford Foundation 2002]."

A simple link between CRA and Fair Lending laws lies in the positive correlation between low-income population and racial minority status. By requiring lenders to meet the credit needs of the entire community including LMI neighborhoods and borrowers, CRA might help mitigate the racial disparity of mortgage credit. For a detail methodological discussion of fair lending laws, tests for discrimination in mortgage lending and enforcement of fair lending regulation see Ross and Yinger [2002], and Yezer [1994]. Given the positive correlation between low-income and minority status, increased awareness of racial discrimination in mortgage credit focused new light on CRA as another potential tool to strengthen fair lending legislation. Therefore, researchers believe that the combination of "public reports of lax enforcement, compelling evidence of lending discrimination in major cities and multibillion dollar taxpayer bailout of the savings and loan industry all contributed to grassroots support for a stronger community reinvestment movement. [William, McConnell and Nesiba 2001]"

Past Revisions to CRA

CRA has undergone several reforms in its twenty-five years' of history. A few of these reform efforts were substantial and elaborate, focusing exclusively on CRA such as, 1989 and 1993 CRA reforms. While some modifications affecting CRA were made as part of other legislations that had a LMI lending components in it such as, 1991 amendment to the Federal Deposit Insurance Corporation Improvement act, 1992 amendments to the Housing and Community Development Act and sunshine provisions of Gramm-Leach-Bliely (GLB) Act. In a chronological manner, these major reforms and amendments are discussed in this section. Following table shows these revisions and the salient features of these revisions.

Table 5: Past CRA Reforms

Revision	Salient Feature of the Revision
1989 Revision in Financial Institution Reform, Recovery and Enforcement Act (FIRREA)	Descriptive rating system
	Disclosure of performance
	Emphasis on performance over promise
1991 Amendment to the Federal Deposit Insurance Corporation Improvement Act (FDICIA)	Discussion about the accuracy and adequacy of the data used in the evaluation
1992 Amendment to the Housing and Community Development Act	Incentives to cooperate with minority- and women-owned financial institutions
1994 Amendment to the Riegle-Neal Interstate Banking and Branching Efficiency Act	Separate rating and written evaluation for each State
1994 Department of Justice opinion on direct enforcement mechanism	Direct enforcement actions for poor CRA performance is beyond the scope of the law
1995 Modernization to CRA	Emphasis on performance over process
	Lender-specific evaluation
	Specification of performance context

	Specification of tests
	Performance rating matrix
	Data collection and reporting requirement
	Revised definition of assessment area
1999 Amendment to the Financial Modernization Act (FMA) or Gramm-Leach-Bliely (GLB) act	Less frequent evaluation for better CRA Performance
	Disclosure of CRA agreements

1989 Revision

The first major revision of CRA took place in 1989, a decade after its initial passage. The revision was known as Financial Institution Reform, Recovery and Enforcement Act (FIRREA)[29]. This revision brought about changes in the performance rating system, enhanced focus on performance and introduced disclosure provisions. Some salient features of the FIRREA are described in the below:

Descriptive Rating Scale over Numeric Ratings: FIRREA changed the numerical CRA rating system, and introduced a descriptive rating scale. This descriptive evaluation had four levels of performance (outstanding, satisfactory, needs to improve and substantial noncompliance) that replaced five-tiered numeric ratings, which were similar to the ratings given to institutions based on safety and soundness. One of the reasons for this change was to differentiate and remove any perceived connection between CRA rating and previously existing safety rating.

Disclosure of performance: The provisions under FIRREA required lenders to disclose their CRA ratings to the public. In addition to the disclosure of composite ratings, the act required disclosure of a written statement of performance evaluation. The performance evaluation, under the revised act, had two sections: public and confidential. The public section would contain statements describing the basis of the rating for each of the twelve assessment factors. For wider availability of the evaluation and ease of administration on the part of the lenders, the act required lenders to place the public portion of performance evaluation in their CRA public file at the head office and at one of the designated office in each local community.

The disclosure of rating and its basis was intended to have several implications. On one hand, the disclosure provides community individuals and groups with more information about the ratings allowing them to participate in CRA process more effectively. On the other hand, requiring

[29] Detail of this revision is set forth at 12 CFR part 228 for FRB, 12 CFR part 345 for FDIC, 12 CFR part 25 for OCC and 12 CFR part 563e for OTS.

examiners to describe how a particular rating is derived makes the examination process more transparent. It allows lenders and community groups to evaluate the rationale and consistency of the examination. This added requirement may have made the bank examiners more accountable to the lenders as well as to the public. As report of the General Accounting Office (GAO) states, "Public disclosure of CRA ratings has also made the regulators more accountable by allowing interested members to the public to see how the regulators were rating various institutions [GAO 1995]."

Performance over Promise: Banking regulators emphasized CRA policy stating that lenders would be evaluated based on their actual performance record *at the time* of examination, and not merely on promises for improvements of their existing record in the future. On this ground in 1989, FRB for the first time denied the merger application of the Continental Bank Corporation to acquire Grand Canyon Bank of Scottsdale. In their decision, FRB ruled, "in light of inaccurate filings, and lack of significant efforts to ascertain the credit needs of its community or advertise its products, with no compensating activities, the Bank's commitments to improve CRA performance did not absolve it for a weak CRA record [Ford Foundation 2002]." This decision of FRB might have affected major policy shifts relating to how CRA evaluations are conducted in the subsequent years. In 1995 CRA modernization, we find that not only the 'promise to perform' has no effect on CRA evaluation, but also the 'plans or strategy to perform' has no effect on CRA evaluation and whole evaluation is based on the 'actual performance'. This performance-based evaluation might have began to take shape in the early 1990's.

1991 amendment

Federal Deposit Insurance Corporation Improvement Act (FDICIA): This amendment required regulators to discuss and comment in the public portion of the CRA evaluation about the accuracy and adequacy of data used in the assessment of institutions' CRA performance. Accuracy of data may play a crucial role in the evaluation process and needs to be discussed, adequately qualified and accounted for as much as possible. For example, GAO report [GAO 1995] states that in a survey conducted by Federal Reserve District Banks from 1993 to 1994 shows that the most significant errors found in the HMDA data during that period were associated with the reported income of the loan applicant. While over half of these errors were the result of banks reporting income figures from unverified application information, the other half consisted of clerical errors of the reporting institutions. Since income information is the most important piece of information that often determines whether a loan is qualified for CRA credit,[30] errors in the income information may produce misleading CRA assessment.

The FDICIA amendment requiring a discussion of data limitation in the CRA evaluation remained relevant long after its passage. FFIEC report on the nationwide summary statistics for 1996 CRA data shows that while reporting the location of small business or small farm loans, borrowers report the census tract of the business or the farm, although the funds may be used to support business activities or offices in another location. Allocation of funds to support activities in a location with different characteristics than the characteristics of location originally reported may provide misleading CRA assessment and may substantially undermine the purpose of CRA. Another instance of misleading assessment caused by inadequate data occurs when business or farmers receiving loans do no provide lending institutions with the street address of their business or farm, rather provide only the post office address where correspondence should be sent. When these loans are geocoded by the lender according to the census tract of the post office as opposed to the census tract of the business or farm, it creates two problems. First, the data shows extraordinary volume of loans in the census tracts with post offices and second, characteristics of the census tracts with post offices may differ from those where the business or farm is located causing misleading CRA assessments. By requiring a discussion about the limitation on data in the CRA evaluation, FDICIA amendment forces the examiners to account for data related distortions. This amendment was intended to encourage lenders to collect more detailed and specific information about the loan and borrowers characteristics.

1992 amendment

Housing and Community Development Act: changes brought forward by this amendment provided incentives to lending institutions for cooperating with minority- and women-owned financial institutions and credit unions. The act required the regulators to consider the activities and investments of minority- and women-owned institutions and low-income credit unions in assessing the CRA performance of the lenders who cooperate with these institutions. In other words, the act allowed regulators to grant CRA credits to the lenders that cooperate with certain community lenders or financial institutions. Although this amendment is not a direct modification to CRA, it tends to exploit CRA enforcement mechanism to create incentives for

[30] Generally, loans made to the LMI borrowers, or in the LMI neighborhoods within the assessment area qualify for CRA credits. Additionally, CRA examination considers loans, investments and services that have 'community development' as their primary purpose. For definition of community development as provided in the 12 C.F.R. § 25.11(h) - (i), see the endnote.

depository lenders to engage in activities that might promote community lending. Whether this incentive has a real effect in addressing the community credit needs is a matter of further investigation, but the use of CRA mechanisms to create such incentives might have adverse effects. In that, CRA might lose its original focus and become a compendium of activities that might promote community lending. For example, there is no evidence that cooperation with minority- and women-owned as indicated in the Housing and Community Development Act necessarily encourage these lender to help meet the credit needs of the entire community. Additionally, this might make CRA performance assessment more complex and difficult for the examiners.

1994 amendment

Riegle-Neal Interstate Banking and Branching Efficiency Act: Riegle-Neal interstate banking and branching efficiency act allowed lenders to operate in a multi-state basis. This act responded to the trends of the banking industry and enhanced efficiency of banking institutions by providing flexibility, economies of scale and scope for larger banks. CRA provision of this act requires that institutions with interstate branching structure to receive a separate rating and written evaluation for each state in which they operate. In addition, the act requires that the bank receive a written evaluation of their performance within a multi-state metropolitan area.

This increased flexibility and liberalization, however, has implications for CRA as described in the previous section on the changing trends of the lending industry. Amendment concerning CRA as proposed by this act addresses a specific issue with regards to CRA ratings in the era of interstate banking. Specifically, the ability to operate in multi-state basis could allow lenders to perform poorly in certain assessment area but extraordinarily in others to compensate the poor performance. Requiring rating and evaluation for each state encourages lenders to perform well in every state it operates.

The trend toward interstate operation in the financial industry has significant implications for CRA. As interstate branching and distance lending become more common, rationale for branch-based deposit to finance investments becomes even weaker. In addition to this weakening effect, the emergence of very large financial institutions has other implications on the effectiveness of CRA. Financial assets holdings of depository institutions dropped from 40 percent to 22 percent of country's total financial intermediary assets from 1977 to 1995 [Litan 1997 as reported in Haag 2000]. Since the total assets of the financial intermediaries have risen in this period, one possible explanation for the reduction of financial assets of the depositories may be the substitution of assets from depository institutions to non-depositories or relative reduction of size of the depositories as compared to non-depositories. The substitution of assets was most likely to occur in the large-sized financial organizations that could own both depository and non-depository institutions under the new banking laws. The other possibility for the reduction of asset could be the absolute reduction of the number of depositories. Indeed, the number of commercial banks and savings associations has dropped more than 40 percent during period between 1975 and 1997 [Avery et. al. 1999]. This reduction of the number of depositories may be attributable to the massive scale consolidations also fostered by new banking legislation. With the reduction of the asset size and of the number of depositories – the major component of CRA-covered institutions - the number of loans made these institutions has also fallen. “From 1993 to 2000, the number of home purchase loans made by CRA-regulated institution in their assessment area as a share of all home purchase loan fell from 36.1 percent to 29.5 percent [Ford Foundation 2002].” As assets, size and financial base of CRA-covered institutions falls, the *effectiveness* of the act in terms of its ability to increase LMI lending, investment and its geographic scope will likely to decline.

The break down of financial barriers and the emergence of financial institutions with large size and wider scope allow lenders to perform multiple activities that have been proscribed before. The most important advantage of deregulation and consequent large-scale institutions is the economies of scale that reduces the average cost of delivering financial services. Some researchers believe, "In reality, deregulation and new technologies have promoted competition and precipitated a great broadening of the credit market [Gunther 2000].” Many others argue that consolidations result in increased efficiency, safety and liquidity to banks that belong to larger and diversified organization, which would contribute to increased credit availability for small business and LMI communities [see Keeton 1997]. Some of these researchers go even further to claim that recent increase in lending to LMI neighborhoods is almost exclusively attributable to the break down of barriers than due to the regulations like CRA. “Economic theory and empirical evidence both indicate the reason for the recent growth in lending to low-income neighborhoods is not the CRA but the effectiveness of market forces in breaking down the types of financial barriers prevalent when the CRA was enacted [Gunther 2000]."

Opinion of Department of Justice: In 1993, initial reform proposal of CRA sought to strengthen enforcement by calling for regulators to use existing formal enforcement actions set forth in the banking laws, such as cease-and desist orders and civil money penalties. In

December 1994, Department of Justice determined that regulators lack authority to use any direct enforcement mechanism for poor CRA performance other than measures taken in the context of an application. Although this opinion disappointed the proponents of CRA including several members of the Congress and community activists, it clearly outlined the extent of enforcement authority available to the regulators. This opinion implied that the original statute permitted an indirect enforcement for CRA and any stronger enforcement, such as direct monetary penalty or cease and desist order would require actions of the legislative body.

1995 Modernization

In 1993, regulators initiated a major initiative to reform CRA regulations. The goal of the reform was to "develop revised rules that would clarify how we (the regulators) would evaluate the performance of the institution we supervise. It also was our goal to develop a new system of evaluating financial institutions' records with respect to CRA that would focus primarily on *objective*, *performance-based* assessment standards that *minimizes compliance burden* while stimulating improved performance. [66 Federal Register 37602]." After seven public hearings and two proposed rules, the joint final rules came out on May 4, 1995 [60 Federal Register 22156].

The 1995 regulations were to phase in by July 1, 1997. At that time, all provision of the revised regulations would be applicable to all financial institutions covered under CRA and the 1978 regulations would fully expire[31]. Since the 1995 joint final rules, regulators have issued two clarifying amendments [60 Federal Register 66048 (1995) and 61 Federal Register 21362 (1996)]. In addition, FFIEC has published guidance to agency staff in the form of Interagency Question and Answers (Interagency Q&A) regarding community reinvestment under the new regulations [61 FR 54647]. This guidance was an attempt to create a comprehensive document regarding guidance on revised CRA regulations that would serve as informal staff guidance for financial institutions, agency staffs and the public[32]. The major features of 1995 final reform can be summarized under the following headings:

[31] Since the full implementation of revised regulations, the FFIEC found that the guidelines and policy statements issued to interpret the 1978 regulations have become obsolete. Consequently, the FFIEC withdrew the 1989 Policy Statement [54 FR 13742], 1990 Rating Guidelines [55 FR 18163] and the 1991 Lending Analysis Policy Statement [December 6, 1991].

[32] On October 7, 1997 the FFIEC supplemented, amended, and republished the Interagency Q&A to provide further assistance about the final rule. In 2000, FFIEC published another interpretive guidance in the form of questions and answers [65 Federal Register 25088] interpreting the CRA regulations.

Performance Over Process: The goal of 1995 modernization was to develop a new method for evaluating financial institutions' record with respect to CRA that would focus primarily on objective, performance-based assessment standards. Under the regulations, the regulators would conduct a performance-based examination in which actual performance in serving the needs and convenience of the local community counts, and the efforts exerted (strategy, manpower and paper work) to achieve the performance is not accounted for.

Performance based evaluation marked a new beginning of CRA enforcement. It proposes a major shift from the previous evaluation methods. Basically, performance based evaluation proposes that regulators will not focus how lenders conduct or choose their CRA activities as long as these activities brings result – meets the credit needs of the entire community. This new way to evaluate the CRA performance is simple, objective and straightforward. It also reduces the need for examiners' judgment to a certain degree in evaluating the effectiveness of varied community lending activities and strategies a lender might choose. Since the lenders are not required to document and prove their community lending efforts, this method also reduces paper work burden for lenders in a substantial way.

In addition, I believe this evaluation method has a similarity with the concepts of 'procedural equity' versus 'equity in outcome'[33]. The emphasis on performance-based evaluation can be thought of as a shift of emphasis from procedural equity to equity in outcome. In that, it is not sufficient for lenders to prove elaborate community lending efforts directed towards borrowers in the community, but an evenhanded distribution of loans across LMI and non-LMI areas and borrowers after allowing for credit needs of the community, considering capacity, safety and performance context of the lenders would give CRA credit to lenders.

Lender-Specific Evaluation: Under the new regulations, the scope of the CRA examination of financial institutions is determined by the institution's size and business strategy. For the purpose of evaluation, agencies have determined two sizes of institutions: small and large. With respect to diverging business strategy, regulators have divided the lending institutions into two types: 'Retail institutions' and 'Wholesale or limited purpose institutions'. Combining different sizes and types of institutions, regulators have devised three different types of evaluations. They are: evaluation for large retail institutions, streamline evaluation for small retail institutions and

[33] The procedural equity and equity in outcome are concepts often used in discrimination and affirmative action literature. The procedural equity requires that everyone, including the minority, must be treated using same standards. While equity in outcome states that when historical discrimination and unequal treatments had persisted in the past, procedural equity is not enough to achieve equity in outcome. Society might need to allow a favorable treatment to minority to achieve equity outcome.

evaluation for limited purpose and wholesale institutions.[34] In addition, to allow for greater flexibility to account for the unique strategic circumstance of lending institutions, regulations also provide an alternative option for any institution to be examined against a strategic plan. This plan consists of a set of objective, measurable goals established by the bank, utilizing the inputs from its community, and approved by the institution's regulator.

The lender-specific evaluation addresses some of the issues raised in the reactions of lending institutions (section III). In that, it was argued that CRA examination did not take the specialized nature of lenders into account. One examination for all institutions had been criticized to be unfair and inefficient. In addition to addressing this criticism, clear guidance regarding lender-specific evaluation reduced the examiner's judgment in the evaluation process. Examiner's judgment may have produced different CRA ratings for lenders with comparable community lending performance. Reducing the scope of this judgment was one of the major goals of revised CRA regulations.

Specification of Performance Context: Regardless of which evaluation method is used, every institution's CRA performance is evaluated within a "performance context". The performance context explicitly takes into account the unique characteristics of the institution under examination and the characteristics and needs of the community in which it operates. The tests and standards set out in the CRA examination are applied against the following six contexts:

1. The economic and demographic characteristics of the assessment areas
2. Lending, investment and service opportunities in the assessment areas
3. The institution's product offerings and business strategy
4. The institution's capacity and constraints
5. The prior performance of the institution
6. Information contained in the institution's public CRA file, including written public comments.

To determine the performance context, the regulators may request information on lending, investment and service opportunities in the institution's assessment area that the institution would normally gather to develop its business plan or to identify potential markets and customers. In addition to the information obtained from the institution, the regulators may

[34] Apparently, no distinction was made between small and large 'wholesale institutions and limited purpose'. Consequently, one evaluation was applicable for all sizes of limited purpose and wholesale institutions.

consider information from other sources including community, government, civic, and other sources.

Explicit recognition of performance context requires examiners to conduct a lender specific test that goes beyond the consideration of lender's size (small or large) and type (retail or wholesale and limited purpose). Performance context also clearly identifies the factors that the examiners should consider to account for the uniqueness of the institution and its market. This explicitness was intended to reduce subjective judgment on the part of the examiners who would use widely varied factors in evaluating the particular context of each institution.

Specification of Tests: Each of the three types of evaluation has its own test that reflect different ways lending institutions can fulfill their community reinvestment obligations. According to final rule, large retail institutions are evaluated under three separate tests: lending, investment and service test, small institutions are evaluated under the streamlined small institution test and wholesale and limited purpose institutions are evaluated under the community development test. In addition to three types of evaluations, regardless of size and types, all institutions have the option to be evaluated under a pre-approved strategic plan. In the following section, I will discuss significant features of these tests.

Lending Test: The lending test is the most heavily weighted component of CRA examination for large retail institutions carrying at least one half of the performance ratings[35]. This test is designed to measure a lender's record of helping to meet the credit needs of its assessment area through home mortgage, small business, small farm and community development lending[36]. The regulation provides five performance criteria and seven factors[37] considered under lending test. The performance criteria for lending test are:

1. *Lending activity*: including the number and amount of loans in the bank's assessment area.

[35] Detail weight distribution in the CRA performance rating is discussed later in this section also see table 2.

[36] If lenders want their regulator to evaluate their *consumer lending* (auto loans, personal loans) record, they may elect to do so by providing consumer-lending data in a specific format. Whenever consumer lending constitutes a substantial portion of lenders' business, the regulators are required to consider those lending whether or not lenders elect to provide consumer-lending data.

[37] Performance criteria and factors under lending, investment and service test are listed in a table at the endnote.

2. *Geographic distribution*: including the proportion of loans in the assessment area and distribution of loans in low-, moderate-, middle- and upper-income[38] geographies in the assessment area.
3. *Borrower characteristics*: including the proportion of loans across low-, moderate-, middle- and upper-income borrowers in the assessment area, and the number and amount of loans to small business and small farm.
4. *Community development (CD) lending*: including the number and amount of community development loans and their complexity and innovativeness. Lenders can elect to have their regulators consider CRA-qualified community development lending by their affiliates under certain guidance. This guidance in terms of types of CD lending that are qualified, data that needs to be collected, maintained and reported and other restrictions on the affiliate lending are discussed later in this section under 'Data Collection and Reporting Requirement'.
5. *Use of innovative or flexible lending practices*: including use of innovative or flexible lending practices to address credit needs of LMI borrowers and neighborhoods.

Investment Test: This test is designed to evaluate lenders' record of meeting the credit needs of their community through qualified investments[39] that benefits their assessment area or a broader statewide or regional area that includes the lenders' assessment area. In evaluating investment test, regulations specifies four performance criteria:

1. *Number and amount* of qualified investment.
2. *Innovativeness and complexity* of qualified investment.
3. *Needs* for the qualified investment or degree to which these types of investments not routinely provided by other private investors.
4. *Responsiveness* of qualified investments to credit and community development needs.

[38] Middle-income geographies include census tracts with more than 80 percent but less than 120 percent of the MSA median income. Upper income geographies include census tract with more than 120 percent of the MSA median income.

[39] A qualified investment has as its primary purpose community development. Some examples of this investment may include an *investment, deposit, membership share, or grants in or to:*
- Financial intermediaries such as CDFIs or CDCs,
- Organizations engaged in affordable housing rehabilitation or construction,
- Small business investment companies (SBICs),
- Projects eligible for low-income housing tax credits,
- State and municipal obligations, or
- A nonprofit organization serving community development needs such as homeownership counseling and other financial service education.

Although these performance criteria tend to specify the factors upon which the regulators would carry out investment test, these criteria hardly remove examiners' subjective judgment associated with the test. There is no clear, objective means to evaluate and compare the innovativeness or responsiveness of different qualified investments. "An area for further review is the definition of 'innovative.' Some lender contend that regulators are slow to consider 'innovations that are actually challenging to accomplish [Ford Foundation 2002]." Moreover, some institutions may not be in a position to engage in any investment at all, but are likely to receive some investment credits anyway. As GAO [1995] study points out, "Institutions with limited investment authority, such as thrifts, are to receive a low-satisfactory rating under the investment test, even if they have made few or no qualified investments, as long as they have a strong lending records." In a study using internal evaluation of OTS, the Office of Inspector General, U.S. Department of Treasury was unable to validate the appropriateness of the investment test ratings for 41% of its sample [Department of Treasure as reported in Thomas 2003]. This allocation of CRA credit may contribute to grade inflation. Additionally, since community development (CD) loans are evaluated under the lending test and these loans form the basis for the investment test as well, some researchers suggests the need for more specific guidelines about the distinction between these two (Thomas 1998).

Experience with the investment test and its effectiveness in utilizing CRA legislation to tap into diversified capital market has been mixed. Development of a secondary market in CRA securities, prompted by new emphasis on CRA qualified[40] investment activities has been considered as an important tool for increasing the lending capital of lending institutions. Allocation of CRA credit for third party intermediary lending and qualified investments in the revised regulations has provided incentive for lenders to pool their resources in various multi-bank lending arrangements such as loan consortia[41]. These institutional arrangements have been used increasingly in recent years because they appear to offer an effective means to reduce transactions cost in lending process by sharing informational benefits, exploiting economies scale and spreading credit risk within a limited geographic area to number of institutions (Haag 2000, Avery et. al. 1997, GAO 1995, Calem and Wachter 1998 and Mendez 1998).

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[40] CRA qualified or CRA eligible loan includes loans to borrowers earning less than 80 percent of area median income and/or loan made on properties in census tracts with incomes less than 80 percent of the Metropolitan Statistical Area (MSA) median income as of the last census.

[41] Loan consortia generally consist of lending institutions often located within spatial proximity and share common assessment area that pool lending funds and collect equity stakes for LMI lending and community development.

Other researchers recognize the benefit of lending consortia and associated information externalities. However, they contend that increased emphasis on investment test may have adversely affected the original objective of CRA. Independent investment and service test shift one half of the weight away from the lending test, which is the original focus of CRA. In addition, the investment test may have produced several unintended distortions in the credit markets. For example, the primary barrier cited by financial institutions in meeting the investment test under CRA is the limited number of qualified CRA investment opportunities within the financial institutions' assessment area(s) [Summary Report 2001]. Due to limited supply of qualified investments but increased demand by lending institutions to fulfill CRA requirements, qualified investments carry a premium which can be as much as one full point. This premium might have induced Wall Street opportunists to exploit CRA 'gold mine' that has nothing to do with LMI credit. "The current investment test has led to many qualified investments that merely recycle existing loans with no new underlying LMI loans being created. One loan may be bought and sold many times and then securitized and then securitized and repeatedly traded as an LMI MBS. Since it is defined as a qualified CRA investment, many banks get CRA credit for but one underlying LMI loan[42] (Thomas 2003)." Indeed, interviews with several national lenders in the Ford Foundation study reveal "this practice, by which the loans pass through the hands of an additional owner on their way to the secondary market, is clearly uneconomic. Lenders appear to treat it as a cost of doing business and one that is preferable to risking a rating below satisfactory that hurts their competitive standing [Ford Foundation 2002]."

In addition to these arguments[43] indicating adverse impact of the investment test on the overall effectiveness of CRA, investment test has important difference as compared to other two tests. In that, investment test does not provide a lender-specific benchmark to measure the degree of compliance with CRA requirements. In a lending or service test, the regulators are able to

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[42] Although CRA regulations impose a general restriction on the number of times a loan can be bought and sold between affiliates, under current regulations an examiner has no means to know the transaction history of underlying loans within a mortgage based CRA securities.

[43] These arguments can be summarized as follows:

a. Lack of definition for innovativeness and complexity of investment.
b. Reliance on the subjective judgment of the examiner.
c. Not suitable for all large institutions to undertake such investment activities.
d. Possible source of profiteering off CRA legislation.
e. Possible source of CRA grade inflation.
f. Lack of benchmark for measuring the degree of compliance.

examine the lending or service activities[44] of a particular lender across LMI and non-LMI neighborhoods and population without having to perform a across-lender comparison to evaluate the degree of compliance. The examiner can also acquire a sense of the community *needs* by looking at the demand for credits or services in the community. On the contrary, for the investment test regulators may be required to look at the across-lender investments in the community to measure the performance of any individual lender. This is because investments in affordable housing, into projects eligible for low-income housing tax credits or grants to local CDFI are essentially directed towards LMI communities and individuals, and therefore lender-specific analysis that looks at the extent and effectiveness of LMI versus non-LMI investments is not applicable. The difficulty in across-lender analysis, however, is that not all lenders are able or choose to participate in investment activities to comply with CRA.

Under these circumstances, many researchers including some members of lending institutions believe that investment test under CRA should be optional or abolished. "Many large banks and virtually every bank trade association are rightfully asking that CRA be returned to its LMI lending roots by abolishing the investment test [Thomas 2003]." Most CRA activists, community groups and advocates, however, are not willing to lessen the regulatory scopes of CRA. Many researchers believe that community groups' attitude to rigidly adhere to the existing provisions and to add only the new requirements are unproductive.

Service Test: The service test constitutes one quarter of the entire weight of the CRA examination for large retail institutions. The service test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) by analyzing both the *availability* and *effectiveness* of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services. Two components - (a) retail banking services and (b) community development service[45] of the service test account the degree to which retail banking and community development services are tailored to meet the LMI geographies.

The performance criteria to evaluate the availability and effectiveness of a bank's systems for

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[44] Activities relating to service test are discussed in the next under 'Service Test'.

[45] Community development (CD) services are the services that benefit a bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s). By the CRA regulation, CD services must be limited to financial in nature. For example, employee's participation in the volunteer neighborhood-renovation program may not be considered as CD service. However, lender's financial assistance in the form of loans or grants to renovate historic properties can be considered as CD service.

delivering *retail-banking services*[46] can be summarized as follows:

1. The current *distribution of the bank's branches* among low-, moderate-, middle-, and upper-income geographies.
2. In the context of its current distribution of the bank's branches, the bank's *record of opening and closing branches*, particularly branches located in low- or moderate-income geographies or primarily serving low- or moderate-income individuals.
3. The availability and effectiveness of *alternative systems for delivering retail banking services* (e.g., RSFs, RSFs not owned or operated by or exclusively for the bank, banking by telephone or computer, loan production offices, and bank-at-work or bank-by-mail programs) in low- and moderate-income geographies and to low- and moderate-income individuals.
4. The *range of other banking services* provided in low-, moderate-, middle-, and upper-income geographies and the degree to which the services are tailored to meet the needs of those geographies.

For the purposes of the service test, the extent and innovativeness of lending service may be measured in several dimensions including access to traditional full-service branch operations and alternative service-delivery mechanisms. The focus of the test, however, is "to be on the institution's current distribution of full-service branches. Alternative systems for delivering retail banking services are to be considered only to the extent that they are effective alternatives in providing needed services to LMI areas and individuals [GAO 1995]." With regards to service test, some of the previously discussed complaints including lack of clarity about the amount of service needed or must be provided, about the relative weights between retail service and community development service, and about the measure of innovativeness can be raised. "By most accounts, the service test component of the examination is the least well developed of the three. Review of the CRA examinations for the banks interviewed for this study suggests that regulators in general spend little time on this element of the examination [Apgar and Duda 2003]." Some community advocates suggest that growth of payday lenders and check cashers in the community who provide similar service as depository lenders at a much higher price should be indicative of lack of meeting the banking needs of the community and should adversely affect the performance of CRA covered lenders.

[46] The performance criteria to evaluate the *community development services* are:

1. The extent to which the bank provides community development services.
2. The innovativeness and responsiveness of community development services.

Streamlined Test for Small Institutions: In order to provide certain regulatory relief to small institutions [see endnote], a streamlined test was designed in the 1995 regulation. This streamlined test reflects regulators' desire to account for the differences in capacity to fulfill CRA requirements that are associated with size. Most notably, small institutions are exempt for data collection and reporting requirements of CRA. The streamlined test for the small lenders are evaluated under the following performance criteria:

1. The bank's loan-to-deposit ratio, adjusted for seasonal variation and, as appropriate, other lending-related activities, such as loan originations for sale to the secondary markets, community development loans, or qualified investments.
2. The percentage of loans and, as appropriate, other lending-related activities located in the bank's assessment area(s).
3. The bank's record of lending to and, as appropriate, engaging in other lending-related activities for borrowers of different income levels and businesses and farms of different sizes.
4. The geographic distribution of the bank's loans.
5. The bank's record of taking action, if warranted, in response to written complaints about its performance in helping to meet credit needs in its assessment area(s).

The above criteria show that streamlined test focuses primarily on lending activities of the small lenders with no separate tests for investment and service related activities. The loan-to-deposit ratio is a simple and easily measurable quantitative criteria considered in the streamlined test. This criterion reflects regulators' desire for a simple and objective evaluation for streamlined test.

Community Development Test for Wholesale and Limited Purpose Institutions: Although wholesale and limited purpose institution[47] fall under the coverage of CRA, due to their limited product line and specialized customer base, their record of helping to meet the credit needs of their assessment area(s) is evaluated under separate community development test. In order to receive a designation as a wholesale or limited purpose bank, a bank must file a request, in writing, prior to the proposed effective date of the designation. If the designation is approved, it remains in effect until the bank requests revocation of the designation or until regulators revoke the designation on their own initiative. Performance in the community development test is

[47] Wholesale institutions are not in the business of making home mortgage, small business, small farm or consumer loans to retail customers and limited purpose institutions offer a narrow product line such as credit card banks.

assessed through lender's community development lending, qualified investments, or community development services. Performance criteria for evaluating the community development test can be summarized as below:

1. The *number and amount* of community development loans[48], qualified investments, or community development services.
2. The use of innovative or complex qualified investments, community development loans, or community development services and the extent to which the investments are not routinely provided by private investors.
3. The bank's responsiveness to credit and community development needs.

At lender's option, the regulators will consider its community development performance in *qualified investments* or *community development services* provided by an affiliate of the lender, if the investments or services are not claimed by any other institution. Community development *lending* by affiliates, consortia and third parties may also be considered under certain rules[49]. Under community development test, lender receives credit for community development loans, qualified investments, and community development services that benefit areas *within* the lender's assessment area(s) or a broader statewide or regional area that includes the lender's assessment area(s). When these similar activities benefit areas *outside* the lender's assessment area(s), the regulators will consider these activities only if the lender has adequately addressed the needs of its assessment area(s).

Performance Ratings Matrix: The performance ratings matrix illustrates performance criteria and factors within the lending, investment, service test for the large retail institutions, the streamline test for the small institutions and within the community development test for the wholesale and limited purpose institutions. For large retail institutions, examiners evaluate each component of performance factors under lending, service and investment test and assign one of the five ratings[50] based on a judgment supported by facts and data. Performance ratings are converted to numerical weight according to the table 6 given below. The table shows that better

[48] Community development loans include originations, purchases and commitments of community development loan by the bank. In case of loan commitments, bank must provide appropriate data on outstanding loans, commitments, and letters of credit.

[49] Rules and requirements for considering such loans are discussed under 'Data Collection and Reporting Requirement (elective data)' subsection below.

[50] The performance ratings are: outstanding, high satisfactory, low satisfactory, needs to improve an substantial noncompliance. Although performance ratings under each test are used to obtain overall composite rating of the institution, performance ratings are not same as composite rating. While performance rating has five possible outcomes, composite ratings have four as shown in the table 6 and 7 respectively.

performance rating in any given test carries higher numerical weight. In order to attach more importance to lending test than service and investment test, numerical weight for any given rating varies across tests. While lending test carries at least double weights than other two tests, service and investment test are treated equally under revised CRA evaluation.

Table 6: Numerical Weights for Performance Ratings under Different Tests for Large Retail Institutions

Performance Ratings	Lending	Service	Investment
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

To obtain the final composite rating for any given large institution, points obtained under all three tests are added up and total points are converted into composite rating according to table 7 below. To provide further importance of the lending test two further rules are adhered. First, Regardless of point values, no institution can receive a composite rating of "satisfactory" unless it receives a minimum rating of "low-satisfactory" in the lending test. Second, an institution that receives "outstanding" on the lending test is assured of a "satisfactory" composite rating, even if it receives "substantial non-compliance" on both the investment and service tests.

Table 7: Distribution of Numerical Points for Composite Ratings

Rating	Total Points
Outstanding	20 or over
Satisfactory	11 through 19
Needs to Improve	5 through 10
Substantial Noncompliance	0 through 4

The matrix and explicit description of the factors may provide greater standardization and uniformity in the evaluation process and may help reduce examiners' judgment inherent in the evaluation process. In addition, this matrix and tables to derive composite CRA ratings may allow regulators to provide well-deserved importance of community lending in the examination process by providing higher weights to the lending test.

Data Collection and Reporting Requirement: These requirements are introduced in the 1995 modernization to evaluate the performance of covered institutions in an objective fashion.

According to the revised CRA regulation, all CRA-covered institutions that are not small [see endnote for definition] or special-purpose institutions are subject to the data collection and reporting requirement of CRA. Data that are collected, maintained and reported under CRA can be divided into two broad groups: essential data and elective data.

Essential Data: This data types must be reported to appropriate regulators by all covered institutions. Data that fall under this category are:

1. Community Development (CD) loans[51]
2. Small business loans[52] and
3. Small farm loans[53]
4. Certain home mortgage loan data[54]

For community development (CD) loans, total number and dollar amount of originated or purchased loans that benefit the covered institutions'[55] assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s) are reported in aggregate form. For reporting purposes, the level of aggregation is the census tract. In other word, total number of tracts in the assessment area represents the number of records in the entire data submission.

For small business and small farm loans, large retail institutions are required to *collect and maintain* information about loans originated and purchased by these institutions on a loan-by-loan basis. This information includes loan amount, loan location, origination date and indicator whether the loan was to a business or farm with gross annual revenues on $1 million or less. In addition to maintenance and collection, these institutions are required to *report* number and dollar amount of small business and small farm loans aggregated by the census tract in which the lender has originated or purchased these loans.

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[51] A community development loan has community development as its *primary purpose*, where primary purpose implies the loan is designed for the express purpose of community development. For further discussion of *primary purpose* see interagency questions and answers 12(i) and 563e.12(h)-7. For the definition of community development as provided in the CRA regulation see the endnote.

[52] Small business loans are defined as those whose original amounts are $1 million or less and that were reported on the institution's Call Report or TFR as either "Loans secured by non-farm or nonresidential real estate" or "Commercial or industrial loans." Therefore, small business loans can be provided to businesses of any size as long as the loan amount is less than $1 million. In other words, it is the loan size, but not the size of the borrowing business or its gross revenue that determines small business loans.

[53] Small farm loans are defined as those whose original amounts are $500,000 or less and that were reported as either "Loans secured by farmland" or "Loans to finance agricultural production and other loans to farmers."

[54] This loan data is reported to supplement the Home Mortgage Disclosure Act (HMDA) data *only* for mortgage loans to properties that are located outside the MSAs.

[55] Since small institutions are exempt from the data-reporting requirement, covered institutions in this case would imply large retail institutions and wholesale or limited purpose institutions.

In order to understand how the essential data may help evaluation of institutions, we need to look at different types of evaluations conducted by the examiners. As mentioned earlier, there are four different types of evaluation methods for different types of institutions. These tests are: the *lending*, *investment* and *service test* for large retail institutions; *community development test* for wholesale or limited purpose institutions; *streamlined performance test* for small institutions; and the *test on strategic plan* for institution with approved strategic plan. Since small institutions are exempt from data collection and reporting requirements, for streamlined performance test that are applicable for these institutions evaluation cannot rely on the reported data. For large retail institutions, examiners consider essential and elective data when evaluating the *lending test* or the *test of strategic plan* if the institutions are approved for the plan. For wholesale or limited purpose institutions, community development (CD) loans reported under essential data are considered when evaluating the *community development test* or *test on strategic plan* as applicable for them.

Elective Data: CRA regulations allow lending institutions to report certain data at lenders' discretion in order to improve their CRA performance. The primary purpose of this provision is to provide incentive to lenders for engaging in activities that are not required under CRA. These activities may have a positive impact in alleviating the credit needs of LMI borrowers or community. For example, lenders may collect and present their MECA[56] activities as "other loan data" to examiners for consideration in the lending test.

Loans originated or purchased by an affiliate[57] constitute another form of elective data. In order for affiliate loans to be counted in the CRA examination, the loans must satisfy certain guidelines with regards to its qualification as well as the methods of collection, maintenance and reporting of those loans[58]. Generally, no affiliate may claim a loan origination or purchase if another institution claims the same loan for origination or purchase. However, there are exceptions to this general rule. For example, if an institution purchases a loan from its affiliate who originated the loan in the first place then both the institution and its affiliate can count the same loan as purchase and origination respectively provided the loan is not sold several times to inflate CRA

[56] MECA stands for Modification, Extension and Consolidation Agreements. MECAs are transactions by which an institution obtains loans from another institution without actually purchasing or refinancing the loans. Although these transactions are not considered as purchase or refinance under CRA, they have positive effects on CRA ratings.

[57] An affiliate means any company that controls, is controlled by, or is under common control with another company. The term "control" has the meaning defined in regulation 12 U.S.C. 1841(a)(2).

[58] For detailed guidelines, refer to FFIEC's 'A Guide to CRA Data Collection and Reporting.'

ratings. Another exception is allowed for multifamily affordable housing loans that may be considered as a community development loan and home mortgage loan at the same time.

If an institution elects to have its regulators consider loans originated or purchased by its affiliates for the purpose of the lending test[59] or community development test[60] or for a test on approved strategic plan, the institution must collect, maintain and report those loan data as if it had originated or purchased those loans by itself. In addition, institutions have the flexibility to elect one or more category[61] of their affiliate's loans for consideration. However, if an institution elects to have its regulator consider its affiliate's loans within a particular lending category in the institution's assessment area(s), the institution must elect to consider *all loans* within that lending category in that particular assessment area(s).

Under the revised regulation, lending institutions may elect to have their regulators consider loans originated or purchased by a consortium or a third party institutions (such as a community development bank or a community development corporation) in which these institutions participate or invest. In order for these institutions to receive CRA credit, the institutions must report aggregate number and dollar amount of consortium or third party loans. Credits for CRA qualified consortium loans can be allocated in two possible ways. One of them is to divide the consortium loans for CRA claim among its participants or investors in way that no loan is claimed by more that one institution, and other is to claim a percentage share (based on the level of participation or investment) of the total loans originated or purchased by the consortium or third party.

Revised Definition of Assessment Area: The most closely scrutinized activities in the CRA examination are lending, investment and service activities of lenders *within* their assessment area. CRA performance outside the assessment area is not examined or graded very heavily. Definition of 'community' or 'assessment area' therefore, can become a significant factor in CRA assessment. This definition, however, has been revised over time. In the original legislation, the assessment area or 'delineated community' was defined as *reasonable delineation* of contiguous area surrounding each office or group of offices of the lender. Under the 1995 revision, the 'assessment area' of a retail institution would include the local areas around its deposit taking facilities, including ATMs in which it has originated or purchased a *substantial*

[59] In case a large retail institution.
[60] In case of a wholesale or limited purpose institution.
[61] The basic categories of loans are: (1) home mortgage loans (2) small business loans (3) small farm loans (4) community development loans and (5) five sub categories of consumer loans [a. motor vehicle loans b. credit card loans c. home equity loans d. other secured loans and e. other unsecured loans].

portion of its loans. This area must compose one or more MSA or contiguous political subdivisions by including full census tracts and block numbering areas.

1999 Changes

Financial Modernization Act (FMA) of 1999: The FMA also known as Gramm-Leach-Bliley Act (GLBA) is one of the most sweeping financial modernization acts in recent years. The act repeals sections 20 and 32 of the Banking Act of 1933[62] that restricted depository institutions' affiliation with securities firms. This act also modifies the Bank Holding Company Acts of 1956 and 1970 and creates a new "financial holding company" that would be able to engage in a list of statutorily provided financial activities, including insurance, securities underwriting, agency activities, merchant banking and insurance company portfolio investment activities. The FMA includes several provisions relating to CRA. I discuss these provisions in some details in the below.

Less Frequent Evaluation for Better CRA Performance the FMA provides certain regulatory relief with regards to CRA examination to small lending institutions. According to this relief provision, small banks and S&Ls that received an *outstanding* rating at their most recent CRA exam shall not receive a routine CRA exam more often than once every 5 years. Small banks and S&Ls that received a *satisfactory* rating at their most recent CRA exam shall not receive a routine CRA exam more often than once every 4 years. FMA also ties modernization and increased flexibility provided to financial institutions with CRA performance of these institutions. The act requires that Federal Reserve may not permit a company to *form* a financial holding company if any of its subsidiary banks or S&Ls did not receive at least a satisfactory rating in its most recent CRA exam. A bank or financial holding company may not *commence* new activities authorized under the Gramm-Leach Act if any bank or bank affiliates of a financial holding company, received less than satisfactory rating at its most recent CRA exam.

The GLB provisions for small banks although provide substantial relief to these lenders, proponents of CRA argue that by keeping a large percentage[63] of lending institutions beyond regulatory reach for five years may diminish the effectiveness of CRA by inducing these lenders not to engage in LMI lending [see Thomas 2003]. The National Community Reinvestment Coalition (NCRC) believes that with less frequent CRA examination, small banks will become adept at gaming the CRA process. They will relax their CRA lending in underserved

[62] Banking Act of 1933 is also commonly known as Glass-Steagall Act.

[63] There are 8,600 small banks and thrifts in urban and rural areas, which are 80 percent of all banks and thrifts.

communities for four years, and then hustle to make loans the last year before a 'twice in a decade' CRA exam.

Disclosure of CRA agreements CRA agreements[64] typically involves cash payments, grants or pledges to extend certain volume of loans to targeted groups and/or communities. Schwartz [1998] provides a detail review of the components of and considerations involved in CRA agreements. Since the early 1980's, community organization and financial institutions have entered into over 300 CRA agreements [Bostic and Robinson 2003]. The FMA enhances CRA data reporting requirements by requiring disclosure of CRA agreements. Section 711 of the FMA is known as "CRA Sunshine Requirements" [see 66 Federal Register]. This is a disclosure and reporting requirement placed on the parties involved in the CRA agreements. This provision requires each bank and each non-bank party to a CRA agreement to make an annual public report on how the money and other resources involved in the agreement were used. In addition, the requirement also describes how the parties to the agreement would make the agreement available to public and report it to the appropriate agency.

With regards to the CRA related pledges, Bostic and Robinson [2003] finds that CRA agreements have helped increase the flow of loans into LMI communities involved in the agreements. They also find evidence suggesting that this increase in lending represents new loans as opposed to redistribution of loans across communities, but these loans are relatively short-lived[65]. They believe that the effectiveness of CRA agreements in increasing lending activity

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[64] For purposes of CRA sunshine requirement, the term 'agreement'—

(a) means—

(i) any written contract, written arrangement, or other written understanding that provides for cash payments, grants, or other consideration with a value in excess of $10,000, or for loans the aggregate amount of principal of which exceeds $50,000, annually; or

(ii) a group of substantively related contracts with an aggregate value of cash payments, grants, or other consideration in excess of $10,000, or with an aggregate amount of loan principal in excess of $50,000, annually; made pursuant to, or in connection with, the fulfillment of the Community Reinvestment Act of 1977, at least 1 party to which is an insured depository institution or affiliate thereof, whether organized on a profit or not-for-profit basis; and

(b) does not include—

(i) any individual mortgage loan;

(ii) any specific contract or commitment for a loan or extension of credit to individuals, businesses, farms, or other entities, if the funds are loaned at rates not substantially below market rates and if the purpose of the loan or extension of credit does not include any re-lending of the borrowed funds to other parties; or

(iii) any agreement entered into by an insured depository institution or affiliate with a nongovernmental entity or person who has not commented on, testified about, or discussed with the institution, or otherwise contacted the institution, concerning the Community Reinvestment Act of 1977. Therefore, agreements entered into by entities or persons that solicit charitable contributions or other funds without regard to CRA do not constitute CRA agreements.

[65] According to Bostic and Robinson [2003], lenders view CRA agreements as a form of insurance against potentially large and unknown costs associated with fair lending violations, poor CRA rating and adverse

ultimately determined by the persistence and sophistication of community groups. Reporting requirements of the FMA, however, might have discouraged many of these groups who enter into the agreements with CRA covered lenders [see NCRC 2000].

The passage of FMA reflects the growing trends of the financial industry that enhanced the emergence of large size, vertically integrated institutions that can perform whole range of financial activities. Economies of scale, scope and efficient use of resources are the rationales behind this trend. The growing trends in the banking sector prompted by FMA may have implications for the enforcement and performance evaluation of CRA. For example, depository banks and non-banks such as insurance company or mortgage lenders are markedly different for the purpose of CRA enforcement. While banks' activities in their assessment areas are stringently examined under CRA, banks' activities outside the assessment area are not examined very strictly and non-banks' activities are not examined at all. Since common ownership allows substitution of assets between depositories and their non-bank affiliates, this substitution may make CRA enforcement weak and ineffective. Since non-banks are not covered under CRA, if loans that are not qualified for CRA credit are shifted to the portfolio of non-banks, and all LMI loans are transferred to the portfolio of CRA-covered institutions then this portfolio substitution will improve CRA performance of banks without any real change in the LMI lending.[66] In addition, current CRA regulations allow banks to selectively include lending activities of their non-bank affiliates in order to bolster their CRA performance. This selective inclusion provision may undermine the effectiveness of CRA enforcement and may unduly inflate CRA ratings of lenders.

Some suggest that consolidation and merger activities facilitated by financial deregulation have a disproportionate impact on lending in LMI and minority neighborhoods. "Due to bank and thrift failures, closures, and mergers, the number of small, independent financial institutions operating in the US has declined substantially, particularly in low-income urban areas, and this trend can be expected to continue [Papadimiuiou et. al. 1993]." Caskey [1992] study on five major cities finds that Black- and/or Hispanic-dominated neighborhoods are substantially less[67] likely to have

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publicity from CRA related protests. Since lenders might only need the 'insurance' for a short period, such as during the course of a merger or other application, these loans can be relatively short-lived.

[66] FMA requires that for larger institution like bank holding company to acquire a subsidiary institution, the to-be-acquired subsidiary must maintain a satisfactory CRA rating. There is no such requirement for acquiring non-banks that are not covered by CRA.

[67] The mean number of banks (including branches) per census tract with a majority of blacks and/or Hispanics is less than half that of "non-minority" tracts.

a local bank. In addition, Caskey study finds some evidence of disproportionate impact of bank closures on low-income and minority neighborhoods. More recently, Avery [1997] study finds that although the number of banking offices have increased during the 20-year study period, the number of banking offices in low-income neighborhoods fell by 21 percent and the number of offices per capita in low-income area fell by 6.4 percent.

Some researchers, however, believe that local and independent banks, especially in LMI and minority community serve an essential function to increase the flow of credit into their communities. They believe that local lenders are in a unique position to collect and gather vital information about neighborhoods and lending opportunities in these neighborhoods [see Haag 2000]. This information base is essential for residential and business lending, especially in the LMI neighborhoods where application of non-traditional underwriting standards may be more appropriate. "Successful lower-income residential lending programs often rely upon techniques and procedures that require local presence and flexible decision making. These might include the use of flexible underwriting standards, nontraditional measures of credit quality, a variety of credit enhancements, or intensive monitoring of outstanding loans that all depend upon knowledge local neighborhoods, and economic conditions and credit risk factors specific to the local community [Haag 2000]."

Mergers of local lenders to larger and distant organizations take away the underwriting authority from local lenders and may adversely impact local information base, vital communication and trust between lenders and local businesses. All these may result in decreased credit availability, increased price and unfavorable terms of the loans offered in the community. "The transfer of bank ownership outside of the local community often means the transfer of the locus of decision making outside the local community as well, potentially defeating many of the procedures that can make lending to lower-income and minority populations viable [Haag 2000]." The empirical study by Lin supports this argument and finds that the probability of mortgage denial rises significantly with the increase in distance between borrowers and lender. This finding is stronger for minority and female borrowers [see Lin 2001].

Reform Initiatives After 2001

In order to assess the effectiveness of 1995 reforms and to address changes in the lending industry and marketplace since the last reform, in July 2001 regulators published an Advance Notice of Proposed Rulemaking (ANPR) [66 Federal Register]. In the ANPR, regulators sought inputs on all aspects[68] of the CRA regulations from interested parties to assist them in determining whether and how the CRA regulations should be revised. Within the comment period that ended on October 17, 2001, the regulators received about 400 comments compared to 6700 comments received during their 1993 request. This substantial reduction of comments may suggest relative satisfaction with the 1995 reforms or it might also reflect the high fixed cost of instituting new regulations and to get all relevant parties accustomed with it.

In February 2004, regulators released their latest ANPR [69 Federal Register]. After reviewing comments received in response to 2001 ANPR, the regulators surmised "the regulations are essentially sound, but are in need of some updating to keep pace with changes in the financial services industry [69 Federal Register]." In the 2004 ANPR, regulators proposed amendments to the existing regulations in three areas[69] and sought comments from all interested parties including public and regulated financial institutions on the proposed amendments or other aspects of CRA regulations. Salient features of the proposed amendments in the 2004 ANPR are summarized in the below:

Redefinition of Small Lending Institutions: In the 1995 final regulation, an institution with less than 250 million of total asset at the yearend in either of the two previous years was considered as small institution. In case of an institution that is an affiliate of a Bank Holding Company (BHC), this definition had an added requirement based on the asset size of the BHC. In that, the total bank and thrift asset of the BHC needed to be less than 1 billion for the institution to be considered a small institution [see endnote for definition]. In the regulation, small institutions were evaluated under a streamlined test that focused primarily on lending performance. As mentioned before, this size specific test allowed regulators to account for varying capacity of institutions to undertake certain activities that are related to the size. Two significant reliefs provided by the streamlined test are: (a) streamlined test had no independent

[68] Although regulators sought comments on all aspects of possible CRA reforms, they outlined eight broad issues that may warrant future review. Those issues were:

1. Large Retail Institutions: Lending, Investment, and Service Tests
2. Small Institutions: The Streamlined Small Institution Evaluation
3. Limited Purpose and Wholesale Institutions: The Community Development Test
4. Strategic Plan
5. Performance Context
6. Assessment Areas
7. Activities of Affiliates
8. Data Collection and Maintenance of Public Files

Detail questions involving each of the above issue are summarized in the endnote [2001 Reform]

[69] These two areas are (1) Redefinition of small lending institutions, (2) Provision against abusive or predatory lending and (3) Enhancement of the public performance evaluation as discussed in this section.

investment test component and (b) small institutions were not required to collect and report data applicable for large institutions. The 1995 revision argued that this relieves would fulfill CRA reform objectives by providing performance-based assessment standards that minimize compliance burden while stimulating improved performance.

In the 2001 comment period, financial institutions expressed concern about fierce competition for qualified investments among large institutions to perform well on CRA investment test. This competition can become a substantial burden to institutions that are just above the threshold size. These marginal institutions also complained about the burden of data collection and reporting requirements, which according to these institutions had impeded their ability to improve their CRA performance. In the 2004 ANPR, regulators have proposed redefinition of small institutions in the following way:

1. The proposed regulation raises the small institution asset threshold from 250 million to 500 million.
2. The proposed regulation eliminates asset size limitation of BHC all together on small institution eligibility.

This change will reduce the number of institution subject to the large retail institution test by half, but the percentage of industry assets subject to large retail institution test would decline only slightly. One of the rationales[70] for this change is that this decline will align the current distribution of asset between small and large institution with the distribution that was anticipated when the definition of small institution was adopted.

Provision against Predatory Lending: In the 2004 ANPR, regulators expressed the need to enhance CRA regulations to address abusive and predatory lending practices that are inconsistent with helping to meet the community credit needs in a safe and sound manner. In doing so, regulators propose the following:

1. Specify a list of examples[71] of violations of certain anti-discriminatory and consumer protection act that will adversely affect an institution's CRA performance.

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[70] The other rationales for the redefinition of small institution can be summarized as follows:

1. Consolidation in the lending industry through mergers and acquisition has increased the gap between smallest and largest institutions substantially since the line drawn at 250-million asset threshold in 1995. Due fixed nature of the
2. Number of institutions defined as small and their relative asset compared to industry asset size has declined substantially in recent years since the threshold was set.
3. Some of the asset growth of small institution since 1995 was due to inflation, not real growth.

[71] Examples of such violation include:

2. Propose that abusive lending activity like equity stripping[72] with respect to home mortgage and consumer loans would adversely affect CRA performance of lenders engaging in such action.
3. Propose that an institution's evaluation will be adversely affected by discriminatory, other illegal, or abusive credit practices described in the regulation regardless of whether the practices involve loans in the institution's assessment area or in any other location.
4. Propose that an institution's evaluation will be adversely affected by discriminatory, other illegal or abusive credit practices by any affiliate if the affiliate loan is elected for consideration in the CRA evaluation.

Enhancement of the Public Performance Evaluations: In the 2004 ANPR, the regulators proposed to use publicly available HMDA and CRA data to disclose following information in the *public performance evaluation* at the assessment area level:

1. The number, type and amount of purchased loans.
2. The number, type and amount of HOEPA loans and of loans for which rate spread information is reported under HMDA[73].
3. The number, type and amount of loans that were originated or purchased by an affiliate and included in the institution's evaluation and the identity of such affiliate.

VI. Assessment of the Past Revisions and Future Trends of CRA

Legislative debates on CRA modifications, past revisions of the act by the regulators and enforcement of the regulations on lending institutions indicate certain principles. Based on these principles and the present status of CRA regulations, we can speculate about future areas of change. These principles and future areas of change are summarized as below:

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a. Discrimination against applicants on a prohibited basis in violation of Equal Credit Opportunity Act (ECOA) or Fair Housing Act.
b. Evidence of illegal referral practices in violation of section 8 of the Real Estate Settlement Procedures Act (RESPA).
c. Evidence of violations of the Truth in Lending Act (TILA) concerning a consumer's right to rescind a credit transaction secured by a principal residence.
d. Evidence of violation of the Home Ownership and Equity Protection Act (HOEPA).
e. Evidence of unfair or deceptive credit practices in violation of section 5 of the Federal Trade Commission (FTC) Act.

[72] A practice of extending loans based predominantly on the foreclosure or liquidation value of the collateral by the institution, where the borrower cannot be expected to be able to make the payments required under the terms of the loan. An institution may determine whether a borrower can be expected to be able to make the required payments based on information about borrower's credit history, current of expected income, other resources and debts, preexisting customer relationships, or other information ordinarily considered by the institution.

[73] This information will be available in HMDA data starting from 2005.

The original CRA proclaimed that *safety and soundness* should be the prime consideration in lending decision. Lenders should consider all other factors, including conforming with CRA requirements, once the safety and soundness of operation criteria is fulfilled. In addition, CRA was not intended to allocate or limit the flow credit to any geographic area based on any criteria, including volume of deposit, minority population, average income levels or type of loans. The act was not intended to disrupt the competitive flow of credit in the market.

CRA is not a prohibitive law; instead, it is an *affirmative law*. The act does not outlaw any actions or behaviors on the part of lenders, rather it reminds the lending institutions of their charter obligations. CRA intends to ensure that lenders do not ignore good borrowing prospects in the community just because borrowers or the businesses are located in the community dominated by LMI populations and treat creditworthy borrowers evenhandedly.

CRA is not intended to be a *race*-based legislation; instead, it is an *income-based or need-based* legislation. The act does not exclusively protect any racial minority, but rather the legislative protection of the act covers all borrowers, and everyone who lives in the LMI neighborhood, including the whites. Despite some researchers' broad generalization of aligning CRA with other anti-discrimination legislations, the act should not be considered as a race-based law. Doing so distorts the primary objective of the act, and reduces its appeal and bipartisan political support.

The act intends to provide *flexibility* to lenders so that they can formulate a CRA strategy to address their community-specific needs according to their size, capability and other market constraints. However, the 'flexibility' and 'specificity of the guideline' can become two conflicting policy objectives. Due to this potential conflict, CRA will continue to require a delicate balance between 'flexibility' and 'consistency'. The examiner's judgment will play an important role to keep CRA flexible. This judgment, however, cannot be arbitrary. Unlimited discretion may produce inconsistent CRA examinations. On the other extreme, removing all discretion from the CRA examiners will hurt the objective of CRA by making it a mechanism for credit allocation. Improved examination standards, extensive interagency examiner training and standardization of evaluation will go a long way toward keeping this balance.

The definition of '*Community'* may be becoming irrelevant in the present context of financial deregulations. In today's market, we need a better way to define community so that CRA may continue to serve its original role, which is to require lenders to 'help meet the credit needs of the *entire community'*. At the time when CRA was enacted, the location of the community and depository lenders were inter-linked; every lender had its own unique community. That link, however, has eroded in the present financial environment. Many lenders have defined 'community' or 'communities' based on the spatial location around its branches and ATMs, although they make substantial loans outside their community directly or through their non-bank affiliates. However, under the current system, CRA performance of the loans outside the community is not strictly examined and the lending through non-bank affiliates is not examined at all unless lender elects to be examined. By changing the definition of community to reflect modern lending practices, these loans and their CRA performance can be bought under CRA regulatory reach. In the 2004 proposed rules, the regulators considered several proposals[74] for redefining community, but decided to continue to adopt the community definition adopted in the 1995 regulation [Federal Register 2004].

The *coverage* of CRA may need to be reconsidered. Dramatic changes in the mortgage market operations have affected CRA in a substantial way. Depository lenders are no longer the dominant players in the mortgage market. Moreover, the rationale for exclusively requiring depository lenders to help meet the credit needs of their community has become weaker. For example, these lenders are not the only receivers of deposits in the community, and they are not the sole beneficiaries of the government's implicit protection. These changes suggest broadening of the coverage of CRA to include the institutions that are not currently covered. For example, credit unions are not covered by the act because they lacked the ability and/or the incentive to neglect their "communities" of members. They were not-for-profit, relatively small, and limited to serving people who shared a single "common bond." In the last two decades, the definition of what constitutes a "common bond", however, has expanded dramatically. Some argue that because of the redefined the "common bond" requirement, credit unions now have the ability and the incentive to engage in the same type of lending practice that led Congress to impose the CRA upon banks [see Cassity 2000]. Similarly, the argument to include non-banks like mortgage banks, mutual funds, pension funds, insurance companies, investment companies consumer finance under CRA coverage is stronger under present financial environment. Since financial institutions can own banks and non-banks under the same ownership, keeping non-banks beyond the regulatory reach of CRA may provide incentive to modify lenders' portfolio in a manner that may undermine the purpose of CRA.

[74] Some proposals include, assessment area should include (1) *all* areas in which CRA covered lenders deliver retail banking service [proposed by National Association of Home Builders (NAHB) in 2001] and (2) areas in which lenders have made more than a 0.5 percent of all home purchase and/or refinance loans [proposed by National Community Reinvestment Coalition (NCRC) in 2001].

CRA investment test for the large retail institutions needs further restructuring. Several important issues relating to investment test must be kept in mind in this restructuring effort. Qualified investments should be considered in the CRA evaluation *to the extent* they help meet community credit needs. The stand-alone investment test requires examiners to grade lenders on investment activities. However, there is an intense competition for these investments due to limited supply of such investment in neighborhoods. This competition for investments has depressed yields, effectively transforming investments into grants and forcing lenders to make equity investments just to pass in the investment test. Regulators correctly realized this inefficient behavior and promised in the 2004 ANPR to provide additional interagency guidance to clarify that the investment test is not intended to be a source of pressure on institutions to make imprudent equity investments. Regulators also realize "it is inevitable that supply of, demand for, and quality investment opportunities will vary by region and city; the performance evaluation is supposed to take those variations into account [Federal Register 2004]." Since investments are *not directly* related to community credit needs, lenders or regulators have no way to determine community investment needs. Therefore, it is essentially up to lenders to decide the level of investment activities based on its capacity and opportunity in the community. CRA regulations should clearly specify this and make investment optional providing incentives to engage in investment activities but not requiring it. One of the possible approaches is to provide credit for qualified investment in the lending test. Currently, loan purchases are given the same weight as loan originations. Similar or some variable weights[75] should be attached to investment activities. In the 2004 ANPR, the regulators have considered some alternative approaches and decided to continue to keep mandatory investment test based on several justifications. These justifications include, (a) changing the structure of the large retail institution test would simply substitute one set of implementation challenges with another and would not necessarily yield a substantial benefit, (b) investment test has contributed to the substantial growth of the market for community development oriented investments and (c) replacement of investment test would change market expectation and would incur substantial implementation cost to get adjusted with the new revisions. However, none of these justifications is based on solid ground. First, making the investment test not only affects the implementation of the act, rather this change would shift examination weights from investment to lending – the original focus of CRA. This may completely change the ratings distribution for the large retail institutions. Shifting of incentive to

[75] Depending on the extent to which the particular investment satisfies community credit needs.

lending may have dramatic effects on community lending and satisfying community credit needs. The regulators need to conduct a rigorous and careful study to figure out the net benefit of this change in regulation. Second, investment test may have created a new market for community development investment and helped spread institutional risk, but CRA is not the only vehicle, and of course, not the primary vehicle to provide incentive to achieve this goal. Finally, if adjustment cost is given precedence without conducting a careful study on the benefits, there will never be a time to revise this regulation.

Innovativeness and complexity of qualified investment is one of the four performance criteria in the investment test. However, in a performance-based evaluation system this criteria not only redundant, but also potentially unproductive creating examination process unnecessarily burdensome, unrealistic and often impossible to account for. Comments in the 2001 ANPR rightly pointed out the ambiguity in measuring the degree of *innovativeness or complexity*, and more importantly asked clarification whether these criteria a *means* for community lending or *an end* in itself. In other words, is it necessary to be innovative and complex, if non-innovative and simple investments appropriately meet community credit needs? Of course, the innovativeness or complex are not the goal or end. Regulators agreed to make this point clear through further guidance. However, I believe regulators do not need to clarify this criterion, but should eliminate this criterion. In an outcome-based evaluation system that focuses on the actual performance, this criterion is redundant and inconsistent. Performance-based evaluation was introduced in 1995 regulation to make the evaluation process more objective, simple and measurable.

Outcome over process will continue to remain the major theme of the future reforms of CRA. The central question facing the regulators is, 'how to modernize CRA to make it relevant and effective under the current banking system?' The Joint Center for Housing Studies [Ford Foundation 2002], proposes two possible directions for future CRA reform: (1) Extension of assessment area to cover larger share of the lending of CRA-regulated entities, and extension of CRA to include newly emerging non-bank financial services organizations (2) Extension of CRA to give greater emphasis to the provision of financial services to lower-income borrowers. I believe that extension of CRA coverage to non-banks like, credit unions and possibly mortgage companies is consistent with the structural changes in the banking industry. However, any extension of CRA credits to influence lending activities must be carefully considered such that this extension is consistent with the original focus of CRA.

Final Remarks

In this paper, I have focused on the historic evolution, present status and future trends of the Community Reinvestment Act (CRA). In doing so, I have discussed pre-CRA, anti-redlining legislations and their effectiveness in resisting disproportionate and often discriminatory allocation of lending based on geography. I have taken an objective look at the provisions and enforcement mechanisms of the original CRA and have considered the points of views of those affected by the act. Specifically, I have considered the views of the regulators, the lending institutions, and the community groups and individuals. Finally, I have analyzed reforms and legislative developments relating to the act and their economic implications. This analysis provides a framework to understand the past and present status of CRA. In light of this framework, we may seek to address some of the possible future research trends concerning the act.

Estimating the impact of CRA may be difficult. Disentangling the effects of CRA from the effects of other concurrent activities and legislation poses an important challenge to the future researchers. Some of these concurrent effects include the influence of other fair lending and anti-discriminatory laws, effects of the streamlined secondary market operations, effects of FHA guaranteed home mortgages, effects of the GSEs in purchasing conventional home mortgage loans from mortgage originators, or the effects of the deductibility of interest paid on a home mortgage from the federal income tax. Despite these difficulties, several attempts to examine the impact of CRA on lending to LMI borrowers and areas are noteworthy [see Shlay 1999, Schwartz 1998, Avery et. al. 1999, Evanoff and Segal 1996]. Some of these studies suggest that CRA-covered lenders and their affiliates have increased their market share in prime lending to LMI borrowers and areas than lenders not covered under CRA. This pattern generally suggests that CRA has positively influenced the growth of LMI lending. Detailed multivariate analysis conducted by the Joint Center for Housing Studies at Harvard University for Ford Foundation [Ford Foundation 2002] confirms that CRA-regulated lenders originate a higher proportion of loans to lower-income people and community than they would if CRA did not exist. Additionally, lower-income neighborhoods targeted by CRA appear to have more rapid price increases and higher property sales rates than other neighborhoods – a finding consistent with the proposition that CRA has expanded the provision of mortgage capital to these neighborhoods.

CRA can become an effective tool to deter predatory lending. CRA examination needs to consider the price and terms of the loans extended to the LMI borrowers and neighborhoods. By structuring CRA credits in a way that lender receive no credits or negative credits for predatory loans, the act might play an important role in reducing predatory lending. Current proposal relating to predatory lending One of the important policy issues relating to CRA is to understand the role of the non-availability of depository lenders in the LMI neighborhoods on the emergence and growth of predatory lenders.

CRA might have produced positive information spillovers, and reduced market failures associated with lack of information. No *theoretical* work has looked at the impact of CRA induced informational benefits on mortgage underwriting. Existence and nature of information externalities over space in the context of mortgage market needs to be explored. Furthermore, there is a need for a basic and simple model that would be able to combine *imperfect information* and associated credit rationing, and *information externalities* in the context of mortgage market with the mortgage underwriting to analyze CRA.

CRA can be made more market-based. One such approach put forward by Richardson [2000] and Klausner [1995] proposes tradable CRA permits. According to tradable CRA permit literature, CRA credits would be bought and sold in the open market for CRA permits. Lenders with more than required CRA credits[76] would sell their excess credits to lenders with less than required CRA credits. Like tradable pollution permits, in doing so CRA permits will provide market based incentives to efficient CRA lenders[77] with valuable local information base to make optimum level of loans, which will be more loans than they currently make. This approach would also allow to non-CRA lenders to make their optimum CRA loans and concentrate their resource to other loans, in which they possess higher expertise. In this context, one might also want to compare the efficiency of currently administered CRA with a monopolistic lender. Although this lender would have larger dead weight loss due to its monopolistic nature, but it will have lower loan production cost due to larger informational set.

CRA has undergone numerous changes. Some of these changes were substantial and sweeping, while some were not so dramatic. These changes were largely in response to the reaction of those affected by the act, and the changing condition of the financial products and delivery of those products. These changes have transformed CRA from a dormant legislation to a vibrant act that has become one of the most significant tools for community activists in their community development and regeneration efforts. This simple and flexible act allowed active participation

[76] The required CRA credit to comply with the act would be set by the regulators.
[77] Lenders who specialize in loans to the LMI borrowers or in the LMI neighborhoods that qualify for CRA credits.

of community members, who often know more about their community than the legislators or the regulators. These changes through a dynamic process of reactions and resolution of conflicts have kept and will continue to keep CRA relevant and effective.

However, in resolving conflicts and in seeking necessary updating, the guiding principle should be historic objective of the act – to ensure that lender fulfills their affirmative obligation to help meet the credit needs of their entire community including low- and moderate-income individuals and neighborhoods. Access to credit for the poor through responsible lending is the objective of CRA and is probably the key to alleviate poverty as well, and it should be just that.

Endnotes:

1. **Low- and moderate-income (LMI) neighborhood** defined by FFIEC regulation refers to census tracts that, as of the latest decennial census, have median family incomes of less than 80 percent of the median family income of the metropolitan area in which they are located.

2. **FHA Loans** The Federal Housing Administration (FHA) loans are intended as a means to facilitate borrowers, usually LMI and/or first time buyers, to get a loan with less down payment and liberal qualifying standards. The FHA sets guidelines for the approval, closing, and insurance of these loans. These rules are more liberal in underwriting standards compared to the conventional loans. However, insurance by the full faith and credit of the United States government removes substantial default risk away these loans. Without this insurance, most lenders would be reluctant to make loans with such liberal underwriting criteria. FHA loan applications are taken by lenders that are approved by the Federal Housing Administration. These lenders can approve and close the loan, and apply for insurance coverage from the FHA. With that insurance in place, the loan can then be sold to the secondary market as a government-insured loan.

3. **Small institution.** A small institution is defined as an institution with total assets of less than $250 million that is independent or in affiliated a holding company that with total bank and thrift assets of less than $1 billion as of the two preceding year ends.

4. **Application for federal approval.** Application for approval includes:
   a. Federal charters
   b. Federal deposit insurance
   c. Establishment of domestic branches of regulated institutions
   d. Relocation of home or branch of regulated institutions
   e. Merger, consolidation and acquisition of assets or shares or assumption of liabilities of financial institutions requiring regulatory approval

5. Detailed performance factors that remained effective since 1989 revision through 1997 are given below:
   Category A: <u>Ascertainment of community credit needs</u>
   1. Bank's activities to ascertain community credit needs.
   2. Extent of the board of director's participation in reviewing policies relating to CRA.
   Category B: <u>Marketing and types of credit offered and extended</u>
   3. Bank's marketing efforts designed to inform the community about bank's credit-related services, including special programs.
   4. Bank's origination or purchases of local community home mortgages, home improvement and rehabilitation loans, and small business and farm loans.
   5. Bank's participation in government-assisted housing programs.
   Category C: <u>Geographic distribution and record of opening and closing offices</u>

6. Geographic distribution of credit applications, approvals, and denials.
7. Bank's record of opening and closing branches and providing services at branches.

Category D: Discrimination and other illegal credit practice

8. Any practices designed to discourage consumer applications for certain credit programs.
9. Evidence of other discrimination or other illegal credit practices.

Category E: Community development

10. Bank's participation in local community development projects and programs.
11. Bank's ability to meet local credit needs based on bank size, financial condition and other limitations.
12. Other relevant factors, which could bear upon the extent to which the bank is helping to meet the credit needs of the community.

6. **Community Development Loans** have community development as its primary purpose. As defined in the regulations, community development means –

a. Affordable housing (including multifamily rental housing) for LMI individuals

b. Community services targeted to LMI individuals

c. Activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenue of $1 million or less

d. Activities that revitalize or stabilize LMI geographies.

7. **Small-business and Small-farm Loans:** Small-business loans are defined as loans whose original amounts are $1 million or less and that were reported on the institution's Call Report or TFR as either "Loans secured by non-farm or nonresidential real estate" or "Commercial and industrial loans." Small-farm loans are defined as loans whose original amounts are $500,000 or less and were reported as either "Loans to finance agricultural production and other loans to farmers" or "Loans secured by farmland."

8. **Performance Criteria and Factors for Large Retail Banks**

Performance Criteria	Performance Factors
A. **Lending Test**	
1. Lending activity.	1. Lending activity
2. Geographic distribution.	2. Geographic distribution
3. Borrower characteristics.	3. Borrower characteristics
4. Community development lending.	4. Community development lending
5. Use of innovative or flexible lending practices.	5. Innovativeness or flexibility of product
	6. Concentration of loans in the assessment area
	7. Responsiveness to credit needs of LMI individuals and geographies and small business.
B. **Investment Test**	
1. The number and dollar amount of qualified investment.	1. Investment and grant activities
2. Innovativeness and complexity of qualified investment.	2. Responsiveness to credit and community development ne
3. Degree to which these types of investments not routinely provided by other private investors.	3. Community development initiatives
4. Responsiveness of qualified investments to available opportunities.	
C. **Service Test**	
1. The distribution of branches among LMI geographies.	1. Accessibility of delivery system
2. The institution's record of opening and closing branches.	2. Record of opening and closing of branches

3. The availability and effectiveness of alternative systems for delivering retail banking services.	3. Reasonableness of business hours and services in meeting assessment area's needs.
4. The extent to which the institution provides community development services.	4. Community development services
5. The innovativeness and responsiveness of community development services.	
6. The range and accessibility of services provided in LMI geographies.	

9. **2001 Reform**: Detail question(s) involving eight broad reform issues identified by the regulators were as follows:

a. Large Retail Institutions: Lending, Investment, and Service Tests: Do the regulations strike the appropriate balance between quantitative and qualitative measures, and among lending, investments, and services? If so, why? If not, how should the regulations be revised?

b. Small Institutions: The Streamlined Small Institution Evaluation: Are the small institution performance standards effective in evaluating such institutions' CRA performance? If so, why? If not, how should the regulations be revised?

c. Limited Purpose and Wholesale Institutions: The Community Development Test:
   1. Are the definitions of ``wholesale institutions'' and `limited purpose institution' appropriate? If so, why? If not, how should the regulations be revised?
   2. Does the community development test provide a reasonable and sufficient standard for assessing wholesale and limited purpose institutions? If so, why? If not, how should the regulations be revised?
   3. Would the community development test provide a reasonable and sufficient standard for assessing the CRA record of other insured depository institutions, including retail institutions? If so, why and which ones, and how should the regulations be revised? If not, why not?

d. Strategic Plan: Does the strategic plan option provide an effective alternative method of evaluation for financial institutions? If so, why? If not, how should the regulations be revised?

e. Performance Context: Are the provisions on performance context effective in appropriately shaping the quantitative and qualitative evaluation of an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

f. Assessment Areas: Do the provisions on assessment areas, which are tied to geographies surrounding physical deposit-gathering facilities, provide a reasonable and sufficient standard for designating the communities within which the institution's activities will be evaluated during an examination?

g. Activities of Affiliates: Are the provisions on affiliate activities, which permit consideration of an institution's affiliates' activities at the option of the institution, effective in evaluating the performance of the institution in helping to meet the credit needs of its entire community, and consistent with the CRA statute?

h. Data Collection and Maintenance of Public Files: Are the data collection and reporting and public file requirements effective and efficient approaches for assessing an institution's CRA performance while minimizing burden? If so, why? If not, how should the regulations be revised?

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