COMMUNITY REINVESTMENT ACT

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ABSTRACT

The Community Reinvestment Act was enacted to encourage banks and thrifts to help meet the credit needs of their entire communities consistent with safe and sound lending practices. Despite the apparent success of the CRA, the examination process has been criticized as being applied inconsistently, generating excessive paperwork and overemphasized process while under emphasizing performance. The CRA regulations were reviewed during 1993 and 1994 and final rules completed in 1995. This paper examines this review and the potential impact of the final rules on banks.

INTRODUCTION

The Community Reinvestment Act, CRA, was enacted as Title VIII of the Housing and Community Development Act of 1977. The CRA was enacted to encourage banks and thrifts to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods, consistent with safe and sound lending practices. In the CRA, the Congress found that:

"(1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;

the convenience and needs of communities include the need for credit as well as deposit services; and

regulated financial institutions have continuing and affirmative obligation(s) to help meet the credit needs of the local communities in which they are chartered."

One major reason for the implementation of the CRA was to eliminate a practice being used by banks to determine to whom they loaned money, a practice is called "redlining". Redlining is a process used by financial institutions to draw lines, both literally and figuratively around neighborhoods identified as "high risk". Banks were refusing to invest money in these neighborhoods, basing loan decisions primarily on site (where the property was located) rather
than economic (whether the borrower could qualify) considerations. Many critics feel that this battle is still being fought today, and needs to be addressed through government action such as the CRA.

Redlining was brought about during the 1960's when many inner city residents were moving out of the city to the more affluent suburbs, and many critics felt that the banks went right with the people. Were these critics wrong? Statistics show that prospective home buyers were unable to obtain mortgages to buy homes in areas that lenders had written off as undesirable, so they settled elsewhere. Existing owners also saw their homes slowly deteriorating. Because they could not sell their homes for reasonable prices, and were also unable to obtain home improvement loans to repair them, many of these homes were abandoned and left to decay.

Community activists charged that the banks were at the center of this cycle of abandonment and decay. The lending policies of financial institutions were charged with depriving these neighborhoods of the credit and confidence needed to survive. There was even a charge that banks were exporting savings deposits from those declining neighborhoods and using them to finance the development in the more affluent areas.

One might ask the questions: Were banks really redlining? If so, would the CRA help to solve this problem of lending discrimination? Statistics did show that lenders were focusing their attention elsewhere, but what the statistics can't show is whether the neighborhoods declined because lenders withdrew, or whether lenders withdrew because the neighborhoods were declining. Regardless of whether the banks were actually redlining or not, the charge was made, and it stuck. Redlining was portrayed as a disease that was destroying "redlined" neighborhoods, and federal legislation was the medicine that was supposed to wipe it out. One dose of medicine is the CRA.

**CRA REGULATIONS: CREDIT AND QUESTIONS**

CRA has come to play an increasingly important role in improving access to credit in
communities in both rural and urban areas across the country. Under the laws of the CRA, many banks have opened new branches, provided expanded services, and made substantial commitments to increase lending to all segments of society. However, some banks have run afoul of the CRA regulations. For example, the Chevy Chase Federal Savings Bank in Chevy Chase, Maryland was fined $11,000,000 for failing to market to African Americans as well as failing to locate or even consider locating a branch into black neighborhoods. $7,000,000 of the fines given to Chevy Chase was set aside specifically to offer cut-rate mortgages to all residents of areas that are said to have suffered from discrimination. If all of these funds are not distributed to these areas over a four year period, the additional $4,000,000 will be added to the fine. Because of the heavy fines handed to Chevy Chase, many banks are asking themselves: 1. Are we vulnerable to Chevy Chase type regulatory criticism? 2. Must we open branches in minority areas? 3. Can we close branches in minority areas? 4. If our lending levels are lower in minority areas than in white areas and we do not have or want branches in them due to sound business factors, what do we do? These four questions pose serious problems for banks unsure if they are abiding by these CRA regulations. Other institutions who have fallen under CRA violations similar to that of Chevy Chase are: Decatur Federal Savings & Loan, Decatur, Georgia was fined a total of $1,000,000, Shawmut Bank, Boston, Massachusetts was fined a total of $960,000, Blackpipe State Bank, Martin, South Dakota was fined a total of $125,000, and First National Bank, Vicksburg, Mississippi was fined a total of $1,800,000. All of these fines were imposed upon these institutions based on premise they had discriminated against minority individuals.

**CRA REGULATIONS: EXAMINATION PROCESS**

Despite the apparent successes of the CRA, the examination process has been criticized. Financial institutions have indicated that policy guidance from the agencies overseeing the CRA is unclear and that examination standards are applied inconsistently. Financial institutions have also argued that the CRA examination process causes them to generate excessive paperwork at
the expense of providing loans, services, and investments to their communities. Many other
groups also have agreed that there are inconsistencies in CRA evaluations and that current
examinations overemphasize process and underemphasize performance. However, these
groups have also criticized the agencies for failing to aggressively penalize banks and thrifts for poor performances.

Because of the negative consequences of CRA evaluations, institutions must be diligent
at all times. Institutions that fail to fulfill their community reinvestment obligations run a
substantial risk of having any expansion plans blocked or delayed. The ultimate punishment
for failing to meet CRA requirements is the revocation of the institution's charter. Even though
this punishment has yet to be used, and is not likely to be, the CRA does require regulators to
encourage banks to meet the needs of their community.

The results of the CRA examination are a vital tool to the success of an institution.
With the CRA exam results becoming part of the institution's CRA file, which is available to
the public. A good score is very important if the institution is to remain in good standing with
the public. A poor CRA exam can mean fewer deposits as well as media bashing. For
example, churches, governments, concerned citizens, and unions and pension funds along
with others, can use an institution's CRA grade to decide whether to deposit their funds with
the institution. In fact, many state and local governments are developing "linked-deposit"
legislation requiring that government funds be placed only in banks who have received an
adequate CRA rating. The media may also report the institution's CRA rating. The media will
use an exam score to compare how well an institution fared with its competition. On the other
hand, complying with CRA regulations will actually benefit your institution. CRA does not
require institutions to make unprofitable loans, only to identify profitable lines of business in
communities and among consumers allegedly ignored in the past. By lending in these areas,
complying institutions can gain some very credit worthy customers as well as customers who
will maintain deposits with an institution.
CRA REGULATION REVIEW

With the examination process still being criticized because of its inconsistencies, President Bill Clinton, in July of 1993, suggested that the Federal financial supervisory agencies reform the CRA regulatory system. He asked the agencies to consult with the banking and thrift industries, Congressional leaders, and leaders of community-based organizations across the country to develop new CRA regulations and examination procedures that "replace paperwork and uncertainty with greater performance, clarity, and objectivity."

At the President's request, the agencies were asked to refocus the CRA performance-based assessment standards that minimize compliance burden while stimulating improved performance. The agencies were to also develop highly specialized groups of examiners who were well trained and versed in CRA examinations. The President asked the agencies to insure that banking institutions were consistently trying to improve the CRA evaluation methods and to more effectively reprimand and reform institutions with consistently poor performance.

1993 REVIEW

In order to meet the President's request, the four agencies arranged a series of seven public hearings all across the country in 1993. In these hearings, the agencies heard from over 250 witnesses.

As a direct result of these hearings, the 1993 proposal was published on December 21, 1993. This proposal had a more performance-based idea and suggested eliminating the twelve assessment factors that are in the present CRA regulations. At present, the assessments are based on how well an institution implemented procedural requirements and documented their community research for needs assessment. The new proposal required that institutions be evaluated on their actual lending service and investment performance. Institutions would have been required to submit reports on the basis of geographic distribution of application denials, and origination and purchases of loans. Smaller banks could elect to be evaluated under a method that would not have required them to report this data. All institutions would have the
option to be evaluated on the basis of a pre-approved strategic plan. There would be four statutorily mandated CRA ratings. However, five strategies would be reserved for lending, service, and investment tests with a satisfactory category split into high and low categories.

1994 REVIEW

In response to this proposal, the agencies received over 6,700 comment letters. In general, the responses supported the idea of a performance based assessment that stimulated improved performance and minimized burdensome paperwork. The concerns were that certain aspects of the proposal encouraged credit to a specific kind of borrower. Due to these concerns a second proposal was published on October 7, 1994. This proposal attempted to keep the aspects of the 1993 proposal that were viewed as positive such as preserving the emphasis on performance and reforming the aspects such as credit allocation.

In the 1994 proposal significant changes were made to the details in order to meet the concerns raised in the comment letters. The 1994 proposal retained but modified the lending investment and service test for large institutions, the modified evaluation for small institutions, and the pre-approved strategic plan option to all institutions. The 1994 proposal removed the criteria that many critics had viewed as calling for credit allocations and substituted a broader range of qualitative and quantitative criteria. Presentation of examiner judgement is essential in order to take into account the unique characteristics and needs of an institutions community and the actual capacity and relevant constraints of the institution. However, along with this element of judgement, it is also important to remain consistent among institutions and examiners. The 1994 proposal would provide a balance between objective analysis and subjective judgement by relying on detailed data measuring an institution's actual lending, service, and investment performance. The agencies provided guidance as to the standards that examiners would have applied in making required judgements.

The 1994 proposal would reduce data reporting burdens. However, in this new proposal, institutions would be required to report information on the race and gender of small
business and farm owners. This was done in order to meet criticism that the 1993 proposal did not give enough weight to the fair lending aspect of an institution's CRA performance.

This proposal would reduce the regulatory burden by indicating that agencies, rather than institutions, would have collected data needed to provide this "assessment context". This would be done in order to take into account specific community characteristics and needs.

The 1994 proposal also modified the rating process from the 1993 proposal. For large retail institutions, in calculating the assigned rating, the revised proposal would have given primacy to lending performance, but an institution's performance on the service and investment tests also would have been reflected in the assigned rating. The rating process for small institutions similarly would have given primacy to lending performance, and would have provided guidance on how the agencies would have considered service and investment performance. Any evidence of discriminatory or illegal credit practices would have negatively affected evaluation on performance.

The 1994 proposal also detailed as to how the proposed strategic plan option would be put into practice. The definition of "service area" was also modified to include the local areas around an institution's deposit facilities in which it has significant lending activity and all other areas equally distant from such facilities.

**FINAL REVIEW**

Collectively, the agencies received over 7,200 comment letters on the 1994 proposal from individuals, representatives of bank and thrift institutions, consumer and community groups, members of Congress, state, local, and tribal governments, and others. All of these comments were incorporated into the writing of the final rule. For the most part the comments were in support of the more objective performance-based assessment and the idea of minimizing the burden on the institution while increasing performance. Most commenters believed that under the old CRA regulations institutions spent too much precious time and energy on documentation requirements. This left too little time to be spent on actual
performance. The majority of those that commented believed that increased training for the CRA examiner would insure fair but consistent examinations for all concerned institutions. In general most critics were in agreement with the agencies overall goals in amending their CRA regulations, but were concerned about certain aspects on the 1994 proposal.

The final rule retains most of the principles and structure contained in the 1993 and 1994 proposals. However, the new rule provides significant changes to some details in order to meet the concerns presented to them by responding parties. Technical modifications were made to certain aspects in the final rule. The agency removed two provisions found in both the 1993 and 1994 proposals. These were the community reinvestment obligation and the enforcement provision. The community reinvestment obligation stated that banks and thrifts have a specific affirmative obligation to help meet the credit needs of their communities. The enforcement provision provided penalties against banks and thrifts with "substantial noncompliance" ratings using the agencies' general enforcement powers under 12 U.S.C. 1818.

The final rule provides that an institution's CRA rating reflects its record of meeting the credit needs of the community. When evaluating applications the agency will take into account an institution's CRA record. On the basis of an institution's record it may be denied branches, office relocations, mergers, consolidations, and purchase and assumption transactions.

**CRA: FINAL VERSION**

The final version of the new CRA regulation was released on April 19, 1995 and will not be fully implemented until July 1, 1997. All insured banks and insured savings and loans associations may choose to be evaluated using the lending, investment and service tests beginning January 1, 1996. They may also choose the option of submitting a strategic plan to their regulator for approval under the strategic plan provision. The requirements for data collection also begin on January 1, 1996. However, transition rules, authority, and definitions officially became effective on July 1, 1995.
Ideally this will allow for a smooth transition to the new regulation. Institutions will have time to study and devise a strategic plan to implement all new guidelines and regulations. The Fed staff identified ten ways in which financial institutions would be affected by the new CRA. The regulation:

* Does not require any collection of race and gender data for any loan customers or applicants.

* Substitutes lending, investment, and service tests (with more performance-based criteria) for the current 12 assessment factors to evaluate the CRA performance of larger retail institutions

* For smaller institutions, establishes a streamlined examination approach that focuses on loan-to-deposit ratios, distribution of loans in their local area, and their record of dealing with CRA complaints

* Permits an institution to elect to be evaluated on the basis of a strategic plan after public comment and Fed approval

* Requires large retail institutions to collect geographic data regarding their small business and small farm loans, report the data to the Fed, and make publicly available a CRA statement containing aggregate reports that show lending activities grouped by census tracts of various income levels

* Establishes a system for making available to the public aggregate data regarding small business and small farm loans reflecting all reporting institutions in each census tract

* Establishes a rating system that relies on examiner judgment, rather than on numerical or formulaic standards, to assign ratings for performance under the
three main tests (e.g., rating performance on specific factors from "excellent" to "poor") and that places primary emphasis on lending by requiring a Satisfactory lending performance to receive a Satisfactory lending performance to receive a Satisfactory or better composite rating
* Adds consumer loans to the list of loans that will be considered under the lending test, but only if a bank requests this consideration and has collected relevant data or if these loans make up a substantial majority of a bank's portfolio (no data collection would be required)
* Deletes any reference to enforcement actions against institutions with less than Satisfactory CRA performance ratings

It is left up to each financial institution to compile a delineation of the local community or communities in which they are a part. There may be no "holes", i.e., areas excluded from the community such as low and moderate income neighborhoods. The bank delineates one or more assessment areas in which the FDIC evaluates the bank's record of helping to meet the credit needs of that community. The delineation of the bank's assessment areas is not evaluated separately as a performance criterion but the FDIC does review the delineation for compliance with the requirements of the CRA 345.41 Assessment Area Delineation.

Conceptually, there is no difference between delineated community in the previous regulation and assessment area in the new rule. Both delineated communities and assessment areas use widely recognized existing borders. The geographic area consists generally of one or more counties, cities, or towns and includes the areas in which the bank has its main office, branches, and deposit-taking ATMs, as well as the surrounding areas in which the bank has originated or purchased a substantial portion of its loans. A bank may adjust the boundaries of its assessment areas to include only the portion of a political subdivision that it can reasonably be expected to serve, such as an area that is extremely large or is divided by significant geographic barriers. A bank must be sure that the delineated area(s) consist only of whole
geographies and does not reflect illegal discrimination such as excluding particular low income areas. Agencies will use the financial institutions delineation area for assessment unless they find it does not comply with the above CRA rules. If the bank's delineation fails the examiner will designate an area that does comply for evaluation purposes.

Several changes were made to the section of the 1994 proposal on assessment tests, standards, and ratings. The terms "performance tests," "performance standards," and "performance criteria" have been substituted instead of using "assessment tests," "assessment standards," and "assessment criteria". This reflects the final rule's attempt to focus primarily on performance rather than process. The information to be used in assessing performance is gathered by examiners, and is specifically identified. The old approach was a "one size fits all" approach where the new approach is a more individualized method. The new CRA treats small banks, large banks, and wholesale and limited-purpose banks differently.

CRA APPLICATION: LARGE BANKS

A large bank is not specifically defined in the final CRA regulations; it is any bank that does not meet the definition of a small or a wholesale bank. If a bank qualifies as a large retail bank, the final regulation on the new CRA establishes three different assessment tests.

Lending is one of the three tests applied under the standard assessment method to institutions that do not qualify for the small bank performance standards. An institution must receive at least a "low satisfactory" on the lending test in order to receive a "satisfactory CRA rating". The lending test is the key component of the CRA score and evaluates origination and purchase of home mortgage, small business, small farm and community development loans. Origination and purchases provide a more accurate picture of current activity not obscured by past performance. By evaluating origination an institution is rewarded that sells loans. FDIC also bases evaluations on the geographic distribution of loans in an assessment area and the number and amount of loans in low-, moderate-, middle-, and upper-income geographies. The financial institution's lending pattern should not exhibit conspicuous gaps not explained by
lending activity. Regulators emphasize an institution is not expected to lend evenly throughout or to every geography in its assessment area. This factor is more important in communities without identifiable low- or high- income areas. This factor considers distribution among income level of borrowers instead of geographic distribution.

Investment is the second test applied under standard assessment method to institutions that do not qualify for the small performance standards. The essential question in this component of the test is whether or not the financial institution meets the credit needs of its assessment area through qualified investments. There are specific exclusions for this test such as activities that were considered under the lending or service tests may not be considered under the investment test. The criteria of performance focuses on the amount, innovativeness and complexity of the investment. The investment must be responsive to credit and community and economic development needs. The final criteria is the degree to which qualified investments are not routinely provided by the private sector. Donating, selling on favorable terms, or making available on a rent-free basis a branch of the bank that is located in a predominantly minority neighborhood will be considered as a qualified investment.

Service is the third test applied under the standard assessment method to institutions that do not qualify for the small bank performance standard. This aspect of the test reflects whether of not credit needs of its assessment area are met through retail banking services; and community development services. These retail banking service areas are evaluated only within the context of the assessment area. Community development services may be directed at an area larger than the institution's assessment area.

The institution is evaluated on how accessible branches are to all segments of the community, record of facilities opened and closed. The bank must also provide alternative systems and a range of tailored services provided for their assessment area. A Community development service has a primary purpose of community development and may not be considered in the evaluation of retail banking services. Overall performance in this area
focuses on the extent to which community development services are provided and the innovativeness and responsiveness of those services.

**CRA APPLICATION: WHOLESALE BANKS**

Financial institutions designated as "wholesale" or limited purpose" institutions fall under a different type of evaluation criteria. The key criteria is whether the financial institution meet the needs of its service area through qualified investments, community development lending and services. The financial institution must meet specific requirements and qualify as a wholesale or limited purpose bank. Designation may be revoked by the financial institution or the regulator. The FDIC evaluates the number and amount of community development loans, qualified investments, or community development services. Investment in third party community development organizations may be treated as either qualified investments or as community development loans. A limited purpose institution need not engage in all three categories of activities considered under the community development test but can perform well under the test by engaging in one or more of these categories.

**CRA APPLICATION: SMALL BANKS**

The third of the three types of institutions recognized under the new CRA guidelines is the small bank. The final rule clarifies that an institution that was a small institution as of the end of the prior calendar year is examined as a small institution. A bank is considered a small bank if it has less than $250 million in total assets and is independent or if it has less than $250 million in total assets and is an affiliate of a holding company that has banking and thrift assets of less than $1 billion. This is a change from the December 1994 proposal, which had established a threshold of $250 million in total holding company assets.

The 1994 proposal provided that to determine whether a small institution’s CRA record is satisfactory, the agencies would consider the institution’s loan-to-deposit ratio, adjusted for seasonal variation and, as appropriate, other lending-related activities, such as loan origination for sale to the secondary markets, community development loans or qualified investments.
This 1994 proposal has been retained in the final rule. Evaluations will also take into account the institution's size, financial condition, and the credit needs of its assessment area.

This final rule also takes into account the consideration of the proportion of the institution's total lending made to borrowers in its assessment area. The agencies will take into account local lending and investment opportunities in assessing this criterion.

In addition, the agencies will evaluate the distribution of loans and lending-related activities among individuals of different income levels and businesses and farms of different sizes. Where appropriate, the agencies will also evaluate the geographic distribution of loans in the institution's assessment area, including low- and moderate-income geographies. However, small institutions are not expected to lend evenly throughout its service area, their loan distribution will be evaluated within the context of an institution's capacity to lend, local economic conditions, and lending opportunities in the assessment area.

The agencies also will evaluate whether an institution has taken appropriate action in response to written complaints about the institution's performance in helping to meet the credit needs of its assessment area(s). The agencies intend to consider all CRA complaints in the course of an examination. Therefore, this criterion is retained in the final rule as proposed.

The CRA takes into consideration that small banks must meet the credit needs of their communities to stay in business. The purpose of the small institution standards are to reduce their compliance burdens and place the burden of evaluating their performance on the regulatory agencies. Sample loan files will be reviewed and local community members contacted to decide whether the institution is performing satisfactorily in the area. It may be hard to predict how examiners will rate a small bank because this process is largely subjective. The small institution's ratings will either be Outstanding, Satisfactory, Needs to Improve, or Substantial Non-compliance. The rating given by the agency will determine if any actions will be taken regarding non-compliance with any of these new regulations.
CONCLUSION

Institutions that undergo the streamlined CRA examination should be ready to defend their loan-to-deposit ratio. It is also important to keep in touch with the leaders of the community and community groups to help the institution earn favorable comments. Banks need to know where the low- to moderate-income areas are in their assessment area(s) and what their loan penetration is in those areas. This can be monitored by a tracking system which can be easily developed by the institution. Also, banks need to keep accurate and comprehensive records of any action they take concerning complaints from the community. This will help the bank to avoid situations where it might come down to the bank's word vs. the complainant's.

The Community Reinvestment Act (CRA) states that banks have a responsibility to meet the credit needs of their local communities. Several examples of "meeting the community needs" would be: sponsoring local school activities; Fair associations; Civic groups; FFA programs; hosting community meetings and functions; Habitat for humanity; etc.. It may also be very beneficial for officers of the institution to take an active role in their community by sitting on school boards, city council, planning committees, or any other types of clubs or committees. Participating in such activities increases an institution's chances of becoming a high-CRA-rated bank. Rather than waiting for regulators to spot evidence of possible lending discrimination, top-rated banks check frequently to see that their advertising message is reaching all parts of the community.
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