Community Reinvestment and Cities: A Literature Review of CRA's Impact and Future

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About the Author

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While the author has attempted to cover the salient work in the subject areas addressed by this review, the result is by no means exhaustive. Omissions, and variations in the extent of detail in bibliographical abstracts, do not reflect a judgment on the importance or quality of the work.

The views expressed in this discussion paper are those of the author and are not necessarily those of the trustees, officers, or staff members of The Brookings Institution.

ABSTRACT

Since its passage in 1977, the Community Reinvestment Act (CRA) has been an important tool for increasing the availability of credit and financial services to lower income and minority borrowers and their communities, and has helped to change the ways that depository institutions approach lending in these communities. This paper examines the effects of the CRA, particularly in urban areas, the continued disparities in the availability of financial services to lower income and minority communities, and how recent changes in the financial industry pose new challenges for community reinvestment efforts in the future. Specifically, this literature review on the CRA summarizes findings on: lending patterns in urban communities; the effects of changes in CRA regulations and enforcement; the nature of CRA commitments; the impact of bank consolidations on access to credit; and how changes in the financial marketplace, like the use of the internet and the increased role of non-bank financial institutions, may shape the future of community reinvestment policies. The literature review includes detailed abstracts of some of the key literature on each of these issues.

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COMMUNITY REINVESTMENT AND CITIES: A LITERATURE REVIEW OF CRA'S IMPACT AND FUTURE

INTRODUCTION

The Community Reinvestment Act (CRA) was enacted in 1977 in response to evidence that commercial banks and savings associations were engaging in "redlining" practices that were contributing to the decline of many inner-city urban areas.[1] Redlining referred to the 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 housing stock, or other factors, regardless of the creditworthiness of individual loan applicants.[2] It was believed that these practices were resulting in the disinvestment and decline of many older, central city and typically low-income and minority neighborhoods and a shift of jobs to surrounding areas. The CRA addressed this problem by recognizing a "continuing and affirmative obligation" on the part of depository institutions to help meet the credit needs of the local communities in which they are chartered to do business, and directing the banking regulators to encourage the institutions that they supervised to carry out this obligation.[3] The hope was that by encouraging depository institutions to look for profitable lending opportunities in their local communities, the CRA would be a tool for revitalizing inner-cities at a time when investment was moving to distant money centers or to more affluent and outlying communities.

The statutory scheme was minimal. The law directed the Federal banking regulators, in connection with their supervisory examination of depository institutions, to "assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation" of the institution. The Federal banking regulators were further directed to take this record "into account," along with safety and soundness and other factors, in their evaluation of an institution's application for a deposit facility, defined to include applications: (1) for a Federal bank or thrift charter; (2) for FDIC deposit insurance for a State bank or thrift; (3) to establish a branch; (4) to relocate a home office or branch; or (5) to merge, consolidate, or purchase assets or assume liabilities of a regulated financial institution. The potential denial or delay of an institution's application on account of an inadequate community lending record served as the statute's principle enforcement mechanism.

The regulatory examination process was supplemented by the input of local citizen groups with expertise in their communities who could monitor an institution's lending record and challenge a pending application on the basis of CRA concerns. The process afforded an opportunity for community groups to negotiate commitments by an institution to improve an inadequate CRA record through specific types of loans, investments, and financial services in low- and moderate-income areas. Public accountability as a tool of CRA enforcement was augmented in 1990 when new amendments to the CRA and the Home Mortgage Disclosure Act (HMDA) went into effect. The CRA required regulators to now prepare written, public evaluations of an institution's record in meeting the needs of its entire community, while residential lending reporting requirements under HMDA were expanded to include the race or ethnicity, gender, and income of loan applicants, and the disposition of their applications. Enforcement under the statute was further enhanced in 1995 through an overhaul of CRA regulations that shifted the focus of CRA compliance and examination criteria from procedural efforts to ascertain community credit needs to the institution's actual record of lending, investments, and financial services in its delineated community.

This paper summarizes some of the key research on the effects of the CRA on low- and moderate- income communities, particularly over the last decade, to help lay the groundwork for further thinking on the future of community reinvestment policy. This literature review places special emphasis on the role of the CRA in urban and metropolitan areas. This review, while extensive, is by no means exhaustive.

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[1] Pub. L. No. 95-128, Title VIII, 91 Stat. 1147 (Oct. 12, 1977), codified at 12 U.S.C. §§ 2901-2901 (as amended).
[2] 123 Congressional Record 17,630 (June 6, 1977).
[3] 12 U.S.C. § 2901.

In general, the research reveals several salient trends. First, home mortgage lending to low- and moderate-income and minority households and neighborhoods during the 1990s has increased at rates that far exceed the increases in lending to other segments of the population during the same time period. Economists have attributed these increases at least in part to the influence of the CRA and fair lending laws.

Second, the CRA has helped spawn a community development infrastructure within the banking industry, the bank regulatory agencies, the secondary market organizations, and in inner-city communities that is changing the terms of CRA compliance. While community development initiatives predated the CRA, the CRA has fostered increased collaborations between and among bankers, local and state governments, and community-based organizations in arrangements such as loan consortia and public/private enterprise partnerships. Further, the last few years have seen the crafting of financial vehicles designed to make the most of the private capital represented by bank CRA commitments, while bringing CRA activities into the financial mainstream. These have included transactions like Citibank's $1 million "equity-equivalent" investment to capitalize community development financial institutions (National Community Capital Association); a $29 million private placement of common stock of a real estate investment trust specializing in affordable housing and community development (Local Initiatives Support Corporation); a $2 billion secondary market program for affordable home mortgage loans launched by Self-Help in conjunction with the Ford Foundation and Fannie Mae; and Bear, Stearns' private placement of securities backed by 5400 First Union CRA loans and guaranteed by Freddie Mac. Such initiatives appear to represent an increasingly important component of the low- and moderate-income credit market.

Third, changes in the financial marketplace may threaten the future efficacy of the law. The consolidation of the banking industry, combined with interstate banking and branching and deregulation of other constraints on financial activities, threatens both the local nexus that underpins CRA enforcement and the proportion of the financial services industry that is subject to the law's requirements. In particular, passage of the Gramm-Leach-Bliley Act in November, 1999, which repealed the Glass-Steagall Act of 1933 and amended the Bank Holders Company Acts of 1956 and 1970, permitted affiliations between depository institutions, securities firms, and insurance companies, which may have important further consequences for the availability of financial services in low-income and minority communities.[4]

This paper examines the CRA literature as it relates to five issue areas. Part I of the paper looks at evidence of how lending in central cities has changed over the course of the 1990s, focusing primarily on home purchase mortgage and small business lending. The review revealed very little research on CRA lending in central cities in particular; analyses for the most part have focused on national aggregate lending, or on the broader metropolitan area. The literature indicates that home purchase mortgage lending to low-income and minority households and neighborhoods increased at a faster rate than home purchase mortgage lending generally during the 1990s, but also that this trend has shown signs of some reversals. The more limited data available on small business lending indicate that small business lending overall has increased, but that lending in upper-income areas exceeded small business lending in low-income areas by about 37 percent; and that loan denial rates for black- and Hispanic-owned businesses far exceed denial rates for white-owned businesses.

Part II looks at the impact of the Clinton Administration's reform of CRA regulations and the enhancement of CRA enforcement. While the literature points out the continuing need for better defined benchmarks of performance and more rigorous application by the regulators, substantial evidence suggests that the new regulations have successfully shifted the focus of compliance to performance, and helped to coalesce a market-based approach to community reinvestment.

Part III examines the nature and scope of CRA commitments adopted by major depository institutions, finding that they take a multi-faceted approach to serving the credit and capital needs of low-income communities; and that banks with agreements generally tend to have better records of lending to low-income and minority borrowers and neighborhoods than banks without agreements.

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[4] Pub. L. No. 106-102, 113 Stat. 1338 (November 12, 1999).

Part IV looks at the research on the impact of depository institution consolidations on lending patterns in communities that no longer have locally-owned banks. In general, this research suggests that consolidations are in some instances associated with decreased lending by consolidating institutions, but that these declines are being offset by lending by other market participants over time. The past twenty years have seen a decline in the number of banking offices in low-income communities, both in absolute numbers and per capita, during a period that saw a substantial increase in the number of branches overall, although the net result has been a more even per capita distribution of banking offices across neighborhoods by income levels. Examination of nationwide aggregate data on the impact of industry consolidation on residential lending found that bank consolidation is consistently associated with declines in residential lending by the consolidating organization in the counties in which it operated offices at the time of consolidation, although national aggregate levels of home purchase lending appear not to be affected. These results suggest that declines in local lending by consolidating institutions may be offset by increased lending by the same institutions seeking geographic diversification in other markets, or by other market participants such as independent mortgage or finance companies. At the same time, the portfolio share of consolidating organizations dedicated to low-income lending increased, suggesting a positive impact of CRA requirements on these organizations. Likewise, in the small business market, declines in lending at the institutional level appear to be offset by increased lending by other market participants. Evidence suggests that credit scoring technologies may be substituting for some of the informational advantages of local presence, although it remains unclear the extent to which credit scoring may have a disparate impact on minority business owners. Other studies of both residential and small business lending and more anecdotal evidence suggest that these shifts may have a disproportionate impact in low-income areas and for low-income borrowers, and in any event can disrupt lending relationships upon which small businesses, in particular, depend.

Part V considers the future of federal community reinvestment policies, given the changes in the financial marketplace. This section looks at the issue of defining CRA assessment areas for internet banks and other non-branch delivery systems, literature that suggests extending a CRA obligation to non-bank financial institutions that hold an increasing portion of domestic assets, and literature suggesting modifications of the CRA. Also included is a summary of the Clinton Administration's current Federal community reinvestment policy as outlined by then-Deputy Treasury Secretary Lawrence Summers. An addendum briefly addresses the profitability of CRA lending.

The literature review closes with a series of appendices, including abstracts of bibliographical sources for those who want to delve more deeply into some of the research findings and a list of contact information for the banking regulators, other government agencies, and nonprofit organizations involved in CRA-related matters. The hope is that the paper will serve as a resource for all those interested in community reinvestment issues.

Former Comptroller of the Currency Eugene Ludwig said, "We live in an age that is redefining – and quite properly so – the role of government in the lives of our people. CRA – a law that calls for no public expenditures, little bureaucratic intervention, and local control – has become a model for this new relationship." Further research, we hope, will yield insight into how to adapt that model to the financial services industry of the 21st century.

I. LENDING PATTERNS IN CENTRAL CITIES IN THE 1990S

To what extent has bank and thrift lending in central cities fundamentally changed since the early 1990s? Are we seeing, for example, substantial increases in market-rate lending in central cities during this period? Are there differences between the lending experiences for residential (both homeownership and rental), small business, and community development?

While disinvestment in central city neighborhoods was a major impetus for passage of the CRA, assessments of bank and thrift lending during the 1990s generally focus on patterns of lending to low-income or minority borrowers or neighborhoods within an entire metropolitan area. An important reason for this focus, presumably, is that the expanded data on the race, ethnicity, and income of residential loan applicants that became available in 1990 revealed dramatic disparities in the rates of acceptance between white and nonwhite applicants for mortgage loans and between applicants from white and nonwhite neighborhoods, and generated substantial policy focus on fair lending/discrimination issues (Canner and Smith, 1991, 1992). Further, because it is a bank's record of lending to low-income components of its community that provides the measure of its CRA performance, regardless of whether that community is the central city or the suburbs, CRA policy analysis has tended to focus on credit access by race or income.[5]

Nonetheless, lending in central cities remains an important barometer of where the CRA has taken us, given the persistent concentration of lower-income and minority populations in central cities, and the persistent migration of wealth and development to outlying suburbs. This section examines sources of data as well as analyses of residential, small business, and community development lending by banks and thrifts in the 1990s, highlighting central city patterns to the extent they are available, as well as race and income measures of community reinvestment activity.

In general, very little analysis of central city lending patterns has been done, although data on residential lending according to geographic location is available that would permit further scrutiny of the issue. One study that does isolate lending in a central city, the City of Boston, from lending in the outlying suburbs, is based on HMDA data, indicating that this sort of analysis can be done for other metropolitan areas, as well (Campen, 1998). The results of that study suggest that the central city trend may mirror nationwide results. Specifically, the literature indicates that home purchase mortgage lending to low-income and minority households and neighborhoods increased at rates significantly higher than lending to higher-income and white households and neighborhoods between 1990 and 1998, although there is some indication of some leveling off in these trends from 1995 to 1997. The literature also reveals significant increases in African-American homeownership rates during the 1990s, as well as some evidence that more black homebuyers are moving into segregated, all-black neighborhoods than at the beginning of the decade (Immergluck, 1999). Data on conventional as compared to government-backed home purchase mortgage lending from 1990 showed the ratio of noncentral city to central city conventional home purchase loan originations at about 1.75 to 1. Other residential lending analyses show multifamily housing lending almost tripled between the periods of 1983-1985 and 1991-1993 in the Chicago area; and significant disparities in refinancing rates between black and other minority borrowers as compared to white borrowers. Finally, data indicate that mortgage companies are claiming an increasing percentage of the home purchase mortgage lending market, although representing a significantly smaller share of lending to low-income and minority borrowers than financial institutions subject to the CRA, at least in the Boston metropolitan area.

Analyses of the geographic distribution of small business lending, based on data reported under the revised CRA regulations and available beginning in 1996, indicate that small business lending declined as a percentage of total business lending from 56 percent to 50 percent between 1996 and 1997 but increased to 58.1 percent in 1998.[6] The spatial distribution of small business loans followed fairly closely the distribution of businesses between central city and suburban areas, as well as the distribution of population across census tracts grouped by neighborhood income. However, the same data reveal that loans-per-

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[5] See Department of Housing and Urban Development, Final Rule, *Federal Register* 60:61,845-62,005, Appendix B (Dec. 1, 1995) (codified at 24 C.F.R. Part 81) (concluding that central city location is not an adequate proxy for lack of access to mortgage credit in setting annual goals for the purchase of mortgages in underserved areas under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992).

[6] The revised CRA regulations also required reporting with respect to loans to small farms (Bostic and Canner, 1998). The rural lending market has received little attention in the literature, but is not addressed by this review.

business in upper-income areas exceeded loans-per-business in lower-income areas by 37 percent. Analyses of other small business lending data indicate that black-owned businesses are more than twice as likely as white-owned business to have their small business loan applications denied, and that Hispanic-owned businesses also face higher denial rates (Blanchflower, et al., 1998). Other trends in small business lending include a substantial increase in small loans (under $100,000) by large banks (with assets over $5 billion) in the latter half of the 1990s, possibly attributable to the use of credit scoring for small business lending, as well as a substantial increase in the business use of credit cards, raising the issue of the extent to which business credit card lending may be shielded from CRA review. Finally, research into the spatial distribution of SBA lending shows these business development subsidy loans predominating in more affluent, suburban, nonminority areas.

Apart from revealing the lending patterns themselves, the literature suggests the critical role of the expanded data on residential lending that has been reported by depository institutions since 1990. This data, the equivalent of which is not available for small business lending, has made meaningful analysis of residential lending patterns possible in the first place, while apparently influencing those lending patterns through the public accountability they have created.

A. Residential Lending

Analyses of residential lending patterns are based primarily on a combination of data reported under the Home Mortgage Disclosure Act (HMDA) and data available from the U.S. Census Bureau.[7] Under HMDA, certain depository institutions and other mortgage lenders report on an annual basis originations and purchases and census tract location of four types of residential loans under both conventional and government-backed lending programs: home purchase mortgage, home improvement, mortgage refinancing, and multifamily home lending.[8] As a result of successive amendments to the statute in 1989 and 1991 and a new exemption standard adopted by the Federal Reserve in 1992, HMDA data during the 1990s have included a greater proportion of the residential lending market than when the statute was enacted in 1975, including loans and purchases by most independent mortgage companies in addition to depository institutions and their subsidiaries. Most importantly, HMDA data since 1990 have included the race or ethnicity, gender, and income of loan applicants and borrowers, as well as whether each application was approved, denied, or withdrawn by the customer.

Residential lending patterns are analyzed by correlating HMDA data with census data on the racial composition, median family income, and central city, suburb, or rural location of the loan property census tract. This combination of HMDA and census data, which is available from the Federal Financial Institutions Examination Council (FFIEC), provides the raw material to generate a broad range of analyses of lending in central cities nationwide or by individual MSA or non-MSA county.[9] The only central city information that is generated and made publicly available on a routine basis is data on applications for home purchase (broken down into government-backed or conventional loans), home refinancing, and home improvement loans by the central city or non-central city location of the subject loan property; and nationwide aggregate statistics on loan application disposition (FFIEC, 1999, Table 2, Table 10).

The other data routinely generated by the FFIEC break down conventional and government-backed home purchase lending by racial or ethnic group and income of borrowers. The income categories used in HMDA analyses, and which also correspond to definitions in the CRA regulations, are low-income (median household income of the borrower or in the census tract in which the loan property is located is less than 50 percent of the median household income in the MSA); moderate-income (median household income is 50-79 percent of the median household income in the MSA); middle-income (median household income is 80-119 percent of the median household income in the MSA); and upper-income (median household income is 120 percent or more of the median household income in the MSA). The literature often groups together lending in the first two categories, referring to low- and moderate-income (LMI) or lower-income lending. Low- and moderate-income and minority

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[7] 12 U.S.C. §§ 2801-2811, as amended.
[8] Covered depository institutions initially included commercial banks, savings associations, savings and loan associations, and credit unions with assets over $10 million. This asset threshold was raised to $29 million in 1997.
[9] The FFIEC is an interagency body comprised of a member of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the National Credit Union Administration, the Comptroller of the Currency, and the Director of the Office of Thrift Supervision.

households or neighborhoods are also referred to in the literature as "traditionally underserved borrowers" and lending to underserved borrowers or neighborhoods as "affordable lending."

1. Spatial Distribution

The Federal Reserve presented some national aggregate central city analysis in the early 1990s, but has not undertaken any comparison analysis in more recent years. In 1990, central and noncentral city areas were nearly identical in total number of housing units (38.1 million housing units in central cities as compared to 38.7 million in noncentral city areas). In contrast, about 38 percent of the loans (and 36 percent of the dollar value of loans) made to borrowers residing in metropolitan areas went to borrowers in central city locations and the rest to borrowers in noncentral city locations in 1992; and the rate of noncentral city to central city conventional home purchase loan originations was 1.75 to 1.0 (Canner and Passmore, 1994, p.93). This disparity has been attributed to various factors, including the pronounced suburbanization of residential development serving the middle- to higher-income populations over the course of recent decades (Canner and Gabriel, 1992), as well as demographic factors such as the relatively higher proportions of low-income families, unemployed individuals, and renters in central cities (43.9 percent of housing units in central cities were rentals, a number 70 percent higher than in noncentral city locations) (Canner and Passmore, 1994, p.93).

The distribution of applications for various types of residential loans across central city and noncentral city locations has stayed fairly constant over the course of the 1990s, except with respect to applications for loan refinancing. In 1993, 46.8 percent of applications for government-backed home purchase loans were for properties in central city locations, while 53.2 percent were in noncentral city locations, as compared to 45.2 percent and 54.8 percent, respectively, in 1997. Applications for conventional home purchase loans were 38.3 percent for properties in central city locations, as compared to 61.7 percent in noncentral city locations in 1993, and 38.8 percent central city and 61.2 percent noncentral city in 1997. With respect to home refinancing loans, 36.6 percent were in central cities and 63.4 percent in noncentral city locations in 1993, as compared to 40.5 percent in central cities and 59.5 percent in noncentral cities in 1997. Finally, with respect to home improvement loan applications, 44.6 percent were related to properties in central cities and 55.4 in noncentral cities in 1993, as compared with 44.4 percent and 55.6 percent, respectively, in 1997.

According to the Federal Reserve, the mix of loans used by borrowers in central city locations in 1992 was similar to that used by borrowers in noncentral city locations with a few exceptions. Twenty percent of home purchase loans made in central cities were FHA-insured compared to 15 percent in noncentral cities; and about 72 percent of the loans made in central cities were conventional, as compared to 79 percent of the loans made in noncentral city locations. With respect to racial distribution, 5.4 percent and 5.1 percent of total loans were made to black and Hispanic borrowers, respectively, in central cities, while 2.4 percent and 3.2 percent, respectively, were made to black and Hispanic borrowers in noncentral city locations. Also, the proportion of multifamily loans was higher in central cities, partly reflecting the higher proportion of multifamily and rental houses. Finally, borrowers in central cities had relative incomes that were similar to those of borrowers in noncentral city areas, although *residents* in central cities had relative incomes that were lower than those of residents in noncentral city areas (Canner and Passmore, 1994, pp.93-94).

2. Nationwide Aggregate Changes in Low-Income and Minority Home Purchase Mortgage Lending

The first expanded data under HMDA for 1990 showed significant disparities in loan approval rates across applicant and neighborhood racial and income categories. With respect to denial rates across neighborhoods grouped by resident income level, Canner and Smith found that the rate of loan denial declined as the income of the residents increased. The rate of loan denial for conventional home purchase mortgage loans relating to properties in low- or moderate-income neighborhoods was 20.2 percent, as compared to 13.9 percent for middle-income and 9.7 percent for upper-income neighborhoods (Canner and Smith, 1991).

The data also showed that black and Hispanic loan applicants were denied credit in greater proportions than white applicants, even within the same income groupings.[10] Nationally, Canner and Smith (1991) reported that in 1990, about 14.2 percent of white applicants for conventional home purchase loans were denied credit, as compared to 33.6 percent of black applicants and 21.4 percent of Hispanic applicants. The denial rate for Asian applicants was the lowest of any group, at 12.8 percent. Within the lowest income group, the denial rate for blacks was still substantially higher, at 40.1 percent, as compared to 31.1 percent for Hispanic, 17.2 percent for Asian, and 23.1 percent for white applicants. Among applicants in the highest income group, the denial rate for black applicants was 21.4 percent, as compared to 15.8 percent for Hispanic, 11.2 percent for Asian, and 8.5 percent for white applicants (Canner and Smith, 1992).

Comparing denial rates for conventional loans across neighborhoods grouped by racial composition and income level of their residents, Canner and Smith found that the rate of loan denials increased as the proportion of minority residents in a neighborhood increased. Thus, areas with less than 10 percent minority residents experienced a denial rate of about 12 percent in 1990, as compared to a denial rate of about 24 percent for areas with 80 percent or more minority residents (Canner and Smith, 1991, p.872-873). The pattern of loan denial for government-backed loans was virtually the same. Analysis of lending across middle-income neighborhoods found that depository institutions covered by HMDA extended roughly three to four times more home purchase loans per single family housing unit in predominantly white neighborhoods than in predominantly minority neighborhoods (Canner and Smith, 1991, p.864). About two-thirds of the loans originated in predominantly white tracts were located in suburban areas, whereas three-fourths of the loans made in predominantly minority neighborhoods were located in central cities (Canner and Gabriel, 1992).

HMDA data indicate that since the early 1990s, originations of conventional home purchase mortgage loans to low-income and minority households and neighborhoods have increased at rates significantly higher than loans to higher-income and white households and neighborhoods. Federal Reserve staff have attributed these changes at least in part to affordable home purchase lending programs targeted to lower-income borrowers and neighborhoods (Avery et al., 1999a). The Federal Reserve reported that the number of home purchase loans extended to low- and moderate-income borrowers increased 36 percent and 29 percent, respectively, between 1993 and 1997, while lending to middle-income borrowers rose 16 percent and lending to high-income borrowers rose 18 percent during the same period (Avery et al., 1999a, pp. 88-89, Tables 1, 2). From 1991 to 1992, 1992 to 1993, and 1993 to 1994, the number of conventional home purchase loans extended to low- and moderate-income borrowers combined increased 27 percent, 38 percent and 27 percent, respectively, while lending to upper-income borrowers increased by 10 percent, 8 percent and then 13 percent during the same three periods (Avery et al., 1996, p.638; Evanoff and Segal, 1996; Canner and Passmore, 1995, pp.100-101). While lending across all income categories showed declines or only very modest increases in the following three years, 1997-1998 saw substantial increases again, with lending to low-income borrowers increasing by 25 percent, as compared to a 20 percent increase to upper-middle-income borrowers, 20 percent increase to lower-middle-income borrowers, and 16 percent increase in loans extended to upper-income borrowers (FFIEC, 1999, Table 5).

Lending to minority borrowers has shown similar patterns. The Federal Reserve reported that lending to minority borrowers increased about 53 percent between 1993 and 1997, while lending to nonminority borrowers increased 13 percent during the same period (Avery et al., 1999, p.88, Table 2). Again, after declines or modest increases between 1994 and 1997, 1997-1998 saw increased lending across all racial and ethnic categories, with an increase of 22 percent in lending to Hispanic borrowers, 13 percent to black borrowers, and 15 percent to white borrowers. Immergluck (1999, p.7) found that African-American homebuying increased by 126 percent between 1992 and 1995, substantially faster than the 54 percent increase in overall home buying activity during that period, or the 78 percent increase in homebuying by low- and moderate-income households during the same period. As a result, the African-American homeownership rate grew from 42.1 percent in the beginning of 1994 to 45.2 percent in 1998, for a 7.4 percent increase that was significantly larger than the overall increase in U.S. homeownership of 3.3 percent over the same period.

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[10] A vast literature has debated whether discriminatory lending practices underlay these disparities, and debating the appropriate research methodology for making the determination. For a recent treatment of this literature, see Margery Austin Turner and Felicity Skidmore, *Mortgage Lending Discrimination: A Review of Existing Evidence*, Washington, D.C.: The Urban Institute (June 1999). See also Evanoff and Segal (1996), pp. 24-28, Boxes A and B (charting mortgage redlining and microeconomic lending studies) and Schill and Wachter (1994), pp. 247-55, Table 1 (summarizing studies on racial and ethnic geographic disparities in home loan mortgage markets).

Segal and Sullivan (1998) found that the gap between black and white homeownership rates decreased by nearly 3 percent between 1995 and 1997 (although the homeownership rate for blacks remained 23 percent below that for whites in 1997).[11] However, there is also evidence that the gap between minorities and whites being denied home mortgages widened in 1996 and 1997, after improving in previous years; and that much of the new lending to blacks in recent years has come from subprime mortgages (NCRC, 1999; Campen, 1998; Marsico, 1999).

3. Lending Patterns at the Metropolitan Level: Low-Income and Minority Home Purchase Mortgage Lending in Boston and other Metropolitan Areas

Studies of home mortgage lending in particular metropolitan areas have shown similar trends as the nationwide aggregates, with the strongest growth in lending rates between 1992 and 1995.

a. Boston

In a study of mortgage lending in the City of Boston and 27 surrounding cities and towns, Campen (1998) found that for the eight-year period from 1990 to 1997, the general pattern that emerged was of substantial increases in total mortgage lending to low-income and minority borrowers through 1993 or 1994, relative constancy through 1996, and a general decline in 1997 from the levels reached in the immediately preceding years – with declines in some cases so substantial that the indicators used in the report were lower in 1997 than they had been in 1990, the earliest year for which comparable data were available. However, when looked at by denial rates rather than loans actually made, the data show continued general improvement in 1997.

Campen's profile of lending in Boston includes data for three geographic areas: the City of Boston, the 12 cities and towns that share a boundary with Boston ("Inner Ring"), and the 15 additional cities and towns that share a boundary with at least one of the Inner Ring municipalities ("Outer Ring"), thus making it possible to isolate central city lending, and to compare it to lending in the outlying suburban areas. Analyzing the spatial distribution of the population by race and income across the three areas, Campen found a substantial concentration of minority households and LMI neighborhoods in the central city. Data from the 1990 decennial census show that the population of the City of Boston was 20.6 percent African-American, 8.1 percent Hispanic, and 66.4 percent white. In contrast, the population of the Inner Ring cities and towns were 3.6 percent African-American, 3.5 percent Hispanic, and 89.3 percent white; and the population of Outer Ring cities and towns were 2.6 percent African-American, 3.5 percent Hispanic, and 92.9 percent white. With respect to income, 68.5 percent of census tracts in the City of Boston were low- or moderate-income (median family income no greater than 80 percent of the Boston MSA, meaning less than $38,950), while 30.3 percent of the census tracts in the Inner Ring cities and towns, and 19.7 percent of the census tracts in the Outer Ring cities and towns, were low- or moderate-income (Campen, 1998, Table 1). The family median income in the City of Boston was $34,377, as compared to $47,758 in the Inner Ring cities and towns, and $51,662 in the Outer Ring cities and towns.

Campen found that total home purchase lending within the City of Boston increased dramatically between 1990 and 1997, from 1,770 loans in 1990 to 5,706 in 1997, with lending to minority households increasing at a significantly higher rate than lending to white households during the earlier years of the study period. Between 1990 and 1993, home purchase loans to African-American borrowers increased by 148 percent, from 287 to 712 loans; and lending to Hispanic borrowers increased by 122 percent, from 91 loans to 202 loans; while lending to white borrowers increased by 85 percent, from 1,266 loans to 2,344 loans. However, while lending to white borrowers continued to increase each year through 1997, lending to African-American and Hispanic borrowers dropped between 1996 and 1997 (from 897 to 836 for African-Americans, and from 392 to 334 for Hispanics). African-American borrowers received 836 loans in 1997, down 12 percent from the high point of 955 loans in 1994, while loans to whites rose by 38 percent during the same period (Campen, 1998, p.3). The number of loans to Hispanic borrowers fell from 392 in 1996 to 334 in 1997, a drop of 15 percent during a period when loans to white borrowers rose by 10 percent (Campen, 1998, p.3, Table 2 and Chart 2).

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[11] But see Evanoff and Segal (l996), who found that the increase in mortgage originations to black households between 1992 and 1994 was insufficient to move the homeownership rate a single point.

Lending in the Inner and Outer Rings between 1993 and 1997 followed a similar pattern as in the City of Boston, with increases in lending to African-American and Hispanic borrowers outpacing increases in lending to white borrowers between 1993 and 1994, and then declining between 1996 and 1997. Thus, between 1993 and 1994, loans to African-Americans in the Inner Ring increased by 59.8 percent and by 71.1 percent in the Outer Ring, loans to Hispanics increased by 29.5 percent in the Inner Ring and by 83.5 percent in the Outer Ring, while loans to whites increased by 11 percent and 9.1 percent in the Inner and Outer Rings, respectively. Lending between 1994 and 1995 saw more modest increases and some declines within each racial group; larger increases again in 1996, and declines in 1997 in loans to African-American borrowers (10.3 percent decline in loans to black borrowers in the Outer Ring, with modest increase of 4.4 percent in the Inner Ring) and Hispanic borrowers (20.8 percent decline in the Inner Ring, 8.9 percent decline in the Outer Ring), while loans to white borrowers increased modestly, by nearly 6 percent, both in the Inner and Outer Rings (Campen, 1998, numbers extrapolated from Table 18-A and 18-B).

The share of total home purchase loans going to low- and moderate-income households in the City of Boston increased between 1990 and 1997, though figures in both categories declined between 1995 and 1997 from their highest levels in 1994. Thus, lending to low-income households as a percentage of all home purchase loans in Boston increased from 2.8 percent in 1990 to 11.6 percent in 1995, but then dropped somewhat to 10.8 percent in 1996 and 10.1 percent in 1997. Likewise, lending to low- and moderate-income households combined increased from 22.4 percent in 1990, to a peak of 40.6 percent in 1993, with the percentage of loans to low- and moderate-income households gradually declining thereafter, reaching 34.7 percent in 1997 (Campen, 1998, Table 3). Lending to low- and moderate-income households in the Inner and Outer Rings followed a similar pattern (Campen, 1998, Tables 23-A and 23-B).

Data on home purchase loan denial rates by race in the City of Boston showed dramatic progress between 1990 and 1997. The denial rate for African-American loan applicants was 32.7 percent in 1990; that rate decreased to 17.5 percent in 1993, with continued decreases until the 1995 low of 15.8 percent. While the African-American denial rate showed increases in 1996 (to 18.3 percent) and 1997 (to 19.5 percent), the denial rate remained dramatically below its 1990 level, and below the 1997 national denial rate of 53 percent. Nonetheless, the denial rate for blacks in Boston when grouped by income category was well above that of white applicants in every income category (Campen, 1998, p.4, Table 5, Chart 5).

Analysis of the relative share of City of Boston home purchase loans by race found that since 1990, blacks and Hispanics have claimed a smaller share of home purchase loans than their percentage representation among Boston households. However, African-American and Hispanic borrowers' relative share of home purchase loans rose, and white borrowers' share fell between 1990 and 1996; but by 1997, the African-American share of loans had fallen below its 1990 level (14.7 percent as compared to 16.2 percent), and white borrowers had regained their 1990 share (71.6 percent as compared to 71.5 percent). Campen also found that lower-income neighborhoods with a high concentration of black and Hispanic residents received only about three-quarters of their proportionate share of the city's home purchase loans measured by mortgageable housing units (Campen, 1998, p.4, Table 6, Chart 6, and Map).

Finally, Campen also assessed lending under three "targeted" lending programs negotiated between banks and community groups in Boston, finding that lending under these programs comprised a substantial portion of the total home purchase lending in the City of Boston. Of the total home purchase loans made to minority borrowers in the City of Boston in 1993, 12.9 percent were made under the three studied negotiated loan programs; 18 percent in 1994, 38 percent in 1995, 27 percent in 1996, and 27 percent in 1997. Of the total home purchase loans made to low- and moderate-income borrowers in the City of Boston, 13 percent were made under the three negotiated loan programs in 1993, 17 percent in 1994, 29 percent in 1995, 29 percent in 1996, and 28 percent in 1997 (extrapolated from Campen, 1998, Table 13 data).

Studies of changes in home purchase mortgage lending to low- and moderate-income and minority households and neighborhoods in other metropolitan areas (none of which isolate central city lending from other lending within the MSA) show similar trends as the nationwide and Boston data.

b. New York City and other Metropolitan Areas

Another recent study examined CRA impact in the New York City metropolitan area by examining relative market share of home purchase mortgage loan originations among five CRA-target communities between 1991 and 1998. Marsico found that the market share of conventional home mortgage loans made to black, Hispanic, and low- and moderate-income applicants, and in minority neighborhoods, increased between 1991 and 1997, with the strongest gains between 1993 and 1995, and the largest increases in market share of loans in predominantly minority neighborhoods and to Hispanic borrowers. The market share of loans held by predominantly minority neighborhoods grew by 37.8 percent, from 7.4 percent in 1991 to 10.2 percent in 1997. The market share of loans held by Hispanic borrowers increased 38.2 percent from 1991 to 1997, from 5.5 percent to 7.6 percent. The market share of loans held by black borrowers and low- and moderate-income persons grew at lower rates, 10.8 percent and 17.4 percent, respectively. Only the market share of loans in low- and moderate-income neighborhoods declined during the period, by 22.5 percent, from 10.2 percent in 1991 to 7.9 percent in 1997.

Marsico suggests that low- and moderate-income communities did not reflect the growth in market share of loans during the period because the increased availability of credit opened previously unaffordable housing markets, in higher income neighborhoods, for members of these subject communities. He found empirical support for this theory in the fact that the strongest growth in market share of loans from 1991 to 1997 was in middle- and upper-income predominantly minority neighborhoods, which increased by 167 percent and 222 percent, respectively, as compared with a growth of 20 percent in low- and moderate-income predominantly minority neighborhoods, and a growth of 37.8 percent in all predominantly minority neighborhoods during the period (pp.497-498).

Marsico also documents a general decline in market shares of applications and loans in the subject communities in 1996 and 1997, suggesting that lenders may have satisfied the accumulated demand for loans in these communities between 1992 and 1995, "after which demand returned to a more normal level" (p.497).

In a study of home mortgage lending in Denver, Ford and Carver (1996) found that the largest Denver banks had doubled, and in some cases tripled, the home mortgage dollars loaned to African-Americans between 1991 and 1994. During the same period, the African-American mortgage loan rejection rate dropped from its previous rate of nearly three times higher than the rate for whites, to 1.7 times greater. Looking at changes in conventional home purchase lending between 1990 and 1995 in six cities (Boston, Wilmington, Raleigh-Durham, Buffalo, Richmond, and Tallahassee), Shlay (1999) found that lending to low-income borrowers, in low-income census tracts, and to black borrowers were either comparable to or exceeded overall market trends.

4. Corollary Trends

In addition to significant increases in the extent of home purchase lending to low-income and minority households and neighborhoods during at least the first half of the 1990s, several corollary trends in residential lending patterns have been identified over the same time period.

a. Increased Segregation

An analysis of residential lending in Chicago by the Woodstock Institute in 1999 found that while homeownership among African-Americans increased significantly during the 1990s, more black homebuyers are moving into segregated, all-black neighborhoods than at the beginning of the decade, with the effect that black homebuying has become more highly segregated (Immergluck, 1999). Immergluck suggests that the statistics on increased African-American homebuying since the early 1990s are indications of the success of the CRA and other federal policies focused on increasing access to credit for home buyers and overcoming other obstacles related to African-American homeownership, but that a complementary strategy of intervention in the home selling markets designed to provide African-American homebuyers with access to a broader variety of neighborhoods is now required.

b. Concentration Effects

Examining a subset of data from the Boston Federal Reserve Bank's 1992 study of lending discrimination in Boston, Schill and Wachter (1994) found evidence consistent with their hypothesis that the CRA may create incentives that cause the concentration of low-income homebuyers in low-income neighborhoods and of minority homebuyers in minority neighborhoods.[12] For example, they found that an average low-income person applying for a loan in a predominantly nonpoor neighborhood was almost three times more likely to be rejected than if he or she had applied in a neighborhood predominantly composed of poor residents; and that nonpoor households that were otherwise similar to poor households had a higher probability of being rejected in low-income neighborhoods (Schill and Wachter, 1995). Likewise, Schill and Wachter found that a black person's loan application is more likely to be accepted if he or she is applying for a loan in a neighborhood with a higher proportion of black residents; and that low- and moderate-income applicants are more likely to be accepted in neighborhoods with higher proportions of black households (Schill and Wachter, 1994). Thus, Schill and Wachter postulate that federal policies that seek to target spatially the flow of home finance capital may have the unintended consequence of intensifying the spatial concentration of poverty (Schill and Wachter, 1994, p.225; Schill and Wachter, 1995, p.453). Further, Schill and Wachter suggest that the CRA could have the unintended effect of increasing disinvestment, to the extent that financial institutions are encouraged to take undue risks in accepting the loan applications of poor and minority households in predominantly poor and minority neighborhoods, and these households ultimately default on their loans (Schill and Wachter, 1995, p.453).

Galster (1995) challenges Schill and Wachter's conclusions on several grounds. With respect to the CRA's unintended effects, Galster argues that Schill and Wachter provide no evidence that the CRA has fomented concentrated defaults and neighborhood blight. To the contrary, he argues, CRA loans have been found to be no riskier than standard loans, and evidence indicates that the CRA may provide the impetus for lenders to overcome the variety of biases, information shortcomings and market failures that have been responsible for past shortcomings in lending in these areas. Second, Galster argues that the loan concentration effects that Schill and Wachter find cannot be traced convincingly to the CRA, inasmuch as the Boston data on which their conclusions are based predate intensified CRA enforcement, and in fact were used to demonstrate in the Boston Federal Reserve Bank study that equally qualified minorities were denied for mortgage applications at a rate 60 percent higher than whites.

5. Interest Rate Issues: Government-Backed Mortgage Lending and the Subprime Mortgage Market

The extent of a banking institution's provision of conventional mortgage loans to low-income or minority borrowers is generally viewed as a barometer of the institution's reinvestment commitment because conventional, or market-rate, lending represents greater risk than government-backed mortgages that carry with them governmental insurance (FHA loans) or guarantee (VA loans) (Schwartz, 1998a, p.283). In addition, while government-backed mortgages have lower downpayment requirements that may make them more accessible in the short-run for low-income households, they can be more costly in the long-run. FHA loans, for example, carry a 3.8 percent mortgage insurance premium that makes them more expensive than conventional loans with loan to value ratios above 80 percent, which typically require less expensive private mortgage insurance, or with loan to value ratios below 80 percent that generally do not generally require any mortgage insurance at all (Megbolugbe, 1993, p.198).

The 1990 data indicate that government-backed home purchase lending was almost evenly divided between central city and noncentral city areas. In contrast, the ratio of noncentral city to central city conventional home purchase loan originations was about 1.75 to 1. This disparity is generally attributed to the relatively high house prices paid by middle- to higher-income homebuyers, coupled with restrictions on the maximum loan amounts backed by FHA insurance or VA guarantees, which together serve to reduce the applicability of government-backed lending in many suburban areas (Canner and Gabriel, 1992, p.254).

Further, the data reveal that even after controlling for differences in applicant income, African-American borrowers rely on FHA and VA loans to a much greater extent than do white borrowers. For example, in 1990, 65 percent of low-income black borrowers used government-backed loans to purchase their homes, whereas only 41 percent of white borrowers relied on these types of loans. Also, although virtually the same proportions of central city and noncentral city low-income black borrowers relied on government-backed loans in 1990 (65 percent in both cases), a higher proportion of low-income white in central cities (49

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[12] See Alicia H. Munnell, Lynn E. Browne, James McEneaney and Geoffrey M.B. Tootell, "Mortgage Lending in Boston: Interpreting HMDA Data." Federal Reserve Bank of Boston Working Paper 92-7 (1992).

percent) used these types of loans than did whites with similar incomes in the suburbs (35 percent). Suggested reasons for this persistent racial differential in mortgage loan utilization were loan product recommendations by real estate agents, self-steering by the loan applicants, differences in marketing efforts by lenders, or lender racial bias (Canner and Gabriel, 1992, p.264).

Another interest rate issue that has claimed increasing attention among community reinvestment advocates and banking regulators alike has been subprime lending. Subprime lending typically refers to lending at above-market interest rates and carrying higher fees, normally offered to high-risk borrowers who do not meet standard underwriting criteria. The subprime market has experienced dramatic growth over the last decade, and research indicates that the subprime 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 living in underserved areas (Immergluck and Wiles, 1999; Cassidy and Englestad, 1998; NCRC, 1998). At the same time, there has been a dramatic increase in reported cases of "predatory" mortgage lending practices, which 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 (Immergluck and Wiles, 1999, p.1). Immergluck and Wiles suggest that while minority and lower-income homebuying increased substantially in the 1990s, the simultaneous growth in predatory lending practices by independent mortgage and finance companies that predominate in low-income and minority neighborhoods threatens to reverse the impact of these gains.

Immergluck and Wiles suggest that CRA examination criteria may tend to support predatory lending in several ways. Because pricing and terms are rarely examined in the CRA context, high-cost and even predatory loans may receive as much credit as conventional lending. And because predatory lenders may concentrate in lower-income communities, they may be receiving high marks under the lending test. Likewise, purchases of predatory loans, or CRA targeted mortgage-backed securities that include predatory loans, may receive CRA credit.

At the same time, banking regulators suggest that properly administered risk-based pricing can broaden the market and improve homeownership opportunities, bringing mainstream lenders into lower tiers of the credit market that until now have had to rely on very high-priced, often predatory, alternative institutions (Seidman, 1999).

6. Multifamily Lending

Multifamily lending refers to loans made for the purchase, improvement, or refinancing of buildings with five or more units, and thus generally signifies rental housing. Nationwide, the proportion of multifamily loans is higher in central cities than in noncentral city areas, partly reflecting the higher proportion of multifamily and rental houses in central city locations (Canner and Passmore, 1994).

One study of multifamily housing lending in the Chicago area by the Woodstock Institute indicates that lending in this market almost tripled between the periods of 1983-1985 and 1991 -1993, from an average of 361 loans averaging $53 million per year in the early period, to an average of 992 loans representing $240 million per year in the later period (Goldwater and Bush, 1996). Analysis of the change in multifamily lending by neighborhoods showed dollar value increases in lending of more than 200 percent in 25 of Chicago's 45 low- and moderate-income neighborhoods, more than 500 percent in eight neighborhoods, and more than 1,000 percent in three neighborhoods.

Goldwater and Bush attribute this increase in multifamily lending primarily to CRA lending mandates, as well as declining real wages that increased demand for rental housing, community development corporation projects that spurred private development, and other financial inputs including low-income housing tax credits, community development block grants and HOME program low-interest second mortgage loans, Federal Home Loan Bank Affordable Housing Program loans, and various other state and local incentive programs.

7. Refinancing

HMDA data on refinancing loans reveal a significant disparity in refinancing rates among African-American and other minority borrowers as compared to white borrowers which one study attributes to poor marketing to borrowers (Healy et al., 1996; Grimes et al., 1995). Healy, Ortiz, and Immergluck found that in both 1992 and 1993, as interest rates dropped to their lowest levels in decades, African-Americans in Chicago showed much lower rates of refinancing relative to their levels of homeownership (9 percent and 11 percent of refinancing loans, respectively, while comprising 29 percent of homeowners) than did white homeowners (69 percent of refinancing loans in 1993, and representing 58.7 percent of homeowners) (pp.19-20). Further, comparing refinancing rates in communities with virtually the same median household income, Healy et al. found that the lowest rates of refinancing in 1992 and 1993 were in those moderate-income communities that were predominantly African-American. Similar disparities appeared for loan refinancing applications. In 1992 and 1993, African-Americans applied for 11 percent and 13 percent of refinancing loans, respectively, while white applicants comprised 67 percent and 61 percent of refinancing applications during the same two years.

Healy et al. found that when interest rates began to rise in 1994, the percentage of refinancing loans made to African-Americans rose dramatically (28 percent of all refinancing loans, as compared with 49 percent of all refinancing loans made to whites), even though the tide of refinancing loans was stemmed. The authors conclude that the disparities in refinancing are largely a result of poor marketing to minorities, with the 1994 rise reflecting more aggressive efforts by banks and mortgage companies to maintain a stake in the refinancing market as rates began to rise. Healy et al. suggest that while a lower rate of refinancing loans to low-income and African-American borrowers are often attributed to factors such as a decline in economic security, inability to gather closing costs for refinancing, or a decrease in home value causing a greater loan-to-value (LTV) ratio, these factors cannot explain the rise in 1994.

A Federal Reserve Bank of Chicago report on refinancing in 1993 found similar racial disparities. Grimes, Woos, and Essig found that the rate of refinancing applications by census tract in Chicago decreased one percentage point for every 10 percent increase in African-American population, though the authors of the report suggest that the higher percentage of FHA/VA loans that go to African-Americans, rather than race, per se, was the cause.

8. Mortgage Banks as Compared to Depository Institutions

Comparisons between depository institution and independent mortgage company lending patterns have been used as an indicator of the influence of the CRA since independent mortgage companies are not covered by the CRA and have no comparable community lending obligation, but have since 1993 reported their residential lending under HMDA. Such comparisons have yielded mixed results, and some commentators suggest that the comparison may have limited utility. In the first place, the comparison cannot address the question of whether the low-income and minority lending rates of CRA-covered depository institutions would have been significantly worse in the absence of CRA, given the trend in banking towards noninterest earnings, or income earned through fees rather than through loan interest, and the incentives that creates to move towards more affluent markets (Immergluck, 1999c). Further, comparisons of lending volumes provide no indication of the extent to which the loans being made are FHA or conventional, or may be subprime loans, which predominate among independent mortgage lenders.

The Federal Reserve reported that in 1992, depository institutions directed a greater share of their total lending to low- and moderate-income borrowers than independent mortgage company lenders, with depository institutions extending 20 percent of their conventional home purchase loans to low-income households, while independent mortgage lenders extended 15 percent of their conventional loans to low-income households (Canner and Passmore, 1994). However, Canner and Passmore also found that depository institutions provided a smaller proportion of home purchase and refinancing loans to minorities than independent mortgage companies, though the difference was attributed in part to a greater proportion of loans to “joint” borrowers and to Asian borrowers, on account of more loans originated in California, which has a large Asian population. Evanoff and Segal (1996) found no significant differences in lending rates between depository institutions and independent mortgage lenders, and that disparities in denial rates between minority and nonminority applicants declined over time for both sets of institutions (p.36). And Gunther et al. (1999) found that the portfolio share of lending to low-income neighborhoods and borrowers by lenders not covered by the CRA increased more between 1993 and 1997 than the portfolio share of such lending by CRA-covered lenders.

A comparison of mortgage bank and commercial bank lending in Boston in 1997 revealed more pronounced disparities between mortgage bank and commercial bank lending to traditionally underserved borrowers. In 1997, mortgage companies made 54.2 percent of all home purchase loans in Boston, 36.6 percent of all the loans made to African-Americans, 31 percent of the loans to Hispanics, and 26.7 percent of the loans to low-income borrowers. In contrast, the biggest Boston banks made just 25.1 percent of total home purchase loans, but accounted for 52.6 percent of the loans to African-American borrowers, 54.2 percent of the loans to Hispanic borrowers, and 55.7 percent of the loans to low-income borrowers (Campen, 1998). Looking at the share of total loans made to low- and moderate-income and minority borrowers by big Boston banks as compared to all other banks and credit unions, and as compared to mortgage companies, Campen found that African-American borrowers received 29.4 percent of the loans made by the big Boston banks, 9.5 percent of those made by mortgage companies, and 7.3 percent of those made by all other banks. Hispanic borrowers received 12.1 percent of the loans made by big banks, 3.2 percent of mortgage companies loans, and 4.0 percent of other bank loans. Low-income borrowers obtained 21.9 percent of big banks loans, 4.8 percent of mortgage company loans, and 8.3 percent of loans from all other banks. Low- and moderate-income census tracts that had over 75 percent black and Hispanic residents received 15.9 percent of the loans by the big Boston banks, but only 7.2 percent of the loans made by mortgage companies and 4.4 percent of the loans made by other banks.

The simultaneous trend in mortgage company lending, which has raised concerns about the declining influence of the CRA, is that mortgage companies are claiming an increasing percentage of the home purchase lending market. Campen (1998) found that the largest Boston banks and their affiliated mortgage companies made one-quarter of all Boston home-purchase loans in 1997, their lowest loan share of the decade (as compared with their peak level of 43.6 percent in 1995, and lower than their 28.9 percent share in 1990), while independent mortgage companies for the first time accounted for more than one-half of all loans (up from 43.4 percent one year earlier, and 23.5 percent in 1990). (Campen, 1998, p.5, Table 7). Nationwide, the Federal Reserve reports that independent mortgage lenders extended about one-third of the home purchase loans in metropolitan areas in 1998. (Avery, Bostic, Calem, and Canner, 1999, p.82 n.6).

B. Small Business Lending[13]

Expanded reporting of data on small business lending since 1993 has resulted in a good deal of attention to the subject in recent years. Under the revised CRA regulations, large depository institutions (having assets over $250 million or owned by a bank holding company with more than $1 billion in assets) are required to report to their banking regulator by March 1 of each year aggregate data on small business loans for each census tract or block numbering area, known as a "geography," in which the bank originated or purchased a small business loan during the year. The reported data includes the aggregate number and amount of loans in each of three loan size categories ($100,000 or less, $100,000 to $250,000, and $250,000 through $1 million), and the aggregate number and amount of loans made to businesses with gross annual revenues of $1 million or less. Information on business ownership characteristics comparable to that required by HMDA on the race, gender, and income of loan applicants is not required.

In addition, since 1993, all insured depository institutions have been required to report the outstanding amount of small business loans in their Reports of Condition and Income filed with their federal banking regulators in June of each year (Board of Governors, 1997). In these "call reports," banks report small business loans in two classes (commercial and industrial loans and commercial real estate loans) and in the same three size categories as CRA reporting (Peek and Rosengren, 1998). Call reports, however, provide no geographic information.

In general, "small business lending" thus refers to loans of $1 million or less, being defined by the size of the loan rather than the size of the borrower. While this approach has been criticized, this loan amount threshold is generally accepted as a fair proxy for identification of small businesses on the rationale that in practice, most loans under $1 million are loans to small businesses (Peek and Rosengren, 1998, p.28; Immergluck and Mullen, 1998; Board of Governors, 1997, p.16). Alternatively, the

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[13] The impact of merger and consolidation activity on small business lending patterns is considered separately in Part IV.

class of businesses with $1 million or less in gross revenues, also identified in CRA disclosures, is also used to represent small business lending.[14]

In the first year of CRA small business loan data reporting under the revised regulations, 2,078 institutions (1,564 commercial banks and 514 savings institutions) constituting 18 percent of all U.S. commercial banks and savings institutions, were subject to the requirements. These institutions accounted for approximately two-thirds of both the number (64.6 percent) and dollar volume (65.9 percent) of small business lending (FFIEC,1998; Bostic and Canner, 1998, pp.7, 11). Approximately 97 percent of the reported small business loans were originated by commercial banks or their affiliates, reflecting the fact that commercial banks are the predominant source of credit for small businesses (Bostic and Canner, 1998, p.8). Reflecting the lack of a well-developed secondary market for small business loans, most reported small business loans were originations; only about 2 percent were reported as purchases from another institution.

From 1996 to1997, the number of small business loans increased from 2.4 million to 2.6 million, totaling $150 billion in 1996, and $159 billion in 1997. During the same period, the proportion of small business loan dollars in low- and moderate-income areas remained virtually the same (20.6 percent), while the percentage of reported small business loans extended to firms with revenues of $1 million or less decreased from 56 percent of total loans in 1996 to 50 percent of total loans in 1997, but increased to 58.1 percent in 1998 (Bostic and Canner, 1998, p.11; FFIEC, 1999). The number of reporting institutions decreased by about 10 percent during the same year (to 1,421 commercial banks and 475 savings associations).

1. Spatial Distribution

CRA data from 1996 and 1997 indicate that small business loans are concentrated in central city and suburban areas (about 81 percent of all small business loans), as are the bulk of the U.S. population and businesses. With numbers that are fairly consistent from 1996 to 1997, approximately 40 percent of the number of small business loans, 43 percent of the dollar amount of small business loans, 41 percent of the businesses, and 37 percent of the population were in central cities, while suburbs represented 41 percent of the loans, 41 percent of the dollar amount, 41 percent of the businesses, and 43 percent of the population (Bostic and Canner, 1998). The data also indicate that most of the small business loans made in lower-income areas were for businesses in central city census tracts: approximately 91 percent of all small business loans made in low-income areas were in central cities, 7 percent in suburbs and 2 percent in rural areas. The higher-income area small business loans were more prevalent in suburban areas, which had 47 percent of all upper-income small business loans percent were in suburban areas, while 40 percent were in central cities, and 13 percent in rural areas (FFIEC, 1998, percentages extrapolated from Table 4-1).

Small business lending data reveal that small business loans have generally followed the distribution of population and businesses. Federal Reserve analysis of the nationwide geographic distribution of small business lending across census tracts grouped by neighborhood income indicates that in 1996, low-income areas represented about 4.9 percent of the population and 5.6 percent of the businesses, and received 4.7 percent of the number and 5.6 percent of the total dollar amount of new or purchased small business loans at CRA reporting institutions. In comparison, moderate-income areas represented 18.8 percent of the businesses, 18.5 percent of the population, 15.9 percent of the number of small business loans, and 16 percent of the dollar amount of small business loans. The total amount of lending to middle- and upper-income neighborhoods taken together only slightly exceeded their share of the population and businesses (Bostic and Canner, 1998, p.13).

However, nationwide loan-per-business rates extrapolated from the same data show rates that are substantially higher in middle- and upper-income neighborhoods than in low- and moderate-income neighborhoods. Thus, the CRA data indicate that CRA-reporting depository institutions made 24.9 loans per 100 businesses in low-income census tracts, as compared with 34.2

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[14] The Small Business Administration (SBA) defines a small business as one that has under 500 employees. Of businesses with under 500 employees, 84 percent also have $1 million or less in revenues, so that some commentators treat this $1 million benchmark as a fair proxy for measuring loans to small businesses (Bostic and Canner, 1998). On the other hand, Thomas argues that the use of loan size was a major policy setback in the CRA regulation (Thomas, 1998, pp.214-16). He asserts that there is not a consistently reliable relationship between loan size and size of business, and that the one revenue indicator of $1 million or less is too large to have any realistic relationship to a small business or farm. He suggests three categories of alternative benchmarks: under $100,000 in revenue as a small business, $100,000- $1 million as a medium-sized business, and $1 million or more as a large business.

loans per 100 businesses in upper-income tracts, yielding a loan-per-business rate that was 37 percent higher in upper-income areas than in low-income ones. The middle-income lending rate was 18 percent higher than in moderate-income tracts (Immergluck, 1998).

The distribution of small business lending in the Chicago area by neighborhood income level in 1996 mirrored the nationwide pattern. Immergluck and Mullen (1998a) found that the number of loans per 100 businesses in the Chicago area was 16.6 in low-income areas, 18.4 in low- and moderate income areas combined, 21.8 in middle-income areas, and 23.1 in upper-income areas. Thus, upper-income tracts received 39 percent more loans per business than low-income tracts. If analysis is limited to firms with annual revenues of $1 million or less, the differentials are greater, with upper-income tracts receiving 67 percent more loans per business than low-income tracts (16.2 loans per business in upper-income tracts as compared with 10.8 loans per business in low-income tracts). Even when businesses with fewer than five employees are excluded, loans per business rates are 30 percent lower in lower-income communities (63 loans per business in upper income neighborhoods as compared to 44 loans per business in lower-income neighborhoods). When these lending rates are mapped by census tract across the Chicago area, the lowest lending rates are generally concentrated in the city, with the highest loan per business concentrations in the outlying areas of the six-county area.

Similarly, Squires and O'Connor (1999) found in their study of small business lending in the Milwaukee metropolitan area that the number of loans per 100 businesses was 20 in low-income areas, 20 in moderate-income areas, 34 in middle-income areas, and 37 in upper-income areas, so that upper-income tracts received 85 percent more loans per business than either low- or moderate-income tracts (Table 4).

CRA data on the distribution of small business loans by neighborhood racial composition suggest that predominantly minority neighborhoods receive a somewhat smaller share of the business loans and loan dollars than might be expected based solely on the distribution of the number of businesses and population across areas (Canner, 1999). Likewise, Squires and O'Connor (1999) found that in Milwaukee, both small business lending and lending to firms with revenues under $1 million are concentrated in white communities, with approximately 90 percent of loans and loan dollars going to firms in these areas, approximately two percent of loans and loan dollars going to businesses in predominantly black neighborhoods, and less than one percent to businesses in Hispanic areas. They also found that the number of loans and loan dollars per 1,000 persons decreased as the proportion of non-whites in the population increased. For example, Squires and O'Connor found that the number of loans per 1,000 persons varied from a high of 13 in neighborhoods where the population was at least 90 percent white to a low of 2 in neighborhoods where the population was more than 70 percent black. Loans per 1,000 persons also varied from 11 in areas that were less than five percent Hispanic to four in areas that were more than 25 percent Hispanic. Lending activity per business by racial composition could not be calculated because data on small business are not available at the census tract level.

2. *Minority-Owned Small Businesses*

While research based on CRA data can examine the geographic distribution of small business lending across lower-income and minority neighborhoods, other data sources have been used to assess access to credit for minority-owned small businesses in particular, which is a critical issue for neighborhood economic development efforts in lower-income and minority communities. One of these sources is the 1993 National Survey of Small Business Finances (NSSBF), a survey conducted for the Board of Governors of the Federal Reserve System and the U.S. Small Business Administration. The NSSBF surveyed over 4,600 small businesses (defined to include businesses with fewer than 500 employees) and includes some information about the firm's primary owner, such as personal demographics, management experience, and credit history, which makes it possible to assess the role of owner characteristics in loan approval decisions. In addition, the NSSBF details demographic and financial data on the business itself, such as the firm's location, primary industry, organizational form, and its recent financial relationships with a variety of depository institutions, which makes it possible to control for a number of other firm characteristics (Lang, 1999).

Several papers presented last year at a Federal Reserve conference on business access to capital and credit (Blanton, Williams, and Rhine, 1999) used the NSSBF data to compare lending to black- or Hispanic-owned small businesses to lending to white-owned small businesses, and found that black-owned firms are up to two-and-a-half times as likely as white-owned firms to

be denied for loans; and that large disparities remained even after controlling for differences in credit histories and a variety of firm and owner characteristics (Blanchflower et al., 1999; Bostic and Lampani, 1999; Cavalluzzo et al., 1999). Blanchflower et al. also found disparities in lending to Hispanic-owned businesses, that minority-owned firms receive smaller loan amounts than white-owned firms, and that black-owned firms pay higher interest rates.[15] While these results appear to confirm disparities found in earlier studies (Bates, 1999, p.270), the recent literature has not examined the extent to which these disparities may have changed over the course of the 1990s.

Blanchflower et al. found that black-owned firms are more than twice as likely to have a loan application rejected relative to white-owned firms (65.9 percent denial rate for black-owned firms as compared to 26.9 percent for white-owned firms). Hispanic business owners were also more likely than white applicants to have their loan application rejected (39 percent denial rate) (pp.8-9, Table 1). Even after controlling for a number of differences related to creditworthiness, such as the firm having been bankrupt or had legal judgments against the firm or owner, black-owned firms remained 28 percent more likely to have their loan request denied compared to white-owned firms; and 25 percent more likely to be denied after controlling for a variety of other factors such as firm size and age, organizational type, educational qualifications of owner, whether or not it had any business lines of credit or revolving credit agreements in 1993, firm location, and industry (Blanchflower et al, 1998, p.12). The researchers also concluded that black-owned firms pay rates of interest that are approximately one percentage point higher than white-owned firms after controlling for differences in creditworthiness, even for black-owned firms with good credit histories, with little evidence that interest rate differentials charged to black-owned firms differed between proprietorships/partnerships, older and younger firms, bigger and smaller firms, and industry (pp.20-21).

Other researchers have also found disparities in loan approval rates for minority-owned businesses. Cavalluzzo et al. (1999) found that black-owned firms were over two-and-a-half times as likely to have been denied credit within the last three years, and almost three times as likely to have been denied credit on their most recent loan request than were businesses owned by white males, and that substantial differences remained even after controlling for a large number of firm and owner characteristics (p.189). Bostic and Lampani (1999) found that 52 percent of loan applications from black-owned firms were approved, as compared to 83 percent of loan applications from white-owned firms, and 83 percent of loan applications from Hispanic-owned firms. Adding variables measuring racial composition of the local neighborhood and variables representing the economic characteristics of the local geography reduces the disparity, but does not eliminate it. Differences between Asian-owned and or Hispanic-owned and white-owned firms remained statistically insignificant. Bostic and Lampani suggest that factors related to local geography may account for some, although not all, of the observed differences in outcomes; although Bates (1999) argues that differences based on local geography should already be reflected in other variables relating to firm profits.

For several reasons, the results of these studies are likely to understate the constraints on minority access to business credit. Bates (1999) points out that the NSSBF data focus on loan accessibility for older, more established small firms. According to Census Bureau data, the median age of NSSBF firms was 14.3 years, while the median age for all minority-owned firms is five to six years (five for Asian and Hispanics, six years for blacks). Consequently, an appropriate data base for examining minority small business credit access would have to focus on younger firms, in operation for less than five years. Many black- and other minority-owned firms that are most vulnerable to loan access difficulties were "dead and gone before they were sufficiently mature to be likely candidates for inclusion in the NSSBF data base" (Bates, 1999, p.273). Another reason that NSSBF data may understate disparities is suggested by evidence that black- and Hispanic-owned firms may avoid applying for bank credit in the first instance because of fear of being denied (Cavalluzzo et al., 1999; Blanchflower et al., 1998).

Furthermore, constraints on access to start-up financing may be a critical reason why minority-owned firms do not have the longevity of white-owned businesses, based on research that has found a relationship between levels of initial capitalization and long-term success (Bates, 1999; Huck et al., 1999). Bates (1997) found that blacks are less likely than whites to receive start-up

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[15] As in the residential lending context, researchers disagree about the extent to which these disparities signify discrimination in the lending process or the extent to which discrimination can be proven with the available data. While acknowledging that none of the studies alone can be conclusive on the issue, Bates argues that it becomes difficult *not* to infer discrimination "when a variety of studies conducted in different years, based upon different data bases, employing various methodologies, all produce consistent empirical evidence of Black loan applicant disadvantage" (Bates, 1999, p.271).

business financing from banks (17 percent as compared to 22.7 percent of white-owned firms), and that those who do obtain bank loans receive smaller loan amounts, on average, than white borrowers. Blacks are consequently more likely to use other forms of consumer credit, such as credit cards or home equity loans, to finance their businesses (29.6 percent of black borrowers as compared to 18.4 percent of white borrowers), which also result in smaller average loan sizes ($20,776 for black borrowers, and $33,060 for white borrowers) (p.491).

Black-owned businesses, on average, begin operations with less than half the capitalization of white-owned firms, with the gap being even wider in capital-intensive industries, such as manufacturing and wholesaling. Among young firms nationwide in 1987 in these fields, average startup capitalization (debt and equity) was $37,571 and $92,935, respectively, for black- and white-owned businesses. Corresponding means for leverage (debt divided by equity) were 0.96 and 1.41 respectively (Bates, 1999). In addition, those firms that do receive bank loans receive smaller loans, on average, than white borrowers, controlling for borrower demographic traits, borrower human capital such as college education, firm traits, borrower equity investment in the firm, and other factors (Bates, 1997, p.487; Bates, 1999, p.271). Bates finds that low startup capitalization results in "stunted firms in fields like manufacturing, and the predictable consequence is higher rates of business closure for Black owners, relative to Whites" (1999, p.272-273).

Blanchflower et al. (1999) conclude that disparities in small business loan approval rates are even greater than in home mortgage loan approval rates. They suggest that one reason is that secondary market requirements, and the fact that lenders will likely be selling the mortgage loans, provides added "distance" in the transaction that might reduce the likelihood of discrimination (p.28). Blanchflower et al. point out that a comparable secondary market for small business loans does not exist.

3. *Growth in Small Business Lending by Large Banks and the Use of Credit Scoring Technologies*

While small business lending has traditionally represented a substantially greater proportion of assets for small banks than large banks, evidence indicates that large banks began to do more small business lending during the latter half of the 1990s, particularly in the smallest loan size category (Peek and Rosengren, 1998; Feldman, 1997). For example, the Federal Reserve Bank of Minneapolis found that small business loans under $100,000 made by banks with assets over $5 billion increased by 16 percent between June 1995 and June 1996, as compared to an increase of 4 percent in the previous year (Feldman, 1997).

This growth has been attributed to several factors. In part, it has been attributed not to a net increase in the number of small business loans, but to a shift in distribution among institutions as a result of consolidation activity. Thus, some of this growth reflects mergers of small or mid-sized banks resulting in the creation of a large-size bank that includes the combined small business loan portfolios of the smaller banks; or the acquisition of small banks, including their small business loan portfolios, by large-size banks. In addition, increases in loan-to-one borrower limitations may accompany mergers of small institutions, permitting larger loans to particular small business customers (Board of Governors, 1997).

Several commentators suggest, however, that the numbers also reflect real growth in small business lending by large institutions and are attributable to the use of credit-scoring technologies previously used in consumer and mortgage lending, which are particularly adaptable to loans in the smallest size category. By substituting analysis of the net worth and economic characteristics of the business owner for the more time-consuming underwriting based on analysis of balance sheets, income statement, underlying collateral, and other indicia of the prospects of the business itself, credit scoring is making the small business lending market more accessible for larger banks that may not have a local presence (Peek and Rosengren, 1998). Additionally, it is thought that the increased standardization provided by credit scoring, with its potential for evaluation of risk of pools of small business loans, increases the potential for securitization of small business loans, which will further contribute to making small business lending more attractive for large institutions (Board of Governors, 1997). In fact, large banks have begun to use credit scoring not only to approve loans, but to select potential small business and market to them through the mail (Immergluck and Mullen, 1998a, pp.14-15). And recent research examining small business lending in 1997 found that banks that credit scored small

business loans generally originated a larger proportion of their loans in low-income areas than banks that did not credit score. (Padhi et al., 1999).

However, while the data indicate a net increase in small business lending over the 1990s, some commentators suggest that the increased use of credit scoring nonetheless raises concerns about its impact on small business credit. First, will the expanded use of credit scoring result in large banks "skimming off" the most profitable business opportunities, leaving smaller and local banks with riskier portfolios, or will it create new demand for bank loans by small firms (Immergluck and Mullen, 1998b; Feldman, 1997; Board of Governors, 1997). Some research has found that large banks do not appear to "cherry pick" the market by only offering loans to larger, higher quality small businesses; but that the smallest small businesses do appear to have access to capital, especially line of credit loans, from large banks than other small business borrowers. (Haynes et al., 1999). Second, there is some evidence that credit scoring may have a differential impact on minority-owned businesses. While on the one hand it may reduce the opportunity for discrimination in the lending decision by substituting objective criteria, the focus on personal wealth and credit history could have a disparate impact on minorities (Ladd, 1998).

Other factors cited as contributing to increased small business lending other than the use of credit scoring technologies have been increased use of small business credit cards, increased origination and sale of SBA and other guaranteed loans, and development of CRA-inspired investment programs, including consortium lending corporations, small business investment companies, SBA 504 development companies, and community-based micro-enterprise loan funds (Board of Governors, 1997).

4. Credit Card Lending

A growing portion of small business lending is represented by business credit cards, which are included in the small business lending data reported under the CRA. The twelve credit card banks that reported some amount of small business lending in 1996 accounted for 30 percent of the total number of small business loans reported for the year nationwide, though only 2.9 percent of the dollar volume of such loans (Bostic and Canner, 1998, p.11; Cyrnak, 1998). In the Chicago metropolitan area, three of the five largest small business lenders were credit card banks; these three lenders accounted for 39 percent of the small business loans in the Chicago metropolitan area reported in 1996 (Immergluck and Mullen, 1998a). Evidence shows that business credit cards increasingly are being used as a source of working capital and small equipment purchases by small firms, and not just for expense management (Immergluck and Mullen, 1998a, citing Board of Governors, 1997, p.15).

The full extent of small business lending being done through credit cards may be unknown, and may be shielded from CRA review. Some banks that issue business credit cards may also be issuers of large numbers of consumer credit cards, on the basis of which they have attained "limited purpose" bank status. Limited purpose banks, whose CRA performance is reviewed under the community development test, are not evaluated with respect to their small business lending activities. Immergluck and Mullen note that American Express, for example, the largest provider of small business financing in the nation, is exempt from CRA examination of its small business lending practices (Immergluck and Mullen, 1998b, p. 15).

5. Federal Business Development Subsidy Programs

An important segment of small business lending is represented by small business loans guaranteed or subsidized by the Small Business Administration (SBA) under programs designed to promote depository institution funding of small business loans. Recent research indicates that while overall lending under SBA programs has increased in the 1990s, these federal subsidies are not reaching lower-income, minority, or central city communities at substantial rates. Instead, they are predominating in more affluent, suburban, nonminority areas, exacerbating problems of spatial mismatch and the decentralization of metropolitan regions (Fisher, Lee, and Zak, 1994; Immergluck and Mullen, 1998a). This spatial distribution of SBA lending raises concerns both because of its economic development impact, as well as its potentially diluting effect on CRA initiatives since financial institutions may receive CRA credit for loans made under SBA programs, regardless of whether they reach underserved borrowers or communities (Immergluck, 1995, p.20).

To analyze the intrametropolitan distribution of loans under the SBA's 504 development company program, Immergluck and Mullen (1997, 1998a) compared the distribution of 504 loans to the distribution of businesses in the Chicago metropolitan region between 1992 and 1996, and found that for the manufacturing, wholesale, and retail sectors, though not for the service sector, firms in higher-income zip codes and those farther from the central business district of Chicago received more 504 loans after controlling for firm count and industrial mix. In the manufacturing sector, 33 percent of all loans were approved to businesses in low-income and lower middle income zip codes (median income below $39,788 in 1989), while manufacturing businesses in those areas accounted for 49 percent of all small businesses; 17 percent of 504 loans to manufacturers were approved in the lowest income quartile of zip codes, whereas these areas contained 27 percent of manufacturers in the six-county area. In the wholesale industry, 32 percent of 504 loans were approved in low-moderate and lower-middle-income areas, while these areas accounted for 42 percent of wholesalers. In the retail sector, 30 percent of 504 loans were approved to retail businesses in low-moderate and lower-middle income areas, while these areas accounted for 46 percent of retail firms. The service sector was the one sector in which more 504 loans were approved for firms in lower-income areas than would be expected based on the spatial distribution of firms, with 50 percent of loans approved for firms in low-moderate and lower-middle income areas, while these areas contained 44-47 percent of all service firms.

When 504 lending during the study period is mapped across the Chicago metropolitan area according to median household income, less than 15 percent of all loans went to firms in the city of Chicago, with the greatest concentrations of loans in middle- and upper-income suburbs in DuPage and Kane counties (Immergluck and Mullen, 1997, Figure 4). Immergluck and Mullen (1997) found that job creation or retention effects (which are a criterion for 504 loan approvals) do not provide a rationale for this geographic distribution of 504 lending, given that most of the job creation and retention claimed under the studied 504 loans was in upper-income areas, often far from higher unemployment, lower-income neighborhoods.

Immergluck and Mullen also found that both the 504 development company program and SBA's 7(a) loan program were serving predominantly nonminority-owned businesses, which represented over 80 percent of the loans approved under these two programs in 1996, although the proportion of these loans going to minority-owned businesses did increase between 1992 and 1996 (1997, p.5). Thus, between 1992 and 1996, the proportion of loans going to minority-owned firms under the 7(a) program increased from 15 to 20 percent, and under the 504 program from 9 to 15 percent. According to the Census Bureau's Survey of Minority Owned Businesses, minority-owned businesses accounted for no more than 13 percent of U.S. firms in 1992, meaning that loans under both programs appear to be serving minority-owned firms at rates exceeding their proportion in the economy (Immergluck and Mullen, 1997, p.5). Immergluck and Mullen suggest that these increases may be due to increased attention to minority businesses by the SBA or by banks, but that a substantial portion of the increase is likely due to demand-side, demographic factors, such as increases in business formation among Hispanics and Asians over the 1987-1992 period. However, the program appears to be the least effective in reaching African-American-owned firms; less than two percent of 504 loans were to African-American-owned firms, despite a 46 percent increase in such firms between 1992 and 1996 (Immergluck and Mullen, 1997, p.7).

Finally, the Woodstock Institute also analyzed the impact of the SBA's LowDoc program on lending to modest-income and minority neighborhoods (Immergluck, 1995). Aimed at increasing the number of 7(a) loans going to smaller borrowers, the LowDoc program succeeded in increasing the number of SBA 7(a) loans nationwide by 36 percent during 1993, and reducing the average 7(a) loan size from more than $245,000 to less than $164,000 during fiscal year 1994. However, comparing SBA 7(a) lending for the year before and the year after the LowDoc program was introduced in the San Antonio MSA, Immergluck (1995) found that minority-owned firms obtained smaller shares of SBA loans and total dollars after LowDoc was introduced (29 percent and $21 million) then before (32 percent and $19.5 million). In contrast, SBA 7(a) loans to white-owned businesses increased from 68 percent of all 7(a) loans in the San Antonio MSA to 71.4 percent, and from $35.4 million to $46.3 million over the study period. Further, comparing loans and lending dollars to nonmanufacturing businesses across zip codes by minority or income composition, Immergluck found that nonmanufacturing firms in lower-income zip code areas received 39 percent of the 7(a) loans and 43 percent of the loan dollars, while these zip codes accounted for 55 percent of the nonmanufacturing establishments and 54 percent of the sales and receipts in these retail and service sectors. After LowDoc, lower-income zip codes accounted for only 34 percent of 7(a) loans. Likewise, prior to LowDoc, minority neighborhoods contained 39 percent of the nonmanufacturing businesses in the area and 39 percent of the related sales and receipts, and received 32 percent of the 7(a) loans and 36 percent of 7(a) loan dollars; after LowDoc, the number declined to 27 percent of 7(a) loans and 26 percent of loan dollars. Comparing the

changes in 7(a) loans to all firms, including manufacturers, lending increased by 52 percent in minority areas and by 10 percent in nonminority areas (Immergluck, 1995, pp.11, 14, Tables 4 and 5).

C. Community Development Lending

The large institutions covered by CRA reporting requirements are required to report the aggregate number and aggregate amount of community development loans they originate or purchase during the year. Community development loans are defined as loans that have as their primary purpose community development, which may include loans for affordable housing for low- or moderate-income individuals, community services targeted to low- and moderate-income individuals, activities that promote economic development by financing small businesses and small farms, and activities that revitalize or stabilize low- or moderate-income geographies.[16] Examples include loans to local lending consortia and local nonprofit organizations (Bostic and Canner, 1998, p.20).

CRA data on community development lending is comprised of only gross numbers, including no information on geographic distribution or details on types of projects. For 1997, community development lending totaled nearly $19 billion, up from $17.7 billion for 1996, with a typical loan size of $745,000, up from $542,000 in 1996. These loan sizes are relatively large compared to the average size for small business and small farm loans (Bostic and Canner, 1998).

[16] 12 C.F.R. § 25.12(h).

II. EFFECTS OF CRA REGULATORY REFORM

What has been the impact of the Clinton Administration's reform of CRA regulations? Have the new regulations shifted bank CRA efforts towards certain qualifying activities? What has been the impact of regulatory reform on CRA enforcement?

The federal banking agencies promulgated revised CRA regulations in April, 1995, in response to President Clinton's call for a regulatory regime that would emphasize performance over paperwork.[17] The primary goal of the revisions was to institute more objective, performance-based assessment standards that would assess an institution's performance in meeting the credit needs of its community based upon its actual lending, investments, and services, instead of its policies and procedures for ascertaining community credit needs or documentation of its community outreach efforts that formed the basis of the previous regime. The revised regulatory scheme also augmented the types of activities explicitly recognized for CRA credit in the evaluation process. Most notable among these were inclusion of a discrete evaluation category for community development investments, recognition of community development as an explicit benchmark of performance in the lending and service tests, and recognition of CRA credit for loans carried out through third party intermediaries.

The impact of the new regulations has been assessed in several ways.[18] Immergluck (1997, 1998) and Thomas (1998) examine performance evaluations (PEs) and ratings for indications of changes in bank activities and regulatory response, as well as the extent of continued "grade inflation" in CRA compliance ratings. Several other articles elucidate the types of community development lending and investment opportunities created or recognized under the new regulations and their potential impact on community development and low-income lending (Lento, 1994; Immergluck, 1998; Mahoney, 1998; Santiago et al.,1998). Other articles look at the extent to which the regulatory revisions have enhanced the effectiveness of the CRA in achieving its goals. Segal and Sullivan (1998) assess the extent to which a significant decrease in the gap between black and white homeownership rates between 1995 and 1997 might be attributable to the new regulations and enhanced CRA enforcement; while Shlay (1999) evaluates the impact of the regulatory changes from a broader political perspective.

The literature suggests that CRA regulatory reform has effectively shifted the focus of examinations to performance rather than documentation of efforts, while also opening up new avenues for community reinvestment efforts. With respect to enforcement, performance evaluations under the new regime reveal the need for continued efforts to increase consistency among the banking regulators, to provide clear guidelines for eligible activities, and to develop better quantitative and qualitative benchmarks for measuring performance.

With respect to community reinvestment activities, the literature suggests that the revised CRA regulations are creating opportunities for enhanced linkages between CRA compliance and the large body of community development expertise and initiatives that has developed along parallel lines with the CRA over the last 25 years. These linkages are represented by various market-based financial arrangements for facilitating bank and thrift CRA efforts, such as equity equivalent investments in community development financial institutions (CDFIs), a real estate investment trust specializing in affordable housing and community development debt and equity assets that meet CRA requirements, and development of a more liquid secondary market for CRA loans through the use of CRA-targeted mortgage-backed and community development securities, as well as the formation of lending consortia and other public-private partnerships for community development. The literature suggests that twenty years after passage of the CRA, and with the impetus of the regulatory reforms of the 1990s, the CRA is finding a niche in the financial marketplace.

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[17] Community Reinvestment Regulations, Joint Final Rule, *Federal Register* 60:22,156-22,223 (May 4, 1995) ("Joint Final Rule"), codified at 12 C.F.R. Parts 25 (Office of the Comptroller of the Currency), 228 (Federal Reserve System), 345 (Federal Deposit Insurance Corporation), and 563e (Office of Thrift Supervision). Section numbers of the regulations correspond from one agency codification to another. For example, the sections dealing with assessment area delineation are 25.41, 228.41, 345.41, and 563e, respectively. Citations to the regulations in this section are to the OCC codification of the joint rule.

[18] The assessment period for the revised regulations has been relatively brief. New data collection requirements and small bank evaluations under the new standards went into effect on January 1, 1996, and large retail institutions could opt-in on that date, but all large banks were not subject to the new evaluation criteria until July 1, 1997. *Federal Register* 60:22,176.

A. Summary of Compliance Tests under the Revised Regulations

The revised CRA regulations establish separate compliance examination tests for three categories of institutions: large retail, small retail, and wholesale or limited purpose institutions. The regulations also offer an alternative option for any institution to be examined against a "strategic plan" of measurable annual goals and objectives to be established by the bank, with input from its community, and approved by the institution's banking regulator. Based on examinations under these compliance standards, an institution is assigned one of four possible overall, composite ratings: Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance, to be taken into account by the institution's banking regulator when acting upon an institution's application to establish a deposit facility.

An institution's community for purposes of evaluating its CRA performance is referred to as its "assessment area," which the bank is to delineate to include one or more entire MSAs or political subdivisions (counties, cities, towns) that include the geographies (census tracts or block numbering areas) in which the bank has its main office, branches, and its deposit-taking ATMs, as well as surrounding geographies in which the bank has originated or purchased a substantial portion of its loans (12 C.F.R. § 25.41). A single institution may have one assessment area or many; and with the easing of restrictions on interstate banking, a single institution might have assessment areas scattered across the country.

In addition to considering efforts directed at low- and moderate-income individuals and neighborhoods within an institution's assessment area, the compliance tests give consideration to loans, investments, and services that have as their primary purpose "community development." Community development is defined to include affordable housing for low- or moderate-income individuals (including multifamily rental housing), community services targeted to low- or moderate-income individuals, activities that promote economic development by financing small businesses or small farms, and activities that revitalize or stabilize low- or moderate-income geographies (12 C.F.R. § 25.11(h), (i)).

1. Large Retail Institutions

The CRA performance of large retail financial institutions (independent institutions having $250 million or more in assets or institutions having a parent holding company with $1 billion or more in assets) is assessed under a three-part test that evaluates the institution's lending, investments, and services. Examiners assign one of five component ratings (Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, or Substantial Noncompliance) and points for each of the tests, which are then added up according to a rating matrix to create the institution's composite rating. Lending is the most heavily weighted in the equation, counting for at least one-half of the composite rating, so that an institution cannot receive a composite rating of Satisfactory or better unless it receives a minimum of Low Satisfactory on the lending test (Evanoff and Segal, 1996, pp.23-24). At the same time, an institution that receives an Outstanding on the lending test is assured an overall Satisfactory, even if it receives Substantial Noncompliance on the other two components (Immergluck, 1997).

The lending test evaluates a bank's record of helping to meet the credit needs of its assessment area though home mortgage, small business, small farm, and community development lending, and includes both originations and purchases (12 C.F.R. § 25.22). Consumer lending may be considered if it constitutes a substantial majority of the bank's business, or at the bank's option. Lending is assessed according to five performance criteria: (i) the number and amount of loans in the bank's assessment area(s); (ii) the geographic distribution of loans, including the proportion and dispersion of loans in the bank's assessment area, and the number and amount of loans in low-, moderate-, middle-, and upper-income geographies in the bank's assessment area; (iii) the distribution of the bank's loans by borrower income characteristics, looking at the number of loans to low-, moderate-, middle, and upper-income borrowers within the bank's assessment area and the number of loans to small businesses and farms with less than $1 million in annual revenues; (iv) the bank's community development lending, including the number and amount of community development loans and their complexity and innovativeness; and (v) the bank's use of innovative or flexible lending practices to address credit needs of low- and moderate-income individuals or geographies. Community development loans both within the bank's assessment area or in a broader statewide or regional area that includes the bank's assessment area are considered.

The investment test evaluates a bank's record of meeting the credit needs of its local community through qualified investments that benefit its assessment area or a broader statewide or regional area that includes the bank's assessment area (12 C.F.R. § 25.23). A "qualified investment" has as its primary purpose community development, and may include an investment, deposit, membership share, or grant in or to financial intermediaries such as CDFIs or community development corporations (CDCs), to organizations engaged in affordable housing rehabilitation or construction, small business investment companies (SBICs), day care facilities, projects eligible for low-income housing tax credits, state and municipal obligations, or nonprofits serving community development needs such as homeownership counseling and other financial services education. An institution's investment activity is evaluated against four performance criteria: (i) the dollar amount of qualified investments; (ii) the innovativeness or complexity of qualified investments; (iii) the responsiveness of qualified investments to credit and community development needs; and (iv) the degree to which the qualified investments are not routinely provided by private investors.

The service test evaluates a bank's record of meeting the credit needs of its community through retail banking and community development services (12 C.F.R. § 25.24). Performance criteria for retail banking services are (i) the distribution of the institution's branches among low-, moderate-, middle- and upper-income areas of its community; (ii) the institution's record of opening and closing branches, particularly those located in low- or moderate-income areas or serving low- or moderate-income individuals; (iii) the availability and effectiveness of alternative systems for delivering retail banking services; and (iv) the range of services provided to low-, moderate-, middle-, and upper-income geographies and the degree to which the services are tailored to meet the needs of those geographies. Community development services are assessed according to (i) the extent to which the bank provides community development services, and (ii) the innovativeness and responsiveness of community development services. Community development services are services that have as their primary purpose provision of financial services to low- and moderate-income communities and not classified as one of the retail banking services. These may include, for example, providing technical expertise for organizations serving low- and moderate-income housing needs or economic revitalization; credit counseling to promote community development and affordable housing; school savings programs, or low-cost or free government check cashing.

2. Small Retail Institutions

Small depository institutions are evaluated under a simplified and less rigorous test that focuses on lending and lending-related activities. Consideration of investment, service, and community development activities is at the bank's option, and is used only to upgrade a rating from Satisfactory to Outstanding.

Small bank CRA performance is evaluated according to five performance criteria: (i) the bank's loan to deposit ratio (and, as appropriate, other lending-related activities such as loan originations for sale to the secondary markets, community development loans, or qualified investments); (ii) the percentage of loans (and, as appropriate, other lending-related activities) in the bank's assessment area; (iii) the bank's record of lending (and, as appropriate, engaging in other lending-related activities) to borrowers of different income levels and businesses and farms of different revenue levels); (iv) the geographic distribution of the bank's loans; and (v) the bank's record of taking action in response to written complaints about its performance in helping to meet credit needs in its assessment area.

3. Wholesale or Limited Purpose Institutions

Wholesale or limited purpose institutions are evaluated under a community development test, which does not consider direct residential or small business lending activities (12 C.F.R. § 25.25). Wholesale banks are defined as banks that are not in the business of making home mortgage, small business, small farm, or consumer loans to retail customers. Limited purpose banks are those offering only a narrow product line such as credit cards or motor vehicle loans.

The community development test looks at an institution's record of helping to meet the credit needs of its assessment area through community development lending, qualified investments, or community development services. Performance criteria for these institutions are (i) the number and amount of community development loans, qualified investments, or community

development services; (ii) innovativeness and complexity of community development investments, loans, and services; (iii) the extent to which qualified investments are not routinely provided by private investors; and (iv) the bank's responsiveness to credit and community development needs. At a bank's option, examiners will consider community development lending by consortia and third parties in which the bank has invested or loaned money, and will consider activities outside the bank's assessment area if the bank has adequately addressed the needs of its assessment area.

4. Performance Context

Examiners are directed to apply the CRA tests in the context of the particular institution and the market in which it operates. This "performance context" is defined to include information about the economic and demographic characteristics of the institution's assessment area, lending, investment, and service opportunities in the bank's assessment area, the institution's product offerings and business strategy, the institution's capacity and constraints, the institution's past performance and the performance of similarly situated lenders, and information contained in the institution's public CRA file (12 C.F.R. § 25.41(b)).

B. Impact on Enforcement: CRA Examination Results

One of the hopes behind the revised CRA regulations was that performance-based evaluation criteria would foster more rigorous examination and rating practices and consequently increased community reinvestment. CRA advocates generally believed that under the previous regime, bank CRA ratings reflected dramatic "grade inflation" and lax enforcement by banking regulators (Immergluck, 1997, pp.2-3; Thomas, 1998, pp.56-58). This view was based primarily on analysis of the distribution of CRA ratings. For example, between 1990 (when CRA evaluations first became publicly available) and 1996, the proportion of banks receiving Outstanding ratings increased from less than 7 percent to almost 26 percent; and the proportion of banks receiving either Outstanding or Satisfactory ratings increased from 87 percent to 98 percent. During the same period, the number of institutions receiving Needs to Improve or Substantial Noncompliance ratings dropped from 14 percent to 2 percent (Immergluck, 1997, p.2; Thomas, 1998, p.57, Table 4-1).

An alternative explanation for the rise in the ratings distribution, of course, was that it reflected the banking industry's improved record of lending in low- and moderate-income neighborhoods under the impetus of the CRA; or at least its increased sophistication in managing the compliance evaluation process (Thomas, 1998). Finding that even the improved trends in lending to low- and moderate-income neighborhoods during those years do not correlate with the extent of the increases in CRA ratings, however, Immergluck (1997) concludes that the rising ratings reflected continued rating inflation (pp.2-3).

In an attempt to ascertain the impact of regulatory reform on ratings, Thomas (1998) analyzed all publicly available CRA performance evaluations (PEs) for 1996, the first full year of operation under the revised regulations. Thomas used independent evaluators to effectively redo each of the component performance tests for each institution, sometimes supplemented by additional demographic, banking, or other data not available in the PEs, and then compared those evaluations with actual examiner evaluations and component and overall ratings. Thomas "quantified" the extent of continued grade inflation, and attributed it primarily to the "friendly regulator" and examiner subjectivity.

Examining results of large bank evaluations the following year, from July 1997 to July 1998, Immergluck found that composite ratings remained high, with less than two percent of institutions receiving Needs to Improve or Substantial Noncompliance ratings. However, Immergluck found that Outstanding ratings did drop significantly from 1997 to the first half of 1998, from 24.3 percent to 18.6 percent of institutions over the study period, with the largest drop occurring in ratings of banks regulated by the Office of the Comptroller of the Currency (from 20 percent Outstandings to eight percent) (1998, pp.13, 23).

1. Investment Test

Looking at the component test results from July 1997 to July 1998, Immergluck found that investment test scores were markedly lower than scores for lending or services. About 4 percent of institutions received a score of Outstanding on the investment test, and 21 percent received a High Satisfactory. In contrast, on the lending test, 12 percent of institutions received an

Outstanding, and another 64 percent received a High Satisfactory; and on the service test, 12 percent received an Outstanding and another 57 percent received a High Satisfactory. Further, more than 14 percent of institutions received low scores of Needs to Improve or Substantial Noncompliance on the investment test, dramatically more than the .8 percent and 1.6 percent of institutions that received those scores on the lending and service tests, respectively (Immergluck, 1998, pp.13-14).

Thomas suggests that more specific guidelines about what will be given credit as a qualified investment, and about the distinction between community development loans and qualified investments, will help institutions to improve their investment performance (1998, pp.386, 396-402). Likewise, Immergluck suggests that these low investment test scores are an indication that banks and thrifts may be seeking additional investment opportunities, creating the potential for increased capital flows to CDFIs (1998, p.13). However, Immergluck points out that the rating scheme provides no real incentive for institutions to strive for higher investment test scores, since the bulk of institutions with component ratings of Low Satisfactory or below on the investment test nonetheless received Satisfactory or better composite ratings.

Immergluck and Thomas both suggest the need for more quantitative and relative measures for evaluating an institution's community development lending and investments. For example, Immergluck found that only three of the 12 large bank PEs he examined made any attempt to measure investment activity relative to bank size, and that among these three, two different measures were used (1998, pp.16-17). Immergluck suggests that the regulators develop a more comprehensive and consistent set of data that examiners can use to compare banks to their peers in a market, including data such as bank size, tier 1 capital, net income, and related bank capacity measures, as well as data that distinguishes between outstanding and new investment and community development loan commitments (1998, pp.6-18). Thomas similarly argues that relative measures of qualified investments are needed in order to make investment ratings meaningful and to reduce the role of examiner subjectivity. Just as ratios are used in the lending test (loans to deposits) and in safety and soundness exams, Thomas suggests a Qualified Investments/Assets (QITA) ratio for evaluating CRA investment performance (1998, pp.393-95).

In addition to better quantitative measures, both Immergluck and Thomas suggest that regulators need to develop and apply more consistent qualitative distinctions and benchmarks for identifying what is complex and innovative and for evaluating responsiveness to credit and community development needs. For example, Immergluck points out that an investment in a small business investment company that does not target investments to minority firms or firms in distressed areas and that provides a rate of return exceeding 20 percent presently receives as much credit as an equity-equivalent investment in a microloan fund targeting minority firms and that would not provide a similar rate of return (1997, p.21). Likewise, Thomas cites the minority bank qualified investment "loophole," which provides investment test credit for deposits or shares in minority-owned financial institutions that are risk-free and pay a competitive rate of return (1998, p.401).

C. Impact on Activities: Qualified Investments in CDFIs, Secondary Market Vehicles, and Loan Consortia

A variety of sources suggest that the new CRA compliance tests have fostered the development or enhanced use of a variety of financial vehicles to meet their compliance criteria.

1. Qualified Investments in Community Development Financial Institutions (CDFIs)

The explicit recognition of CRA credit for activities that promote community development through lending, investments, or services has focused attention on the potential for increased linkages between traditional financial institutions and CDFIs. While CDFIs trace their origins to "immigrant guilds of New York City's Lower East Side [and] the Prairie Populists of the late 1800s" (Santiago, 1998, p.598), the industry in its present form has existed less than 20 years, with most of its growth in the last ten[19] (Taibi, 1994, p.1526). CDFIs include a broad variety of locally-based financial intermediary organizations, including community development loan funds, community development credit unions, community development banks, and microenterprise loan funds, all of which are primarily devoted to developing the community in which they operate (Santiago, 1998, pp.602-609; Taibi, 1994,

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[19] As of Fall 1998, there were over 350 established CDFIs in 50 states that had loaned $3.5 billion in distressed communities "with a collective loan-loss rate comparable to the best banks." David Daniel, "CDFIs Unmasked," *The Neighborhood Works* 21(4):11-12 (July/August 1998).

p.1521). A CDFI may make loans and investments that are considered risky or unbankable by conventional industry standards; serve borrowers, investees, and customers not serviced by mainstream financial institutions; or link financing to other development activities (Santiago et al., 1998, pp.596-602). In particular, by locating in the community it seeks to develop and undertaking coordinated, comprehensive action, a CDFI can develop specialized market expertise and the critical mass of investment and activity necessary to shift residents' and investors' perceptions (Lento, 1994).

CDFIs receive their operating support and lending capital from a variety of sources, including sale of stock (for-profits only), deposits by members, loans from banks, and grants.[20] The CRA has been an important vehicle for facilitating the growth of these institutions by providing a source of private capital (Parzen and Kieschnick, 1992). CDFIs, in turn, have been an important source of expertise to traditional financial institutions in discovering and reaching underserved segments of the community. As Immergluck (1998, p.1) notes, "Each side brings resources to this partnership. CDFIs bring knowledge of local and distressed markets, expertise in community development finance, and philanthropic and government resources to bear on the problems faced by economically distressed communities and individuals. Banks bring the resources of scale, as well as the ability to tap secondary markets and a broader network of financial services."

Under the revised regulations, CDFIs present a source of CRA credit to financial institutions either for investments used to capitalize a CDFI, or for the financial institution's pro rata share of loans made by the CDFI, or both. An investment vehicle devised to accommodate bank and thrift investments in CDFIs is the "equity equivalent," or EQ2, investment created in 1997 by the National Community Capital Association (NCCA) in collaboration with Citibank. As not-for-profit institutions, CDFIs generally cannot raise equity by issuing stock, and so have relied upon capital grants from philanthropic sources. With the impetus of the revised CRA regulations' recognition of CRA credit for investments, the EQ2 was created to provide CDFIs an alternative source of capital and financial institutions a vehicle for CRA investment test credit (Lehr, 1997, pp.1-2). In the first EQ2 transaction, Citibank made a $1 million investment to capitalize NCCA's Central Fund, which would then garner further investments and grants to make loans to NCCA's CDFI members. The CDFIs, in turn, would use the funds to support community development programs.

The EQ2 is a hybrid instrument with sufficient equity-like attributes to be treated as an investment for CRA and other regulatory purposes. The EQ2 is heavily subordinated and so behaves like permanent capital, increasing NCCA's debt capacity by protecting senior lenders from losses. At the same time, the investment is unlike permanent capital in that it must eventually be repaid and requires interest payments during its term, although at rates well below market. Given the particular attributes of the instrument, the OCC ruled that the EQ2 investment could be considered for CRA credit under the investment test; or alternatively, Citibank could have its EQ2 investment considered under the lending test, claiming credit for its pro rata share of community development loans originated by NCCA (OCC, 1996, p.3). Under some circumstances, partial credit could be claimed under both the investment and lending tests.

2. *Secondary Market Vehicles: CRA-Targeted Mortgage-Backed Securities and a Real Estate Investment Trust for Community Development Loans*

Development of a flourishing secondary market in CRA securities has been seen as an important tool for increasing the affordable lending capacity of financial institutions and the available funds for community and economic development by permitting banks to recycle CRA capital. By selling CRA assets, depository institutions free up part of their balance sheets for more lending. However, because of the lower downpayments, flexible underwriting standards, and lack of mortgage insurance on typical "CRA loans," they traditionally have not been saleable in the mainstream secondary market.[21]

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[20] CDFIs received Federal recognition and support with passage of the Community Development Banking and Financial Institutions Act of 1994, Pub. L. No. 103-324, tit. I, 108 Stat. 2160, codified at 12 U.S.C. §§ 4701-4718, which created a $382 million CDFI Fund to provide financial support in the form of loans, investments, grants, and deposits, which must be matched dollar for dollar with non-governmental sources (Marsico, 1995, pp.307-308).

[21] The "government-sponsored enterprises" (GSEs) that dominate secondary market activity are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Government National Mortgage Association (Ginnie Mae). Fannie Mae and Freddie Mac mainly buy conventional mortgage loans that are packaged into securities and then sold to investors. Ginnie Mae does not purchase loans, but rather guarantees the timely payment of principal and interest for privately issued securities backed by FHA-insured

However, the literature reflects the mainstream secondary mortgage market becoming increasingly responsive to low-income housing and community development needs in recent years, driven in part by the impetus of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which required HUD to set annual affordable loan-purchase targets for Fannie Mae and Freddie Mac; but also by demand for products that can satisfy the investment test compliance criteria.[22] Thus, secondary market products, such as mortgage-backed securities and other instruments backed by affordable housing and community development loans, that provide a source of investment test credit at the same time promote the liquidity of the secondary market for the CRA loans that underlie the instruments. Thus, the revised CRA regulations are helping to foster increased secondary market activity by supporting both sides of the secondary market equation.

There are several examples of recent secondary market programs for affordable housing loans. In October, 1997, First Union Corporation completed a securitization involving $384 million in mortgage loans originated through First Union's CRA program and guaranteed by Freddie Mac. Bear, Stearns arranged the private placement of the securities primarily with financial institutions seeking qualified investment credit under the revised CRA regulations (Mahoney, 1998, p.265). Likewise, Fannie Mae has developed mortgage-backed securities backed up to 100 percent by mortgage loans to borrowers with incomes below 80 percent of the area median income, with geographic distribution custom-designed to meet the CRA assessment area of each investor (Fannie Mae, Investment Tools, 1999). Described as CRA-Targeted Mortgage-Backed Securities, Fannie Mae developed the product in order to help CRA originators as well as institutions seeking to purchase CRA-qualified investments. Finally, Self-Help, a North Carolina CDFI that initiated a secondary market program in 1994 for purchasing affordable home mortgage loans from lenders in North Carolina, expanded its program nationwide in 1998 with the help of a $50 million grant from the Ford Foundation to be used for credit enhancement and a commitment from Fannie Mae to purchase and/or securitize $2 billion of loans, including loans that do not meet traditional underwriting standards (Havemann, 1998; Self-Help, no date). The program was launched with participating lenders that included Bank of America, Bank One, Chase Manhattan Bank, First Union, and Norwest.

It has been more difficult to establish a high-volume, fully-functioning secondary market for community development loans, which include multi-family affordable housing and economic development (Kenny and Altman, 1997). However, various efforts by national nonprofit organizations since the late 1980s have built the beginnings of a secondary market for community development loans, as well. Again, with the assistance of philanthropic organizations like the Ford Foundation, these organizations act as a bridge between community development lenders and institutional investors, offering flexibility to accommodate unconventional products (Kenny and Altman, 1997). For example, the Community Reinvestment Fund (CRF), a non-profit founded in 1988, purchases and bundles loans from community development organizations and uses them as collateral to issue bonds that are sold to private investors.[23] As of 1999, CRF had purchased more than 670 loans, providing more than $24.5 million in new, private capital to development organizations in nine states and Washington, D.C.

Another recently developed secondary market vehicle for multifamily and other nonconforming mortgages is a real estate investment trust (REIT) that specializes in acquiring debt and equity in affordable housing and community development projects that satisfy CRA criteria. Launched by the Local Initiatives Support Corporation (LISC), a nonprofit supporter of community development initiatives, Community Development Trust (CDT) closed a $29 million private placement of common stock in June, 1999, with investments from Fannie Mae and 16 leading financial institutions and insurance companies (Local Initiatives Support Corporation, 1999). A REIT operates much like a mutual fund for real estate in that multiple investors obtain the benefit of a diversified portfolio. The participating institutions are eligible for CRA credit for their investments as long as they hold their CDT stock. The REIT's debt acquisitions focus on multifamily mortgages, primarily those nonconforming to other secondary markets because of small size, location (inner city or rural), configuration (scattered site, urban rehabs) or type (assisted

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and VA-guaranteed loans. Banks, thrifts, insurance companies, and other entities are also secondary market participants. The GSEs each impose strict underwriting guidelines for loans eligible for purchase, such as maximum loan-to-value and monthly debt-to-income ratios, as well as loan-size limitations, which vary somewhat among the secondary market entities. (Canner and Passmore, 1994, pp.99-100.)

[22] This is reflected, for example, in various Fannie Mae initiatives, including its CRA- targeted mortgage-backed securities program, commitments to invest at least $75 million in CDFIs through the end of the decade, its Housing Impact Fund to support innovative development or financing opportunities for lower-income rental or ownership housing, and its "trillion dollar commitment" low-income housing goal. Fannie Mae, "Investment Tools," www.fanniemae.com/neighborhoods/investment/investment_tools.html.

[23] Community Reinvestment Fund, "About CRF and Our Services," www.crfusa.com/about/aboutcrf.html. CRF also provides loan servicing and other portfolio management services to its loan sellers and some other clients.

living), with the goal of providing liquidity to banks, CDFIs, loan consortia, and state and local housing finance agencies. The REIT's equity investments include HUD Section 8 and other affordable housing properties. CDT planned to hold these properties and continue to operate them as affordable housing, rather than converting them to middle-income or luxury housing as other REITs have done.

Noting the promising early use of secondary market vehicles such as First Union's transaction, Mahoney (1998) suggests development of a "primary purpose of community development" safe harbor and other interpretive refinements to the CRA regulations to facilitate greater certainty and ease of administration for institutions and thereby development of a more liquid and active secondary market and increased lending to low-income neighborhoods. For example, under Mahoney's safe harbor proposal, depository institutions would receive 100 percent CRA credit for investments backed by pools comprised of 80 percent qualifying loans. This approach would (i) permit leavening of loan pools with a mix of geographically and demographically diverse loans; (ii) facilitate valuation of the securities and thereby increased liquidity and demand; (iii) permit lenders and issuers to commit to delivery of securities meeting fixed criteria on specific dates; (iv) reduce the information costs for financial institutions by avoiding having to gather loan-level data for CRA examination purposes.

3. Loan Consortia: Spreading Credit Risk and Sharing Transaction Costs

The broader recognition of CRA credit for third-party intermediary lending and qualified investments in the revised regulations has provided greater scope for lenders to pool their resources in various multi-bank lending arrangements such as loan consortia (Avery et al., 1997, p.1). Loan consortia generally consist of institutions that pool lending money or collect equity stakes for low- and moderate-income housing and community development.

These institutional lending arrangements have been used increasingly use in recent years because they appear to offer an effective means to address transaction cost and credit risk concerns related to community lending (GAO, 1995, p.73). Credit risk concerns focus on the perception or reality that lending to low- and moderate-income borrowers entails higher risk of financial loss due to borrower default. Higher transaction costs than for other commercial or consumer lending may be attributable to the additional time and effort necessary to ascertain the creditworthiness of the borrower or the related property in low- or moderate-income areas.

Thus, the literature suggests that these multi-bank lending arrangements can reduce the costs of lending through the pooling of resources and economies of scale. Avery et al. (1997) find that in many low- and moderate-income neighborhoods, demand is too low to allow more than a handful of lenders to learn enough about the area to operate profitably. As a result, encouraging all lenders to be active in all neighborhoods may increase the costs of lending in neighborhoods with thin loan demand. By establishing institutional arrangements such as community development banks or loan consortia, lenders can pool their resources and specialize in collecting and analyzing local market data, and thereby stand a better chance of generating economies of scale than they would through direct financing. Likewise, Mendez (1998) suggests that by assuming the role of subcontractor to their bank investors, consortia can provide community development expertise and capacity that small- and mid-sized financial institutions often cannot afford; and provide large financial institutions with an effective way to reach underserved populations through products and services that might be initially unprofitable if performed internally.

Multi-bank lending arrangements can also ameliorate the credit risk that institutions normally associate with low-income lending. By sharing risk among a number of institutions, individual institutions can avoid concentration of credit risk in a particular project or in a limited geographic area (GAO, 1995, p.73). Further, Calem and Wachter (1998) suggest that collaborative community reinvestment efforts focused on targeted neighborhoods may mitigate credit risk by increasing lending activity in those neighborhoods, based on the results of their empirical study of an affordable home loan program in Philadelphia that found that the likelihood of loan delinquency declines with increased levels of neighborhood housing market activity.

Mendez (1998) charts how each of the CRA compliance tests accommodates bank involvement in various types of multi-bank lending. He points out that the revised regulations recognize both loans to a consortium and loans made through a consortium, through either participation or purchase, as community development loans.

D. Impact on Homeownership Rates and Lending Activity

Attempts to quantify the impact of regulatory reform on lending suggest that the CRA amendments have had a discernible effect. LaCour-Little (1998) examined a geographically diversified portfolio of $374 million of first mortgage loans originated by a single lender following the Clinton administration's reform of CRA regulations (from 1993-1996 and observed through year-end 1997). During the review period, the lender substituted judgmental underwriting standards for automated credit scoring methods for loans in low-to-moderate income census tracts or loans to low-to-moderate income borrowers. LaCour-Little found that approximately half of the total loan volume, or $187 million, reached borrowers who would not have qualified for credit under the credit scoring rule.

Analyzing homeownership data between 1977 and 1997, Segal and Sullivan (1998) found a drop of three percent in the gap between black and white homeownership rates between 1995 and 1997. Finding that very little of the drop reflected changes in demographic and income factors, they attribute the change to the recent CRA amendments and their more vigorous enforcement.

Shlay (1999) found that home purchase mortgage lending to low- and moderate-income and minority borrowers and low- and moderate-income neighborhoods increased at a rate that exceeded changes in overall lending between 1990 and 1995 in the six cities studied. Shlay concludes that these changes in lending patterns can be explained by a combination of favorable market conditions and a CRA-minded political climate created by the coalescence of local organizing and the Clinton administration's attention to regulatory reform and strengthened CRA enforcement, which together have influenced lender decisionmaking by causing lenders to reach out to under-explored communities to which CRA has pointed the way.

III. CRA COMMITMENTS

What has been the nature and scope of CRA commitments adopted by major depository institutions? To what extent do the CRA commitments follow a common pattern? Do some commitments emphasize certain kinds of lending over others? How spatially targeted are the commitments?

The term "CRA commitments" denotes a banking institution's promises to provide particular types of credit, capital, or services to low-income and minority households and neighborhoods, generally made in anticipation of a merger or other transaction that will trigger CRA review. The term is used to refer both to agreements negotiated between community groups and/or state or local governments and depository institutions, as well as to publicly-announced, unilateral community reinvestment plans such as those undertaken by NationsBank (10-year, $350 billion) and CitiGroup (10-year, $115 billion) in 1998. The only source of systematic information on CRA commitments adopted by depository institutions is the National Community Reinvestment Coalition (NCRC), the trade association of more than 690 community reinvestment organizations. NCRC keeps and publishes an ongoing tally of CRA commitments nationwide, maintains copies of most negotiated agreements, and has compiled an overview of the types of programs and products that have been addressed. According to NCRC, banks and community organizations have entered into 360 agreements representing commitments for over $1 trillion in loans, investments and services to minority and low-income households and neighborhoods since passage of the law in 1977, with 99 percent of the total being committed since 1992.

This dramatic increase in commitments in the last seven years has been attributed to various factors, including enhanced HMDA data and CRA disclosures for assessing bank performance; the increased sophistication of community organizations in assessing community needs and entering into partnerships with banks; the proliferation of mergers and acquisitions that create the occasion for CRA challenges that result in negotiated agreements or for banks to launch voluntary reinvestment programs; and the structural evolution of the banking industry that has created the context for commitments that are regional or national in scope (NCRC, 1998; Schwartz, 1998). For the most part, these commitments have been touted as a sign of the tremendous progress of the CRA in encouraging banks to focus on the credit and capital needs of lower-income borrowers and neighborhoods. On the other hand, some community reinvestment advocates have been skeptical of the extent to which unilateral, multimillion dollar packages are tailored to truly meet credit needs in disadvantaged areas.

For example, of the $115 billion commitment made by CitiGroup, $60 billion was for consumer loans, including a large but unspecified portion of which would be credit cards, which historically have been problematic in low-income communities."[24]

No regulatory mechanism monitors CRA commitments to determine the extent to which institutions deliver on their promises. In the earlier days of the statute, banks with inadequate CRA records often received approval on a pending application nonetheless, based on commitments for future performance. However, in 1986 the regulators announced that commitments for future action would not be taken into account. Thus, for example, in denying its first application on CRA grounds in 1989, the Federal Reserve Board ruled that the bank's commitments and plans to improve its CRA performance could not "serve as a substitute for the established record of CRA performance required by the statute."[25] Based on this regulatory stance, the agencies have taken no role in monitoring bank commitments, and correspondingly, will not adjust downward an institution's CRA rating based on its failure to keep its commitments.[26] However, negotiated agreements usually include their own mechanisms for

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[24] Timothy L. O'Brien, "For Banks, A Big Nudge to Do More: Communities Fear Lending Drop-Off." *New York Times*, July 5, 1998, p.1.

[25] Continental Bank Corp., *Federal Reserve Bulletin* 75:304, 305 (1989). In the place of approvals combined with commitments for future action, regulators frequently use the mechanism of conditional approvals.

[26] CRA Final Rule, *Federal Register* 60:22,156, 22,165. In adopting the final revised CRA regulation, the banking agencies rejected the suggestion to consider as part of the lending test the extent to which an institution has fulfilled lending agreements made with third parties, stating that "the CRA requires the agencies to assess an institution's record of helping to meet the credit needs of its community, not to enforce privately negotiated agreements. Therefore, an institution's record of fulfilling these types of agreements is not an appropriate CRA performance criterion." In September, 1998, the Office of the Comptroller of the Currency signaled its concern over this monitoring issue by publishing a notice of its intent to conduct a survey of national banks that have publicly announced commitments to undertake lending, investment, or other activities pertaining to their obligations under the CRA. The notice sought public comment on proposed survey questions designed to determine the adequacy of the systems and procedures banks are using to track their progress in achieving their announced goals. No further action has been taken on this survey to date.

monitoring the implementation of commitments, such as review boards, regular meetings between community groups and lenders, disclosure of lending records, and use of mystery shoppers (NCRC, 1998, pp.41-42; Schwartz, 1998b).

This section reviews the nature and scope of CRA commitments, as well as several articles that examine the outcomes of CRA agreements. At their best, it appears that commitments, particularly those represented by negotiated agreements, can play a role in fostering communication and collaboration between financial institutions and community-based organizations, serving as a tool through which lenders discover new and profitable markets and make serving low-income and minority neighborhoods a regular part of their business (Schwartz, 1998b; Squires, 1992). With respect to the outcomes of CRA agreements, Schwartz (1998a) found that banks with agreements approved a higher proportion of conventional mortgages, particularly to low-income and minority households and census tracts, than banks without agreements; and that the market share of mortgage approvals for minority and low-income households and census tracts of banks with agreements significantly exceeded their overall market share of mortgage approvals within the state or metropolitan area. Shlay (1999) found in general that increased lending to low-income and minority households and neighborhoods was not limited to financial institutions with CRA agreements, but that larger increases were associated with institutions with CRA agreements.

A. Nature and Scope of Commitments

CRA commitments have evolved into sophisticated, multi-year programs that reflect a multi-faceted approach to addressing the obstacles that can impede access to credit and capital for low-income and minority households and neighborhoods. Often they rely upon some collaborative effort between the bank and the local community in implementing the agreement, such as community involvement with marketing, financial counseling, or other services designed to facilitate the development or success of CRA-related products and services. While commitments generally do target minority or low-income borrower populations or neighborhoods, they do not appear to be spatially targeted. This may reflect the fact that the relevant geographic focus for purposes of CRA review is the depository institution's assessment area surrounding its main office, branch, and ATM locations, wherever that falls along the city/suburb line.

NCRC has categorized the types of CRA commitments into seven broad subject areas, providing a useful survey of the nature and scope of CRA commitments, which is summarized below (NCRC, 1998a, pp.13-42). These subject areas are housing; business and economic development; consumer loans; farm loans; building community capacity; banking services and branch and staff policies; needs assessment, marketing, and outreach and accountability to the community.

1. Housing

Most CRA agreements include specific dollar or volume targets for residential lending, and usually specify a particular type of housing. Commitments for single-family housing loans are the most common, but commitments also have included multifamily housing, funding for nonprofit and minority housing developers, housing cooperatives, land trusts, mobile homes/manufactured housing, and mixed use real estate.

In addition to lending targets, agreements frequently include commitments to provide specified loan terms and conditions and underwriting standards in connection with residential lending to the targeted populations. These loan terms and conditions often include below-market interest rates, lower minimum mortgage size requirements, waiver or reduction of closing costs and points, lower downpayment requirements (often referred to as loan-to-value (LTV) ratios), and waiver of mortgage insurance requirement. These latter two provisions are often used in conjunction because mortgage insurance is generally required when a borrower's downpayment is less than 20 percent, but is believed to be difficult for low-income and minority borrowers to obtain. Less common terms include allowance of sweat equity, loans to nonprofits on a nonrecourse basis, and greater forbearance on distressed properties.

Commitments related to underwriting standards often include a flexible approach to credit history, such as a second review of all applications from minorities and low- and moderate-income applicants and efforts to lend to applicants with marginal credit scores, and referrals of denied applicants to homeownership counseling programs. These types of commitments also often

include a flexible approach to employment history that focuses on steady income rather than continuous employment in a single job, consideration of broader sources of income in evaluating creditworthiness, and use of higher ratios of acceptable housing expense-to-income and income-to-debt.

Another common subject of housing-related commitments is participation in federal, state, or local government loan programs that encourage creation of affordable housing by providing insurance and/or subsidies to private lenders. Such commitments have included offering FHA-insured and VA-guaranteed insured mortgage loans at less than market rate interest, participation in Federal Home Loan Bank Affordable Housing and Community Investment Programs, purchase of state housing finance agency bonds used to finance affordable housing projects, investments in low-income housing projects eligible for federal low-income housing tax credits, and investments in loan pools or consortia that provide funding for affordable housing and/or community reinvestment projects.

Other types of commitments include support of loan counseling programs, "second look" programs to ensure that denials of applications are not due to discrimination, hiring of outside discrimination testers, and notification or offer of foreclosed properties to nonprofits.

2. Business and Economic Development

As with housing, many CRA agreements include specific dollar and volume target commitments for small business, minority and women-owned businesses, micro-businesses, and economic development project lending. Other frequent commitments in this area include agreements to participate in governmental loan programs that encourage economic development by providing insurance and/or subsidies to private lenders, such as SBA loan programs; and agreements to create or participate in public or private loan pools and consortia that spread the risk and reduce transaction costs of small business lending, such as an equity investment to capitalize a pilot micro-lending program focused on start-up and non-bankable businesses. Other commitments aimed at support for business include loan review programs, provision of counseling and technical assistance to small businesses, and use of minority business vendors for bank contracts.

3. Consumer Loans

Examples of commitments in the area of consumer loans are use of flexible underwriting criteria to qualify low- and moderate- applicants without traditional credit histories; and dollar amount targets for second mortgages and home equity loans to be used for any purpose.

4. Farm Loans

According to NCRC, only a few CRA agreements have focused on rural credit needs. Examples of these commitments include a dollar amount target for loans to small farms located in low- and moderate-income areas, and agreements to restructure debt for farmers where it would be cheaper than foreclosure or forced liquidation.

5. Building Community Capacity

Many agreements include commitments to support alternatives to mainstream financial institutions such as community development credit unions or community development loan funds, or to provide loans or lines of credit to community development corporations engaged in community development activities such as housing development, business financing, day care centers, and job training and placement activities. Many agreements also include commitments for grants to community reinvestment organizations.

6. Banking Services, Branch, and Staff Policies

CRA agreements frequently include commitments to offer basic banking services at low cost, such as lifeline checking accounts that have low or no fees or minimum balances. Other commitments include establishment of Individual Development Accounts (IDAs) or cashing of government checks for customers and noncustomers at no charge.

With respect to branch policies, commitments have included keeping existing branch offices open, improving bank services at branches located in or near low-income neighborhoods, or opening new branches. CRA agreements have also been used to increase bank hiring of low-income, minority, and bilingual staff, require training of bank staff on credit needs of low-income and minority communities, and require female or minority board representation.

7. Needs Assessment, Marketing and Outreach, and Accountability to the Community

This last category of commitments frequently found in CRA agreements includes commitments to conduct needs assessment of the community to ascertain appropriate loan products and services; commitments to increase marketing and outreach efforts to encourage low-income and minority individuals to apply for loans, including advertising, call programs to brokers and realtors and small and minority businesses, seminars and trainings to explain bank credit programs and application procedures, marketing through community organizations, creation of a CRA liaison position to work with community groups, or creation of a special community outreach unit. Finally, to ensure that commitments are met, agreements usually include provisions establishing review boards, regular meetings between community groups and lenders, and disclosure of lending records.

B. Outcomes of CRA Agreements

While there is no formal mechanism for monitoring CRA commitments, negotiated agreements normally include mechanisms for implementing and monitoring their progress.[27] Additionally, recent articles have assessed the extent to which CRA agreements attain their goals, and have assessed the impact of CRA agreements by comparing lending to low- and moderate-income households and neighborhoods by depository institutions with and without CRA agreements.

Schwartz (1998b) compares the implementation of four particular negotiated agreements – in Chicago, Cleveland, Pittsburgh, and New Jersey – in order to assess the extent to which lenders attain the goals established in the agreements. Because no objective indicators are available by which to evaluate outcomes of most of the commitments included in reinvestment agreements, Schwartz’s research is based on interviews with agreement participants. Schwartz found that some types of commitments are more consistently met than others. He found that lenders are generally most successful in meeting their targets for single-family home mortgages, and also consistently meet their goals for investments in low-income tax credits and for grants and loans to community organizations. Also, Schwartz found that banks with agreements tend not to have the reductions in branch operations that have occurred generally in the industry; overall, these banks have kept existing branches open and in some cases opened new ones. Schwartz found results more uneven for construction loans, permanent financing for new housing development, and business loans, possibly because these types of lending are less structured and standardized than single-family mortgages, and thus a bank may be less accountable for its decision to reject particular applications. Commitments aimed at influencing bank hiring and procurement processes have also proved to be less successful. Shlay (1999) found that another key variable in the success of particular agreements was the extent to which top level bank management was involved in implementation of the agreement, and the working relationship between the bank and the community-based organization that negotiated the agreement (pp.34-35).

Schwartz (1998a) and Shlay (1999) also attempt to assess the impact of CRA commitments by comparing home purchase mortgage lending by financial institutions with and without agreements. Schwartz compared mortgage and home improvement lending in 1994 for all banks in states and metropolitan areas with one or more CRA agreements and found several salient results.

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[27] A sample, non-exhaustive bibliography of assessments of lender performance under particular community reinvestment agreements is included at the end of this section.

First, looking at the entire sample of mortgage lenders, Schwartz found that banks with agreements are significantly larger than those without agreements in terms of the number of mortgage applications and approvals involving each market segment; and that banks with agreements approved a higher proportion of conventional mortgages across all market segments, although the differences were sharpest with respect to low-income and minority households and census tracts. Nearly three-quarters of the mortgage loans approved for black households by banks with agreements were conventional, as compared to less than 60 percent of those approved by other banks. Among white applicants, conventional mortgages accounted for 84 percent of the agreement-banks' approvals, and 78 percent of the non-agreement banks' approvals. Second, Schwartz (1998a) found that banks with agreements had significantly higher rates of approvals of mortgage loans to black borrowers, with an average share nearly 20 percent higher than their share of total approvals, while the average share of approvals of mortgage loans to black borrowers by non-agreement banks was 14 percent less than their share of total approvals (p.285).

Schwartz found that for banks with agreements, their market share of mortgage approvals for low-income and minority households and census tracts exceeded their overall market share within that state or MSA by 12 percent. In contrast, for banks without agreements, low-income and minority households and neighborhoods represented 18 percent less than their market share of total mortgage approvals. With respect to denial rates, Schwartz found that banks with agreements denied mortgages to African-American applicants 2.5 times more often than to whites, whereas other banks denied mortgages to African-American applicants 3.13 times more often. Schwartz found few significant differences in market share based on differences in agreements such as voluntary or negotiated status, age, geographic coverage, or the number of additional agreements signed by the same community group.

Shlay (1999) assesses the impact of CRA agreements by comparing the relative market shares of home purchase mortgage loans to low- and moderate-income and minority households and neighborhoods between 1990 and 1995 of lenders with CRA agreements and those without in three cities. Shlay found that in general, lenders with CRA agreements showed larger changes in the direction of more CRA-oriented lending and along more indicators than lenders without CRA agreements during the six-year study period (p.33). Nonetheless, Shlay found that lenders without agreements also showed increased lending to low- and moderate-income and minority individuals and neighborhoods during the study period, and did not exhibit the "patterns of redlining and racial avoidance that characterized lending activities during the 1980s" (p.33).

Shlay also undertook to compare changes in bank and thrift conventional home purchase lending between 1990 and 1995 in three cities with at least three negotiated CRA agreements in effect (as signifying a high level of CRA organizing) and three control cities without at least three negotiated CRA agreements in effect (as signifying low levels of CRA organizing). Shlay found that increases in lending to low- and moderate-income and minority individuals and neighborhoods exceeded increases in overall lending in all six cities during the study period, with no apparent correlation with whether it was a high- or low-CRA organizing city. Shlay suggests that the changes in lending patterns found in the research can be explained by a combination of favorable market conditions and the influence of a CRA-minded political climate on lender decisionmaking, created by the coalescence of local organizing and the Clinton administration's attention to strengthening CRA. Shlay posits that with an expanding economy and more capital for investment, lenders have reached out to the underserved markets that inner-city communities represent and to which the CRA has pointed the way. Thus, rather than altering market forces, Shlay concludes that the CRA may be helping the market to work better by providing incentives for lenders to discover and develop products for underserved markets and by reducing class and racial bias in the lending decision.

IV. Impact of Bank Mergers and Acquisitions on Lending

To what extent has the rise of mergers and acquisitions in the banking industry affected lending patterns in communities that no longer have locally-owned banks?

The banking industry has undergone considerable consolidation in the last 25 years. Between 1975 and 1997, the number of commercial banks and savings associations in the United States dropped by more than 40 percent, from 18,679 institutions in 1975 to 11,077 in 1997 (Avery et al., 1999a, p.83). Between 1993 and 1997 alone, 21 percent of all institutions were acquired in a merger or acquisition, and the total number of institutions dropped by 18 percent. Much of this consolidation has involved mergers and acquisitions among institutions that had been operating in different local markets, resulting in a drop in the number of independent, locally-owned institutions. By mid-1998, more than one-quarter of banking institution assets were owned by banking organizations with headquarters in another state (Avery et al., 1999a, p.83; Keeton, 1997).

The impact of this loss of many independent, locally-owned institutions on lending to lower-income and minority borrowers and neighborhoods has been of especial concern for several reasons. First, successful lower-income residential lending programs often rely upon techniques and procedures that require local presence and flexible decisionmaking. 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 of local neighborhoods, and economic conditions and credit risk factors specific to the local community. Likewise, these programs may be sponsored by local public agencies or community organizations (Avery et al., 1999a, p.84). The transfer of bank ownership outside of the local community often means the transfer of the locus of decisionmaking outside the local community as well, potentially defeating many of these procedures that can make lending to lower-income and minority populations viable. Second, recent research documents the importance of the relationship between lenders and small business customers in determining the terms and availability of credit (Board of Governors, 1997, p.vi). Due to the greater complexity of business lending as compared to mortgage lending, commercial loan officers have traditionally utilized their local presence to market their products and to gather information for making lending decisions, reducing the cost of providing credit while providing borrowers with better access to credit and potentially lower borrowing costs (Cole, 1998; Immergluck and Mullen, 1998; Strahan and Weston, 1996, p.1). The merger of local institutions into larger and distant organizations may impact these lending relationships, and consequently the availability or pricing of small business loans. A third, related concern is that consolidations may result in branch closings, and that the loss of lending personnel familiar with the needs of the local community, and the disruption of working relationships with individual loan officers will result in decreased credit availability, as well as the loss of the branch's anchoring presence in the community. On the other hand, some argue that consolidations should result in increased credit availability for small businesses and low-income communities as a result of the increased efficiency, safety, and liquidity that banks enjoy from belonging to larger and more diversified organizations (Keeton, 1997, p.1).

This section examines empirical studies of the impact of banking industry consolidation on changes in low-income residential and small business lending, as well as on changes in the distribution of banking offices. In general, the research reveals the following. First, research indicates that the number of banking offices in low-income communities declined substantially between 1975-1995, while the number of banking offices overall increased by one-third during the same period, although the population of low-income communities also declined during the period; and that mergers of banking organizations with offices in the same ZIP code area prior to the merger resulted in declines in the number of banking offices, and that these declines were significantly greater in low-income neighborhoods in urban areas than in non-low-income neighborhoods in urban areas between 1985-1995. However, mergers between a local institution and an institution with no offices in the local area showed no consistent significant correlation with changes in bank branching (Avery et al., 1999b). With respect to residential lending, research found that the number of home purchase mortgage loans made by banking organizations involved in consolidations consistently declined substantially in counties in which the acquired banking organization operated banking offices, both overall and across low- and moderate-income borrower and neighborhood categories, with acquisitions of banking offices by out-of-MSA banking organizations being associated with the most dramatic declines in lending (Avery et al., 1999a). At the same time, overall lending by these organizations did not decline during the period, leading the researchers to conclude that the decline in local lending represented a trend toward geographic diversification. However, Avery et al. (1999a) also found that the proportion of the

portfolio of the typical consolidating organization devoted to loans to lower-income and minority borrowers and neighborhoods in counties in which they had banking offices *increased* during the study period, and by larger numbers than changes among banking organizations not involved in combinations, suggesting that the CRA merger enforcement scheme may be having an effect. With respect to small business lending, the research reveals divergent results for mergers as opposed to acquisitions. Mergers resulted in a significant decrease in the proportion of small business loans made by participating institutions, across a variety of types of transactions and sizes of banking organizations. Acquisitions of equals and out-of-state-acquisitions tended to increase small business lending, while acquisitions of unequals and in-state acquisitions reduced small business lending; and depository institutions involved in acquisitions increased the proportion of loans in the largest loan size category. The research found that mergers and acquisitions both resulted in statistically significant increases in small business lending by other banks in their local market that essentially offset declines in lending at an institutional level by three years after the consolidation (Berger et al., 1998).

A. Distribution of Banking Offices

One of the concerns raised by the increasing consolidation of the banking industry is that the process of organizational restructuring may be resulting in the closing of banking offices, particularly in lower-income neighborhoods, affecting the availability of credit as well as banking services in these communities. While some commentators suggest that the number of banking offices may not be a reasonable proxy for the availability of banking services (Osterberg and Sterk, 1997), and that research directly measuring the quality, quantity, and pricing of banking services is necessary to clarify the impact of consolidation on the availability of banking services (Avery et al., 1999b, pp.531-32), others have found evidence that the proximity of an institution's branch networks to low- or moderate-income neighborhoods is related to the proportion of the institution's loans made in those neighborhoods (Immergluck and Mullen, 1998; Squires and O'Connor, 1999; Goldwater and Bush, 1996). In addition, community reinvestment advocates emphasize the economic and psychological significance of a local banking office to a community, since the local branch is typically the anchor business tenant, the most stable of all businesses, which not only attracts other businesses but supplies them with customers and financial resources with which to operate (NCCA, 1997, p.35).

In looking at changes in the distribution of banking offices between 1975 and 1995, Avery et al. (1997) found, contrary to expectations, that the total number of banking offices increased during this period by nearly 29 percent (38 percent increase in number of commercial bank offices, and 5 percent increase in the number of savings association offices). This change represented an increase of 38 percent in the number of banking offices in the first decade of the study period from 58,911 to 81,161 (with the number of savings association offices increasing 63 percent and the number of commercial bank offices increasing 29 percent), while the total number of institutions fell slightly. This increase was followed by a decline of about 6 percent in the number of banking offices in the second decade (to 76,056), while the number of banking institutions declined nearly 32 percent (Avery et al., 1997, pp.708-709). The six percent decline between 1985 and 1995 represented divergent trends, with the number of savings association offices dropping by about 36 percent, and the number of commercial bank offices continuing to increase, although at a much slower pace than the previous ten years, by about 7 percent.

Despite this overall increase, the Federal Reserve found that the number of banking offices in low-income neighborhoods declined during the 20-year study period by 21 percent (from 2,164 offices to 1,719 offices), and that the number of offices *per capita* in low-income areas declined by 6.4 percent (Avery et al., 1997, p. 719-29).[28] Between 1985-1995, the number of banking offices declined in all neighborhoods except those in the high-income category, with the reduction in the number of banking offices in low- and moderate-income areas together between 1985 and 1995 representing nearly two-thirds of the total decline in offices during that period, which had about one-fifth of all banking offices in 1985 (Avery et al., 1997, p.720). Avery et al. (1997) also found, however, that low-income areas had the highest number of offices per capita in 1975, and that combined with population declines in these areas during the period, there was relatively little difference in the per capita number of offices among neighborhoods across income categories by 1995 (pp.720-21, Table 7).

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[28] Nearly all of the general decline in the number of banking offices in low-income areas was in areas with low rates of owner occupancy, which are generally taken to denote business areas, while the number of offices per capita increased slightly in low-income areas with higher rates of owner occupancy (Avery et al., 1999, p.722).

While the overall percentage of banking offices in metropolitan areas remained fairly constant between 1975 and 1995, suburban areas gained share and central cities lost share during the 20-year period. This change corresponded to shifts in the population, suggesting that population shifts into suburban areas were a strong catalyst for office expansion (Avery et al., 1997, p.715). Overall, the proportion of offices in central cities declined from 35.6 percent in 1985 to 33.6 percent in 1995, and the proportion of offices in suburban locations rose from 37.2 percent to 39.0 percent during the same period (Avery et al., 1997, p.709, Table 3).

Furthermore, between 1975 and 1995 the number of banking offices increased in all neighborhood income categories within suburban and rural areas, but increased only in high- and middle-income neighborhoods in central city areas (Avery et al., 1997, p.721). However, the same general trends of high growth in the number of banking offices from 1975 to 1985 followed by a contraction from 1985 to 1995 appeared in every geographic category, including suburban areas, where the number of offices declined between 1985 and 1995, although the suburban share of banking offices grew during that period (Avery et al., 1997, p.715). Among central city ZIP code areas, those with the lowest incomes had the most banking offices per capita in 1995 (3.46 banking offices per 10,000 residents), while among suburban ZIP code areas, those with the highest income had the most banking offices per capita (3.42 banking offices per 10,000 residents).

Avery et al. (1999b) subsequently examined the correlation between bank consolidations and changes in the number of bank branches in local markets. Avery et al. classified banking offices geographically by ZIP code area and analyzed consolidation and branching data during two ten-year time periods, 1975-1985 and 1985-1995, and with respect to three different types of mergers: within-ZIP mergers (both the acquiring and acquired institutions had offices in the ZIP code area), within-market-but-not-within-ZIP mergers (both the acquiring and acquired institutions had offices within the same county or MSA), and out-of-market mergers (the acquiring institution was located outside of the ZIP code's market at the time of the merger).

Avery et al. (1999b) found that only consolidations between banking institutions with overlapping branch networks in the same ZIP code area were consistently related to declines in the number of banking offices per capita in a ZIP code area; and that the higher the percentage of offices involved in a within-ZIP merger, the larger the expected reduction (p.514). The authors found that declines in the number of banking offices in connection with within-ZIP mergers were significantly greater in low-income neighborhoods than in non-low-income neighborhoods for the 1985-1995 period in urban areas. The number of banking offices per capita in low-income areas also showed greater declines in connection with within-market-but-not-within-ZIP-mergers during the same period in urban areas (p.523). Out-of-ZIP mergers showed no consistent significant correlation with changes in bank branching.

The authors qualified these results with the finding that these declines in branch offices in low-income neighborhoods occurred only in those states in which state laws were eased during the study period to permit statewide branching, and were closely tied to changes in the number of savings association offices. Avery et al. conclude that these findings of differential impact in low-income urban areas may not be indicative of future branching patterns because most states now have unrestricted branching and because savings associations are less prevalent and financially healthier than in the past.

The authors did not find any consistent significant correlation between changes in bank branching and neighborhoods with a high proportion of minority residents; although the few instances where there was a significant interaction between minority neighborhood status and mergers showed increases in bank branches (Avery et al., 1999b, p.523).

B. Residential Lending

The Federal Reserve has also examined the impact of consolidation of banking organizations on home purchase mortgage lending between 1993-1995 and 1995-1997, both overall and to lower-income and minority borrowers and neighborhoods (Avery et al., 1999a). In order to assess the impact of consolidation activity on residential credit availability in the local neighborhood in which a banking office was involved in a consolidation, the authors distinguish between changes in banking organization behavior in counties in which a depository institution component of the organization had banking offices before the

consolidation, and therefore had a CRA obligation in the county, and changes in their behavior in counties in which a depository institution component did not have a banking office prior to the consolidation.[29]

The authors considered a number of factors in their analysis. Avery et al. (1999a) used three-year study periods in order to allow time for the effects of a consolidation to influence home purchase lending, and used two study periods in order to compare and contrast observed relationships.[30] Further, in order to take into account the geographic proximity of acquiring and acquired organizations, the authors divide consolidations into three types: within-county consolidations (both acquiring and acquired components of the organizations operated offices within the county; within-MSA-not-in-county-consolidations (acquiring component operated an office in the MSA containing the county but not in the county); and out-of-MSA-consolidations (acquiring component did not operate offices in either the county or its MSA) (p.92). Finally, in order to account for differences in size of the organizations involved in a consolidation, the authors group consolidations according to asset size: a small organization (assets of less than $250 million acquiring another small organization; a medium-sized organization (assets between $250 million and $10 billion) acquiring a small organization; a medium-sized organization acquiring another medium-sized organization; a large organization (assets greater than $10 billion) acquiring a small organization; a large organization acquiring a medium-sized organization; and a large organization acquiring another large organization (Avery et al., 1999a, pp.93-94).

Avery et al. (1999a) found that the number of home purchase mortgage loans made by banking organizations involved in consolidations declined substantially in counties in which the acquired banking organization operated banking offices, both overall and across low- and moderate-income and minority borrower and neighborhood categories, and showed greater declines (or less growth) than lending by non-consolidating organizations[31] (p.95). Specifically, the number of loans extended by banking organizations in counties in which they had banking offices involved in consolidations declined about 14 percent during the 1993-1995 period, and by 14 percent again during the 1995-1997 period, while the number of loans extended in those counties by banking organizations that were not involved in consolidations increased 3 percent during both periods, and total lending by all mortgage lending organizations increased by 3 percent in 1993-1995 and 17 percent in 1995-1997. The number of home purchase loans to minority borrowers by banking organization-county combinations involved in consolidations increased by 12 percent in the 1993-1995 period, and then decreased by 11 percent in the 1995-1997 period, while home purchase loans to lower-income borrowers declined by 13 percent and then 6 percent over the two study periods. In contrast, lending to minority borrowers by banking organizations not involved in consolidation increased by 26 percent and then decreased by 2 percent in the 1995-1997 period, while lending to lower-income borrowers by these non-consolidating banking organizations declined by 2 percent over 1993-1995, and increased by 1 percent over 1995-1997.

All three geographic types of consolidations were associated with declines in lending both overall and to lower-income and minority borrowers during the study periods, although lending by banking organizations involved in within-county consolidations showed the least change. Home purchase mortgage loans by banking offices acquired by out-of-MSA banking organizations declined by 27 percent between 1993-1995, and 23 percent between 1995-1997. These overall declines included a 20 percent decrease in mortgage lending to minority borrowers, and an 18 percent decrease in mortgage lending to lower-income borrowers. Within-MSA-but-not-within-county mergers resulted in declines in home purchase lending to minority borrowers of 34 percent, and to lower-income borrowers of 20 percent. In contrast, home purchase mortgage lending by banking organizations involved in within-county consolidations decreased by 8 percent to minority borrowers, while lending to lower-income borrowers showed no change.

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[29] The authors note that many banking organizations do considerable lending in areas where they do not have banking offices, often through affiliated mortgage and finance companies. Loans made by banking organizations in counties in which they had banking offices accounted for only 38 percent of overall home purchase lending in 1993. (Avery et al., 1999, p.91).

[30] The authors selected 1993 as the initial year of analysis because HMDA data for that year and after would include the information on income and race or ethnic origin of borrowers that had been included in HMDA beginning in 1990; and because 1993 was the first year that HMDA data included the activity of most of the nation's most active independent home purchase mortgage loans in metropolitan areas (Avery et al., 1999, p.82 n.6).

[31] To count as a consolidation in a given county, the consolidation must have involved the acquisition of a banking institution operating banking offices in that county. Counties in which only the acquiring institution operated banking offices were not considered to have had consolidations (Avery et al., 1999, p.87).

The authors conclude that these declines in home purchase mortgage lending by consolidating organizations in areas where they operated banking offices were attributable to a trend toward geographic diversification of lending activity, and not to overall reductions in lending by the consolidating organizations. Avery et al. (1999a) found that overall home purchase lending by these organizations in fact grew 16 percent during the 1993-1995 period and 22 percent during the 1995-1997 period, with virtually all of the growth in counties in which the acquired banking organizations did not have banking offices at the beginning of the study period (p.96). For example, between 1993 and 1997, banking organizations increased their overall lending by 69 percent in areas where they did not have banking offices at the beginning of the period, but by only 8 percent in those counties where they did operate banking offices, with similar differences in growth rates for the four borrower and neighborhood lending categories (Avery et al., 1999a, p.91). The authors speculate that this diversification may have been fueled by acquisitions of large, previously independent mortgage banking organizations and an expansion of activity by previously affiliated mortgage and finance companies. Also, increased standardization in the home purchase mortgage market, facilitated by changes in the secondary market and the growing use of automated underwriting, may be reducing the need for local presence in originating home purchase mortgage loans.

Notwithstanding the overall declines in lending in local markets, the authors found that the typical consolidating organization increased the *proportion* of its portfolio devoted to loans to lower-income and minority borrowers and neighborhoods in counties in which it had banking offices; and that these increases were generally larger (or less negative) than changes among banking organizations not involved in combinations. For example, during the 1993-1995 period, the typical organization involved in consolidation increased its portfolio share of loans to minority borrowers by 31 percent, compared with 21 percent for the typical organization not involved in a consolidation (Avery et al., 1999a, p.97, Table 9). The consolidating organizations increased their portfolio share of lending to lower-income borrowers in the same period by 3 percent while the portfolio share of lower-income lending declined by 5 percent for organizations not involved in a consolidation. The authors conclude that these results are consistent with the view that the CRA has been effective in encouraging banking organizations, particularly those involved in consolidation, to serve lower-income and minority borrowers and neighborhoods in their local communities (Avery et al., 1999a, p.97). As the authors point out, however, a banking organization may have a growing portfolio share of lending to a given population, yet a shrinking presence overall in lending to that population in terms of absolute numbers of loans or market share (Avery et al., 1999a, p.93).

In contrast to their findings at the organization level, the authors found that the overall level of consolidation activity within a county had little effect on total home purchase lending or on lending to either lower-income or minority borrowers or neighborhoods within a county[32] (Avery et al., 1999a, p.89). Thus, the authors conclude that the overall reduction in lending in local markets at an institutional level was generally more than offset by expanded home purchase mortgage lending in geographic areas where banking organizations did not operate banking offices, by both the banking organizations and independent mortgage and finance companies and credit unions.

C. Small Business Lending

The traditional reliance of small businesses on local commercial banks for external finance has caused concern about the impact of the restructuring of the banking industry into larger organizations headquartered outside of local markets. Various studies have verified a correlation between the location of banking offices and small business lending. Berger et al. (1998) report that 84.9 percent of small businesses utilize the services of a commercial bank within 30 miles (p.196). Immergluck and Mullen (1998) found that in the Chicago metropolitan area, banks with a high percentage of small business loans in low- and moderate-income areas tended to be small- to medium-sized institutions, and to have relatively high proportions of their branches located in and near central city and low- and moderate-income tracts. Conversely, many of the Chicago area's largest banks and bank holding companies with extensive networks of branches concentrated more in affluent than in low-income areas tended to make a smaller proportion of their loans to firms in low- and moderate-income areas. Squires and O'Connor (1998) found a similar

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[32] Consolidation activity within a county was characterized as low if the proportion of loans extended by organizations involved in consolidation was less than or equal to the median share of loans extended by organizations involved in consolidation for that period. Characterization as a high consolidation activity county meant that the proportion of loans extended by organizations involved in consolidation was greater than the median share of loans extended by organizations involved in consolidation for that period (Avery et al., 1999a, p.87).

pattern; lenders with branches in economically distressed census tracts in Milwaukee made 6.6 percent of their loans in low-income tracts, compared to 5.1 percent for lenders without a branch in the low- or moderate-income neighborhood. Padhi et al. (1999) also found branch presence a significant factor in the amount of small business loans that are originated in a given census tract

Economists also have consistently found that larger institutions generally devote a smaller proportion of their assets to small business lending than do smaller institutions, raising the concern that as the industry becomes dominated by larger institutions, small business credit will decline.[33] Based on June 1997 call report data, banks with less than $100 million in assets invested about 9 percent of their portfolios in small business lending, whereas banks with over $10 billion in assets invested about 2 percent of their assets in these loans (Berger et al. 1998, p.188). Other studies have found similar trends (Berger et al., 1995; Keeton, 1995; Peek and Rosengren, 1996; Strahan and Weston, 1996). Along similar lines, research also suggests that the smallest small businesses fare better in obtaining credit from smaller institutions, in part as a result of findings that large banks may utilize a so-called "cookie-cutter" approach to loan approval decisions, in contrast to smaller bank reliance on character and pre-existing relationships in evaluating small business borrowers (Cole et al., 1999); and that large banks hold a higher proportion of loans for larger, older, and more financially secure businesses than smaller banks (Haynes et al., 1999).

In response to these concerns, a number of studies have assessed the impact of mergers and acquisitions on small business lending in the last several years. Since 1993, all insured depository institutions have been required to report the outstanding amount of small business loans in their Reports of Condition and Income filed with their federal banking regulators in June of each year (Board of Governors, 1997). In these "call reports," banks report small business loans in two classes (commercial and industrial loans and commercial real estate loans) and in the same three size categories as CRA reporting, although with no geographic information (Peek and Rosengren, 1998). The other principal source of small business lending data used in the research is the Federal Reserve's Survey of the Terms of Bank Lending to Businesses (STBL), which contains detailed information on loan terms for about 50 banks with the largest volume of commercial and industrial loans, and a sample of loans made by about 300 additional banks per quarter since the late 1970s (Board of Governors, 1997, p.39). While the STBL data is less comprehensive in terms of total bank coverage, it provides a longer time frame for analysis (Berger et al., 1998).

The research suggests that the impact of banking organization consolidations on small business lending may be sensitive to a broad range of variables, such as the relative sizes of the surviving and the target participants, the lending proclivities of the participants prior to consolidation, or the geographic proximity of the acquiring organization. The earliest studies (Berger, Kashyap, and Scalise, 1995; Keeton, 1995, 1996; Peek and Rosengren, 1996) supported the idea that mergers reduce small business lending on net. This section examines a recent study that attempts to capture simultaneously several of these effects on small business lending, and concludes in general that lending by consolidating organizations does result in decreases in lending in the short term, but that this decline is generally offset by lending by other organizations in the local market over time. However, the impact of these changes on particular business customers in the short-run as a result of the disruption of lending relationships, and the broader impact on lower-income borrowers and communities in general, requires further research.

Using a data base that includes the majority of U.S. bank mergers and acquisitions from the late 1970s to the early 1990s, Berger et al. (1998) analyze the impact of consolidations from the perspective of four types of potential effects. The first three, which relate to the effects of mergers or acquisitions on the small business lending of the participants, are the "static" effect (change in lending propensities resulting from simply combining the balance sheets of the participating banks into a larger pro forma institution); the "restructuring" effect (the change in lending that follows from any restructuring of the institution in terms of its size, financial characteristics, and local market competitive position); and the "direct" effect (the change in lending by the consolidated institution attributable to a change in lending focus above and beyond the changes associated with the transformations of institution size and other characteristics created by the static and restructuring effects, capturing the difference in lending between the new "restructured" institution and the lending of an otherwise similar institution that has not undergone a recent merger or acquisition). The fourth is the "external" effect, and refers to responses by other depository institution (but not

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[33] While large banks may devote only a small proportion of their assets to small business lending, their greater size adds up to a nonetheless substantial role in the small business lending market. According to the Federal Reserve, large banks currently account for approximately 30-40 percent of total small business loans outstanding (Board of Governors, 1997, p.16).

nonbank) lenders in the same local market.[34] Importantly, Berger et al. include data three years following a merger or acquisition to allow for the latter three "dynamic" (non-static) effects to occur. Small business lending is comprised of loans less than $1 million, and is measured as a proportion of gross total assets.

In general, Berger et al. found that the static effect of mergers tended to substantially reduce small business lending, consistent with prior research although acquisitions did not appreciably reduce small business lending by the acquired institutions. However, the authors found in both cases that the declines were largely if not fully offset by dynamic effects that included increased lending by other banks in the same local market.

1. *Mergers*

Examining mergers involving 6,369 banks that merged between 1977 and 1992, which reduced their number to 2,508, Berger et al. found that the institutions involved in mergers reduced their small business lending as a proportion of assets by 41.6 basis points, which translated into $20.2 billion over the study period. Static effect alone reduced the small business lending proportion of the pro forma banks by 53.3 basis points, or one-half of one percentage point, amounting to approximately $25.8 billion less small business lending or 16 percent of total small business lending in 1995 (Berger et al., 1998, p.212). The positive restructuring and direct effects somewhat offset this negative static effect by increasing small business lending by 6.7 and 4.9 basis points, or $3.5 billion and $2.6 billion, respectively. Thus, by the end of three years after mergers, the negative static effect is only slightly offset by the positive restructuring and direct effects. However, Berger et al. (1998) estimated the external effect of lending by other banks in the local market as increasing small business lending by $48.6 billion over the study period, more than offsetting the reduction in lending at an institutional level by the merging banks (p.222).

Berger et al. found that mergers of small and medium-sized banks (with gross total assets of less than $1 billion) resulted in increased small business lending, consistent with Peek and Rosengren (1996, 1998) and Strahan and Weston (1996, 1998); and that mergers of large survivor banks (gross total assets of $1 billion or more) with either large or medium-sized target banks resulted in declines in small business lending. The authors speculate that this result may be attributable to the fact that mergers of small- and medium-sized banks allow the participants to increase their business lending as a whole, most of which is restricted to small business lending because of legal lending limits and limited diversification. For example, a bank with $50 million in assets and a 6 percent equity capital ratio has a legal lending limit to a single borrower of $450,000 (15 percent of equity). A merger with a similar bank would double the size of loans and commitments that are permitted, with the additional loan amount still counting as small business lending (Berger et al., 1998, p.217).

2. *Acquisitions*

In contrast to mergers, Berger et al. found that acquisitions in which a depository institution is acquired by a new top-tier holding company but retains its charter, did not appreciably reduce the proportion of small business lending by the acquired institution. Looking at the effects of 4,146 acquisitions, the static effect resulted in a decline in small business lending of 63.8 basis points, or $7 billion, the restructuring effect was very small (3.2 basis points, or $.35 billion), and the direct effect showed increased lending of 61.6 basis points, or $6.8 billion, that essentially offset all of the static effect (Berger et al., 1998, p.213).

This overall result of essentially no change in small business lending related to acquisitions masks some significant differences related to the size of the organizations involved. Acquisitions of large banking organizations by other large organizations tended to increase small business lending, while acquisitions of smaller organizations by large organizations tended

[34] Local market effect is assessed based on evidence that small businesses rely on nearby banks for financial services, such that small loans size may be a proxy for local effect (Berger et al., 1998, p.220).

to decrease small business lending (Berger et al., 1998, p.217). Berger et al. speculate that these differing results may reflect differences in the purpose behind the acquisition. For instance, the very largest acquisitions may often be for the purpose of market expansion by aggressive acquirers who wish to expand all types of lending.

Depository institutions involved in acquisitions also increased the proportion of loans to medium and large businesses more than was the case for banks involved in mergers. Berger et al. found that lending in the largest loan size category, over $25 million, reflected a large positive static effect, suggesting that larger bank holding companies may allow acquired banks to initiate more large loans as a result of improved overall diversification.

Looking at changes by type of merger or acquisition, Berger et al. found that all categories of mergers (mergers of equals, family mergers, all mergers) tended to reduce small business lending by comparable amounts, but that the zero overall effect of acquisitions also masked varying results by type of acquisition[35] (p.215, Table 4). Acquisitions of equals and out-of-state acquisitions showed increased lending, while acquisitions of unequals and in-state acquisitions yielded negative effects on small business lending (-6.1 basis points and -61.0 basis points, respectively) (p.215). The results of out-of-state acquisitions run contrary to some other literature, and against the conventional wisdom that out-of-state acquirers impose non-local policies and procedures that inhibit relationship-driven small business lending (Keeton, 1997; Whalen, 1995).

Berger et al. suggest that the difference in impact between mergers and acquisitions may be that acquisitions are associated with keeping mostly the same lending policies and procedures and loan officers within the bank, so that the acquired bank's loan officers can maintain their ties to the local community that enable them to continue extending relationship-based loans to small, informationally opaque borrowers, minimizing the impact of the consolidation on small business lending. The choice of a merger, on the other hand, may more often be associated with a strategic decision to integrate the acquired bank more fully into the acquiring organization, rather than maintaining its local identity, making it less inclined or less able to extend relationship-based small business loans. However, Berger et al. point out that acquisitions may still have important effects on small business lending in the long run if these acquisitions are preludes to family mergers over the following few years. In some cases, an acquired bank is merged with an existing bank holding company affiliate some time after the acquisition, which then yields a reduction in small business lending. Nearly a quarter (23.7 percent) of newly acquired banks engage in family mergers in the three years following acquisition. Further, Berger et al. suggest that family mergers are likely to increase dramatically in the near future, as the Riegle-Neal Act of 1994 removed most of the restrictions on family mergers across state lines as of June 1, 1997 (Berger et al., 1998, pp.213-14).

3. External Effects

Estimating the impact of mergers and acquisitions on lending by other banks in the same local market, Berger et al. found that both mergers and acquisitions resulted in statistically significant increases in small business lending by other banks in their local market that essentially offset declines at an institutional level by three years after the consolidation (p.222).

4. Issues for Further Research

While the offsetting impact of external effects on small business lending is promising, a critical question is the effects caused by the disruption in the supply of funding. For example, if it takes two to three years for the market supply to respond to the decline caused by the withdrawal of a bank because of a merger or acquisition, "will the affected small firms have the internal resources to ride through the storm?" (Small Business Administration, 1997, p.12).

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[35] Mergers of equals are mergers in which the surviving bank had between one-third and two-thirds of the pro forma bank's gross total assets before the merger. Family mergers are mergers in which both banks were already in the same top-tier bank holding company prior to the merger. Acquisitions of equals are acquisitions in which the acquiring bank holding company's gross total assets before the merger was between one-third and two-thirds of the pro forma holding company's gross total assets. An out-of-state acquisition is an acquisition in which the bank was purchased by an out-of-state holding company. (Berger et al., 1998, p.216, Table 4.)

One suggested possibility for being able to examine these issues is development of a database linking borrowers and lenders, in order to better understand borrowing and lending behaviors of small businesses and post-merger banks (Small Business Administration, 1997, p.12). One study has attempted to address this question by examining results of a survey of small businesses that elicited information about the firms' most recent attempt to locate financing. (Scott and Dunkelberg, 1999). Among its questions, the survey asked whether the firm's principal financial institution had been bought out or absorbed by another, with follow-up questions regarding how the change had affected the firm. The researchers concluded that consolidation did not impair, and may even have enhanced, credit availability; and they found no significant adverse effect on interest rates or loan-to-value ratios. However, consolidations did appear to be associated with a higher probability that a bank would require the small firm's use of additional financial services as a condition of the loan, and higher fees on other bank services, which resulted in higher frequency of shopping for a new financial services provider by firms experiencing a merger.

V. THE FUTURE OF FEDERAL COMMUNITY REINVESTMENT POLICIES

Given the fundamental changes in the marketplace, what does the future hold for the Community Reinvestment Act as currently structured? How should federal lawmakers and regulatory officials think about the community obligations of non-traditional financial institutions?

The twenty years since passage of the CRA have seen two principal alterations in the financial marketplace that 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 purposes of CRA compliance. To the extent that the geographic focus for evaluating bank CRA performance continues to be the area surrounding physical facilities (even if they be more modern incarnations such as supermarket kiosks or ATMs), then a growing portion of bank lending and other activities will fall outside the purview of CRA review. 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 nonbank financial services providers such as insurance companies, mutual funds, pension funds, and finance companies. In 1977 when the CRA was passed, depository institutions held nearly 40 percent of the country's total financial intermediary assets. By 1995, that number was less than 22 percent (Litan, 1997, pp.63-65). As the segment of the financial services community subject to any CRA obligation diminishes, so will the dollar amount of CRA-type lending or investments. Thus, changes in the financial marketplace threaten to pull the rug out from under the CRA by limiting its geographic scope and its financial base.

This section examines the community reinvestment policy implications raised by the "non-traditional" financial institutions denoted by both of these market developments. It examines recent rulings by the banking regulators defining the CRA assessment area applicable to various non-branch delivery systems; the potential for using technology to improve low-income access to depository and payment services; and proposals for extending the CRA to the nonbank financial services providers that are taking the place of banks and thrifts in many areas of financial intermediation. The section concludes by looking at some proposed modifications of the CRA enforcement scheme, and where Federal community reinvestment policy currently stands.

A. Defining the Community: Assessment Area Issues

One of the current challenges to enforcement of the CRA is how to adapt the CRA mandate for depository institutions to help meet the credit needs of the local "community" they were chartered to serve to institutions that deliver banking services regionally or nationally through non-branch delivery systems such as the internet, credit cards, or insurance agents. Under the revised regulations, a financial institution's CRA performance is evaluated within its geographic "assessment area." A financial institution (other than a wholesale or limited purpose bank) is directed to delineate its assessment area or areas to correspond to MSAs or contiguous counties, cities, or towns and to include the whole "geographies in which the bank has its main office, its branches, and its deposit-taking ATMs, as well as the surrounding geographies in which the bank has originated or purchased a substantial portion of its loans."[36] CRA advocates assert that the "surrounding geographies" language would include areas where an institution has agents or conducts business through electronic means.[37]

Three of the banking regulators addressed the assessment issue this year in the context of applications that involved the delivery of banking products and services through the internet and through a nationwide network of insurance agents. While the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Office of Thrift Supervision (OTS) all maintained

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[36] 12 C.F.R. § 25.41. "Geography" refers to a census tract or a block numbering area delineated by the Bureau of the Census in the most recent decennial census. 12 C.F.R. § 25.12(l))

[37] Letter from Malcolm Bush, President, Woodstock Institute, and Convenor, Chicago CRA Coalition, to John D. Hawke, Chair, Federal Financial Institutions Examination Council (Feb. 22, 1999). The Woodstock Institute and the Chicago CRA Coalition propose a standard for determining where a financial institution conducts sufficient business to warrant a new assessment area based on wherever (i) the financial institution has a significant share of the loan market or deposits (.05 percent) and/or (ii) the number of loans/deposits represents a large portion of the institution's total portfolio.

assessment area delineations based on physical facilities, the OTS appears to be reading the assessment area delineation more broadly.

In July, 1999, the OCC (1999) approved the application of Canadian Imperial Bank of Commerce (CIBC) to charter a new full-service national bank that would have no traditional banking offices but would deliver its products and services through ATMs, through the internet via a transactional website, and through the bank's toll-free customer service line. Customers would be able to access all of these electronic delivery channels at kiosks located on the premises of a grocery store chain. Each kiosk would house a dedicated phone line to the bank's call center and a computer with dedicated access to the bank's website. A bank ATM would be placed on an external wall or otherwise adjacent to the kiosk. The kiosk would be staffed with a part-time customer service representative who would facilitate use of the electronic delivery channels, but would not have the ability to accept deposits, approve loans, negotiate interest rates, or otherwise commit the bank to transactions or activities. The bank planned to offer deposit products including no-fee checking and savings accounts earning above-market interest rates, certificates of deposit, electronic bill payment, and an ATM card. Loan products would be limited initially to unsecured consumer loans, but might later include residential mortgages, secured consumer loans, and credit cards. Based on the location of the bank's main office and initial kiosks in the Orlando, Florida area, the OCC decided that the bank's plan to designate the Orlando MSA as its initial assessment area was appropriate, and summarily rejected the idea that this assessment area delineation would not be consistent with the bank's plans to operate on a nationwide basis via the internet. The Federal Reserve thereafter likewise approved CIBC's bank holding company application to acquire the newly chartered national bank, finding that convenience and needs considerations were met by the bank's definition of its assessment area in the Orlando MSA and by its satisfactory prior CRA record (Federal Reserve System, 1999).

In November, 1998, the OTS (1998) granted a thrift charter to State Farm Mutual Automobile Insurance Company, the largest automobile, property, and casualty insurance company in the country. The new thrift, State Farm Financial Services, F.S.B., would be based in the State Farm headquarters complex in Bloomington, Illinois, would also operate in the St. Louis area, and eventually expand operations throughout Illinois and Missouri, to Arizona, and other states. The thrift planned to offer a full range of banking services, including taking deposits and making various types of home mortgage, auto, and home equity loans, by direct mail and through its nationwide network of independent agents, to State Farm's insurance customers.

Although State Farm's CRA assessment area was defined as the Bloomington-Normal MSA in which its headquarters is located, State Farm's CRA commitments were much broader. The OTS press release accompanying the approval asserts that State Farm's thrift committed to make $195 million in loans to low- and moderate-income borrowers in the states served by the new thrift during the first three years of operation, and set a long-term goal of CRA-related loan commitments and activities equal to the greater of 5 percent of the thrift's assets or the amount of deposits generated from low- and moderate-income persons (OTS, 1998). The thrift also agreed to review the extent of insurance agent participation in the distribution of its credit products in each state it enters and how that would affect the thrift's CRA and fair lending performance; agreed to provide CRA and compliance training to State Farm field coordinators and officers; hired a director of residential lending experienced in community development activities; planned to participate in a variety of community organizations and programs; agreed to create a national community advisory council at the time its operations expand beyond the initial three states; and agreed to submit to OTS a quarterly analysis of the disposition of the thrift's loan applications by race, income, and geography, as well as the price, terms, and conditions of approved loans.

OTS Director Ellen Seidman articulated the rule underlying the State Farm ruling that would apply to other thrift charter applications that propose nationwide or super-regional home mortgage or multi-product consumer lending through non-traditional means with a single main office or branch. Seidman stated that the thrift "must demonstrate its capacity to achieve satisfactory CRA performance (i) by at least adequately addressing the needs in its main office assessment area, given the performance context of its operations in that area, (ii) by showing that the prospects for its retail products penetrating low- and moderate-income markets in the regions it reaches outside its assessment area are favorable, and (iii) by demonstrating that its community development lending, qualified investments and community development services provide appropriate levels of benefit to appropriate markets throughout the scope of its thrift operations" (Seidman, 1999). Seidman emphasized that State

Farm's thrift's assessment area would be limited to the MSA surrounding its Bloomington, Illinois headquarters only initially; and that the OTS would evaluate the institution's performance in other states and regions as the thrift's operations expand there.

According to Seidman, the banking regulators have considered several other alternatives for adjusting the idea of community underlying the definition of an institution's assessment area. First, expand eligibility for the community development test from wholesale and limited purpose banks to a larger variety of nontraditional institutions. This test evaluates community development lending, investments, and services in the institution's assessment area as well as the broader statewide or regional area that includes the assessment area, or beyond, and could accommodate nationwide deposit or lending activities. Second, expand the regulatory definition of assessment area to include areas where an institution gathers a substantial amount of its deposits or makes a substantial portion of its loans. Third, use customer-based assessment areas, based on the location of customers rather than branch location, which is presently the approach used under the regulations for institutions that serve military personnel or their dependents. Fourth, use the strategic plan option, which permits an institution to develop its own plan, in consultation with community representatives, for helping to meet community credit needs. As an example, Seidman (1999) describes the strategic plan recently approved by OTS for Household, FSB, which established goals for community development activities within the Chicago metropolitan area where its home office is located, as well as customer-based lending goals based on the nationwide membership of the AFL-CIO (p.5).

B. Digitization of Commerce: Low-Income Access to Depository and Payment Services

Technological changes in the delivery of banking products and services also raise issues with respect to low-income access to depository and payment services. While some community reinvestment advocates warn that technologically-driven delivery systems will further marginalize low-income people from mainstream finance because they lack access to home computers or computer training, others suggest that the lowered costs and increased alternatives present an opportunity for expanded access to affordable and reliable depository and payment services.[38]

Fueling this divergence of views is research that reveals the growing extent to which the basic financial services needs of low-income households are met by alternative financial institutions. Caskey (1994) documents the dramatic increase in the number and use of commercial check-cashing outlets and pawnbrokers since the 1980s, and the critical role that this system of "fringe banks" plays in the financial system by providing basic credit and payment services to millions of low- and moderate-income households that rarely interact with the formal banking system. Caskey suggests that this boom in fringe banking reflects falling standards of living of many lower-income households and consequent reduced ability to save, combined with the deregulation of interest rates and increased competition in the financial services markets resulting in elimination of previously cross-subsidized services such as low-cost, small-balance deposit accounts, and the closing of unprofitable or marginally- profitable branches, many of which were in low-income areas. However, Caskey and Stegman (1999) also suggest that lower-income households use fringe banking alternatives because their product and service offerings and fee structure better fit their needs. For example, check cashing outlets may offer "payday loans" or "deferred presentment" for small amounts and for short periods; and may be less intimidating, and offer more personal contact, than mainstream institutions. Nonetheless, fringe banks are problematic because households that utilize them pay more for basic financial services than households that maintain financial savings and use mainstream financial institutions, and because they afford none of the Truth-in-Lending or other consumer protections afforded by mainstream financial institutions (Caskey, 1994; Hogarth and O'Donnell, 1999).

The potential of technology to enhance low-income access to mainstream depository and payment services has been an important focus in the Treasury Department's implementation of the Debt Collection Improvement Act of 1996 (commonly referred to as "EFT'99'"), which required that all recurring Federal payments (other than tax refunds) be made by means of

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[38] One study has shown that the average cost of completing a banking transaction through a telephone call center, ATM, or internet is $ .54, $ .27, and $ .01, respectively, as compared to $1.07 for a traditional branch. Booz, Allen & Hamilton, "Consumer Demand for Internet Banking," July, 1996, III-5F (cited in Comptroller of the Currency, 1999, p.7 n.15). Based on these costs, the Canadian Imperial Bank of Commerce plan to provide services through a supermarket kiosk equipped with internet access and staffed by trained personnel, for example, would seem to offer a workable model for low-income communities.

electronic funds transfer by January 2, 1999.[39] Part of the significance of EFT'99 is that it also required creation of an Electronic Transfer Account (ETA) for the unbanked, through which recipients may receive their benefits (Hogarth and O'Donnell, 1999, p.468). Litan (1997) suggests that implementation of the law may well provide the occasion for bringing the 15 percent of American households presently without bank accounts into mainstream finance, and the ambit of affordable and reliable payment and deposit services. Likewise, Stegman (1999) argues that if combined with an economic literacy campaign and a national individual development account (IDA) savings initiative, the law could be the first step towards helping the working poor to accumulate savings and become financially self-sufficient. IDAs are dedicated savings accounts that can be used only for purchasing a first home, for education or job training expenses, or for capitalizing a small business. Deposits from salary or wages by lower-income individuals into their IDAs are matched on a dollar-for-dollar basis using both public and private sources. Stegman suggests that a national IDA program could be put in place for as little as $100 million a year, less than the $195 million annual savings that EFT'99 makes possible, and only a fraction of the $17 billion, ten-year cost of the Roth IRAs Congress made available to higher income workers in 1997[40] (Stegman, 1998).

Stegman suggests that inclusion of lower-income individuals in mainstream banking through the direct deposit mechanism of EFT'99 provides an important link to enhanced credit access, by enhancing the ability of the working poor to accumulate savings and become creditworthy. Stegman suggests that CRA enforcement can be enhanced in several ways to support the transition to electronic benefits transfer, which he argues will ultimately increase the demand for mortgages and other mainstream loan products. First, financial institutions should receive CRA credit for offering and heavily marketing ETA and other low-cost/no-cost depository and payment services. In particular, banking regulators should examine the extent to which an institution markets and promotes the use of these accounts through direct or indirect support of financial education services, based on research indicating that giving the unbanked inexpensive access to account services without intensive outreach will fail to draw many of them into the mainstream banking system. Second, regulations should be clarified and codified to ensure that institutions receive CRA credit for participation in IDA programs, such as by providing free checking and ATM services to low- and moderate-income IDA account holders, or deposit subsidies or matching dollars to an IDA program, or participation of bank management or staff in the development or implementation of financial education and training for low- or moderate-income IDA holders. Third, increase the weight assigned to the services test in the CRA compliance examination scheme. Presently, delivery systems for banking services other than bricks and mortar branches may be awarded CRA credit, but only to the extent they are effective alternatives to branches in providing needed services to low- and moderate-income areas and individuals. Stegman suggests that giving more weight to the services component might give banks an incentive to re-examine how they provide basic financial services.

Apart from EFT'99, there have been a variety of proposals for ways to use technology to lower costs and increase low-income access to depository and payment services, both through the mainstream banking system and through fringe banks (Hogarth and O'Donnell, 1999, p.472). For example, Caskey proposes that we follow what he calls a European model, which is to offer low-cost, low-minimum balance savings accounts (rather than low-cost lifeline checking accounts) combined with low-cost convenient access to money orders. Pointing out that money orders can now be delivered through reconfigured ATM machines, Caskey envisions an ATM machine printing a money order and dropping out an envelope and a stamp, so all that needs to be done is to fill in the name of the person being paid and to drop it in the mail. The primary benefit of this system would be to help people avoid bounced check fees, which are normally $20 or $25, and tend to be incurred by the people with low-balance accounts, who can least afford it. Indeed, Caskey points out that because of the bounced check fees, many low-income people who are using banks would find it cheaper to use check-cashing outlets, paying the fees to cash checks and purchase money orders. Another example of technological innovation serving the particular needs of low-income people is the use of ATM networks for money transfer. Caskey describes the Envia Card, which is an account with two ATM cards offered by Banco Popular in Puerto Rico. The accountholder keeps one and sends the other to a family member elsewhere (in the Dominican Republic, for example, because a

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[39] Pub. L. No. 104-134, ch. 10, 110 Stat. 1321 (April 26, 1996), codified at 31 U.S.C. § 3332. The Treasury Department's regulations implementing the law, promulgated in September, 1998, are codified at 31 C.F.R. Part 208.
[40] Senator Joe Lieberman has introduced a bill to promote IDAs by awarding banks a tax credit of up to $300 for each IDA account to which they contribute. Only individuals making less than 60 percent of their area median income would be eligible to participate (on average less than $22,000 per year). See The Savings for Working Families Act, S.895 (introduced April 29, 1999).

great deal of money transfers go on between the two places). Currently, the cost of such a transfer is $20; but with the Envia Card, Banco Popular can do it for $3.00.

Other proposals and experiments involve taking advantage of the existing fringe banking system that is effectively serving many low-income communities. Caskey (1994) suggested that check-cashing outlets be permitted to function as agents for banks by taking deposits. This arrangement would permit people who live in communities without bank branches to obtain bank payment and deposit services locally, while saving banks the cost of establishing a full-service branch. While check cashing outlets are not "financial institutions" eligible to offer deposit accounts or to receive electronic deposits directly from the government under Treasury's EFT '99 regulations, some check cashers have developed hybrid arrangements that permit consumers to open an account with the financial institution and then move the funds into an intermediary account that consumers can access through check cashing outlets, although these arrangements are not covered by FDIC insurance or other consumer protections (Hogarth and O'Donnell, 1999, p.470). In another arrangement, the National Check Cashers Association (NaCCA), in collaboration with a depository institution, offers a debit card to consumers without bank accounts who frequently cash Federal benefit or payroll checks at check cashing affiliates of the association, that permits debit card purchases or ATM withdrawal at any NaCCA-member check cashing outlet in the country (Hogarth and O'Donnell, 1999, p.471). Stegman (1999) offers other examples of a growing number of collaborations between banks and check cashers.

In terms of consumer education, one byproduct of EFT '99 has been the creation of the Financial Services Education Coalition, comprised of Federal agencies, bank trade associations, and consumer and community groups, including the Federal Reserve, the American Bankers Association, and the National Community Reinvestment Coalition. This Coalition has produced a resource guide for community-based educators with information on planning, implementing, and evaluating EFT '99 education programs in their communities[41] (Hogarth and O'Donnell, 1999, pp.469-70). According to Hogarth and O'Donnell, staff of the Coalition have worked with church groups, housing service providers, senior citizen groups, nutrition programs, and tribal councils to reach consumers with information on choices for receiving federal payments.

C. Nonbank Financial Institutions: Extending the Reach of the CRA

The last thirty years have seen the shift of an increasing portion of domestic financial assets out of depository institutions and into nonbank financial intermediaries comprised of four major types of nonbank institutions: mutual funds, pension funds, insurance companies, and finance companies. D'Arista and Schlesinger (1993) coined the term "parallel banking industry" to denote these nonbank financial intermediaries that have taken over many of the functions traditionally served by depository institutions. In addition to holding more than two-thirds of Americans' long-term savings and investments, as compared to less than one-third in the mid-1970's, nonbank intermediaries now serve as the primary source of credit for many American households and businesses (Pinsky and Threlfall, 1996, p.1).

Many commentators and CRA advocates propose that a reasonable and meaningful public policy would extend a community reinvestment obligation to the full spectrum of financial institutions, including the parallel banking industry, as a practical necessity for ameliorating conditions in distressed local economies, as well as to level the playing field in the financial marketplace. In particular, they argue that the expectation of a commensurate community reinvestment responsibility from parallel banks is justified by the reliance of these nonbank institutions on the same or comparable governmental, taxpayer-supported benefits as the banking industry, such as direct access to Federal guarantee programs and State guarantee associations, as well as indirect access to back-up credit and liquidity from the conventional banking system (D'Arista and Schlesinger, 1993; Southern Finance Project, 1995; Pinsky and Threlfall, 1996).

Proposals to tailor reinvestment obligations to the non-bank institutions that make up the parallel banking industry include vehicles for direct involvement in low-income communities, as well as indirect involvement through partnerships with CDFIs. Pinsky and Threlfall (1996) suggest that direct involvement in low-income communities might be accomplished through

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[41] Financial Services Education Coalition, "Helping People in Your Community Understand Basic Financial Services."

"distribution" requirements for nonbank investment and loan portfolios. For example, finance companies might be required to target a percentage of their total lending at affordable rates to low-income households that meet certain income requirements; in turn, favorable ratings of finance company commercial paper issues could reflect the company's demonstrated ability to consistently target affordable loans to low-income populations. Savings instruments such as mutual funds and pension funds could be tailored to meet the savings and investment needs of low-income individuals, possibly on the model of IDAs that help low-income individuals accumulate wealth and direct savings towards high-yield public purpose investments such as education, business creation, and home ownership. The creation of similar "asset building" mutual funds for low wage earners could help lower-income households save for the future and also provide an entry point for participation in the parallel banking system.

Alternatively, parallel banking institutions could fulfill a community reinvestment role through indirect means, by partnering with CDFIs through various types of investments, loans, or management of lending pools in the same manner as conventional banks have done (Pinsky and Threlfall, 1996, p.14). Other proposals include the possibility that aggregated savings instruments like pensions and mutual funds make investments in for-profit CDFIs, or equity-like investments in non-profit CDFIs, on the model of socially responsible mutual funds. Or, as proposed by the Southern Finance Project (now known as the Financial Markets Center) (1995), creation of a National Reinvestment Fund (NRF), not unlike the concept of the CDFI Fund, but to be financed with mandatory investments by all private nonbank financial institutions and managed on a regional basis by the 12 Federal Reserve Banks. The NRF would capitalize the growth of existing CDFIs and provide seed capital for new CDFIs; and provide credit enhancements, financial guarantees, and policy coordination for federal loan-guarantee programs (Southern Finance Project, 1995).

As a practical matter, the controversy over the CRA that preceded passage of the Gramm-Leach-Bliley Act in November, 1999, suggests that these proposals to extend the reach of the CRA are unrealistic for the foreseeable future.[42] While the new law did make a satisfactory CRA rating a prerequisite for engaging in the expanded financial activities permitted under the law, the law also reduced the CRA examination cycle for small banks to every four years for institutions with a satisfactory rating at their last examination, and every five years for institutions with an outstanding rating. In addition, new CRA agreement "sunshine" provisions require that depository institutions disclose their agreements with community groups, and that community groups report to banking regulators on their use of funds received under these agreements.

D. Proposals and Current Policy

This section focuses on proposals to create better incentives within the CRA scheme, and a summary of the Clinton Administration's three-part approach to community reinvestment through the CRA, the CDFI Fund, and targeted tax incentives.

1. Positive Incentives

Several commentators propose that the CRA make increased use of positive incentives for compliance. Hylton and Rougeau propose rewards in the form of relaxed regulatory constraints, a reduction in taxes, or outright payments to encourage banks to move into inner-city communities. As an example, they cite a bill introduced in 1996, the American Community Renewal Act, which would have designated 100 "renewal communities" based on pervasive poverty and economic distress, and would have offered incentives such as tax credits, regulatory relief, and low-interest loans to businesses and individuals that invested in those neighborhoods. Banks could satisfy their CRA obligations by making certain approved types of investments in these renewal communities.

Swire (1993) proposes a regulatory "safe harbor" for banks and their holding companies from CRA enforcement as a means to increase community investment while reducing bank compliance costs and minimizing misallocation of credit. Swire proposes that a bank or bank holding company that met certain CRA investment criteria, through substantial investments in community development banks and other qualifying investments, be exempt from CRA examinations and have its applications

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[42] Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999).

subject to review under the CRA receive automatic favorable treatment. Swire argues that while other alternatives offer some supplemental benefits, the CRA, with adoption of a safe harbor, is a preferable means to achieve the goals of eliminating redlining, preventing racial discrimination, and increasing investment in low- and moderate-income communities. For example, Swire argues that the CRA is preferable to direct government expenditures, because banks are in the business of making loans and are in a better position than the government to make local investment decisions; tax programs are difficult to establish effectively; and antidiscrimination suits are unsuited to achieving the corrective and affirmative goals of the CRA.

Marcus (1996) proposes a market-based framework for generating low- and moderate-income lending based on restricted access to the secondary markets. Marcus proposes requiring that Fannie Mae and Freddie Mac purchase loans from banks only in blocks that contain a minimum percentage of low- and moderate- income loans originated within a bank's assessment area. Thus, in order to sell its mortgage loans to Fannie Mae or Freddie Mac, a bank would have to originate enough low- and moderate-income loans to meet the percentage required to sell a block, or else be forced to hold its loans until maturity. This would also create an incentive for banks to enlarge their assessment areas to include more of the low- and moderate-income areas around their branches (rather than less, as under the current law), because only loans originated within its assessment area would count toward satisfying the percentage requirement in each block of loans. This block system would also be an effective tool to expose banks that are not doing such lending, to be investigated for evidence of racial discrimination by the Justice Department.

In a similar vein, Klausner (1995) recommends a market-oriented alternative in the form of a system of "tradable CRA obligations." Under this proposal, banks would be assigned an annual quota of CRA-qualified loans, which might be a specified percentage of assets or deposits, and would include loans to residents, businesses and projects in low-income neighborhoods, designated by median incomes as under current CRA regulations. A bank could meet its quota by originating or holding qualified loans, buying them from another lender, or lending through a consortium. Potential advantages would include promotion of specialization and information efficiencies; internalization of neighborhood externalities, resulting in more value per dollar lent than untargeted and uncoordinated lending; reliance on market forces to allocate loans in low-income neighborhoods; and reduction of enforcement and compliance costs.

2. Focus on Provision of Services rather than Branches

Several commentators suggest that the CRA's assessment criterion based on an institution's record of opening and closing offices in low-income communities may be counterproductive by making bankers unwilling to open offices in these communities in the first instance (Hylton and Rougeau, 1998). On the other hand, other commentators argue that if institutions comply with the requirement that assessment areas be delineated to include entire MSAs or political subdivisions, then the CRA's compliance scheme should not be able to operate as a disincentive to operating in low- to moderate-income communities.

In any event, several alternatives have been offered that focus on reducing or sharing the costs of operating in low-income communities. Caskey recommends that appropriate policy should separate the issue of promoting business and housing credit from the issue of the availability of services, since provision of services may be addressed by means less costly than a full-service branch, such as by establishment of a community credit union, or a consortia of banks that jointly capitalize and operate a branch in an underserved area (NCCA, 1997, Caskey, 1994). Similarly, Thomas (1998) recommends a joint venture approach, suggesting that a bank office be shared between competitors, on the model of shared ATMs. A proprietary shared office would be owned and operated by a single bank, with other competitor banks sharing the facility through specially designated teller lines and a per-transaction fee; or two or more financial institutions could join together in a generic shared branch, or what Thomas calls a "Community Banking Center," to share all of the major noninterest expenses of operating a branch – the costs of brick and mortar, neutral personnel, and technology. Possible sites for such a banking center might be retail stores, senior citizen complexes, large condominiums, office buildings, college campuses, or transportation terminals (Thomas, 1998, pp.170-71).[43]

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[43] Thomas' recounting of an attempt to establish such a branch, and the experience of the single bank that ultimately opened a branch in the targeted location, suggests that a shared branch may suffer from many of the same problems as an individually-owned bank, and indeed of any

3. Localism and CDFIs

Both CRA advocates and critics alike have pointed to CDFIs as having an important role to play in community reinvestment policy. Litan (1997) maintains that federal policy, in addition to operating through the CRA's broad mandate placed on banks and aimed at entire neighborhoods, also needs to operate through more specialized institutions, ranging from credit unions to nonprofit community development groups, that "know how to reach the neediest and to succeed where ordinary commercial finance cannot easily thrive" (p.145). The Southern Finance Project (1995) recognizes the "patient, labor-intensive, direct portfolio lending necessary in distressed communities and targeted investment areas" that banks often no longer routinely provide. Lacker (1995) also finds that CDFIs may be uniquely situated, as banks are not, to address the credit and capital needs of low-income neighborhoods. Marsico (1995) likewise sees CDFIs as a superior tool for fighting poverty (as compared to direct commitments by banking institutions) by developing the economic infrastructure of low-income communities and promoting community self-determination rather than dependence on banks and other outside institutions. In sum, it appears that CDFIs are gaining importance because they embody the local nexus that underlay the CRA model, but that no longer completely defines the mainstream banking industry.

On the other hand, CRA advocates are generally adamant that CDFIs cannot be a substitute for banks, having neither the resources nor the capital commensurate with the market that needs to be served; and that the CDFI Fund is no substitute for the CRA (Thomas, 1998, p.163; NCCA, 1997, p.6). Pinsky notes that CDFIs manage approximately $2.5 billion in assets, equivalent to the size of a moderate bank; and though substantial enough to make a difference, the CDFI field simply lacks the scale to fuel the long-term economic change necessary to foster opportunity at a meaningful scale, and are too small to supplant banks, commercial credit providers, and other conventional institutions. The role of CDFIs, rather, is to leverage conventional private and public financing sources.[44]

4. Current Community Reinvestment Policy

As outlined by then-Deputy Secretary of the Treasury Lawrence Summers in 1998, the Administration's current community reinvestment policy has three components: the CRA, the CDFI Fund, and targeted tax incentives. The Administration's policy is based on the premise that private financial markets fail when it comes to the very poor – that market psychology and other barriers tend to artificially restrict the flow of capital to certain neighborhoods or to minority groups, and that mechanisms are needed to "revive the power of the market for low-income families." First, Summers touts the revitalized CRA as establishing a new paradigm in community regeneration strategies, in which public sector and nonprofit organizations "work shoulder to shoulder with mainstream banks and other financial institutions to bring affordable credit and private sector investment to distressed districts and transform their prospects" (Summers, 1998, p.4). In particular, Summers points to 1996 HMDA data revealing that conventional home mortgage lending to African-Americans increased 67.2 percent, lending to Hispanics increased 48.5 percent, and lending to low- and moderate-income areas increased 37.9 percent, in a period in which the entire market grew by only 18 percent.

Second, Summers points out that the CDFI Fund has since its inception in 1994 awarded 80 CDFIs over $75 million in grants, loans, equity investments and technical assistance, and notes that these CDFI awards would be leveraged 3-4 times in the short term alone; and under the Bank Enterprise Awards program, had made 92 awards worth $30 million to insured depository institutions that had increased their investments in CDFIs or increased their direct lending and other services to low-income communities. Summers compares CDFIs to a "niche venture capital firm" that "deploys its superior knowledge of an emerging market niche to invest and manage risk better than other investors. CDFIs are often 'early birds' or 'market scouts' who see the market potential of overlooked customer segments. . . . But like other frontier investors, CDFIs cannot survive unless they find

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single business attempting to make it in a distressed community. Sharing costs may not solve the problem of bringing back the community in which it is located sufficiently to support its operations.

[44] According to Pinsky, NCCA members leverage $6 in conventional financing for every $1 invested in development. Mark A. Pinsky, "CDFIs: Bridges to Opportunity," *Neighborhood Works* 21(4):9 (July/August 1998).

paying customers. They must make loans and investments that are repaid. And, in the end, they must aim to be supplanted. By definition, CDFIs' customers are not yet fully served by the market. But the end goal is always to change the psychology of the marketplace to catalyze more investment by the private sector" (1998, pp.4-5).

Third, Summers outlines the Administration's use of targeted tax incentives including "brownfields" tax incentives, empowerment zones, wage credits for employers that hire families coming off welfare, and making the low-income housing tax credit a permanent feature.

ADDENDUM: THE PROFITABILITY OF CRA LENDING

The question of the profitability of CRA lending as compared to non-CRA lending is viewed by some as a question about the economic and political legitimacy of the CRA as federal policy. Some economists suggest that if CRA lending is profitable, it proves that bankers were indeed overlooking profitable lending prospects in their communities, and perhaps not treating creditworthy borrowers evenhandedly. By providing the impetus for institutions to seek out these previously underserved markets, the CRA represents good business and good policy.[45] On the other hand, if CRA loans show greater than average default rates, or prove to be unprofitable as a result of transaction costs or underwriting flexibilities, it proves the concern of CRA opponents that the law represents credit allocation based on the volume of deposits coming from certain areas, without regard for credit demand or the merits of individual loan applications.

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[45] Economists have identified several types of market failures that would explain why institutions may overlook profitable lending opportunities absent the CRA, including imperfect information, externalities, and discrimination. See, e.g., Charles W. Calomiris, Charles M. Kahn, and Stanley D. Longhofer, "Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor," *Journal of Money, Credit, and Banking* 26(3):634-78 (August 1994, Part 2); Keith N. Hylton and Vincent D. Rougeau, "Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act," *Georgetown Law Journal* 85:237-88 (December 1996); Leonard Nakamura, "Information Externalities: Why Lending May Sometimes Need a Jump Start," *Business Review* pp.3-14. Federal Reserve Bank of Philadelphia (January-February 1993); Peter Swire, "The Persistent Problem of Lending Discrimination: A Law and Economics Analysis," *Texas Law Review* 73:787- 869 (March 1995).

While some research finds higher default rates in low- and moderate-income loans (LaCour-Little, 1998), other literature finds the performance of these loans not significantly different from more typical lender portfolios (Mills and Lubuele, 1994). Others suggest that the profitability of CRA lending, like any line of business, depends upon particularized techniques; and that the banking industry and the financial marketplace have been developing the expertise to make CRA lending a profitable part of the banking business (Board of Governors, 1997).[46]

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[46] The Gramm-Leach-Bliley Act requires the Federal Reserve to submit to Congress by March 15, 2000, a report on the performance and profitability of CRA lending, which will be based on a survey of depository institutions. Pub. L. No. 106-102, § 713, Nov. 12, 1999, 113 Stat. 1469-70.